



## WAGE DYNAMICS IN EUROPE: IN DANGER OF COLLAPSING?

### **ETUC COLLECTIVE BARGAINING INFORMATION BULLETIN 2009/1**

Economic prospects are grim. The Commission in its interim forecast of January is now expecting economic activity to shrink by almost 2% in 2009.

In the Commission's scenario, the EU economy would gradually recover over the course of next year. However, there's also a possibility of the crisis becoming self sustaining if negative spillovers between product, labour and credit markets are left unchecked.

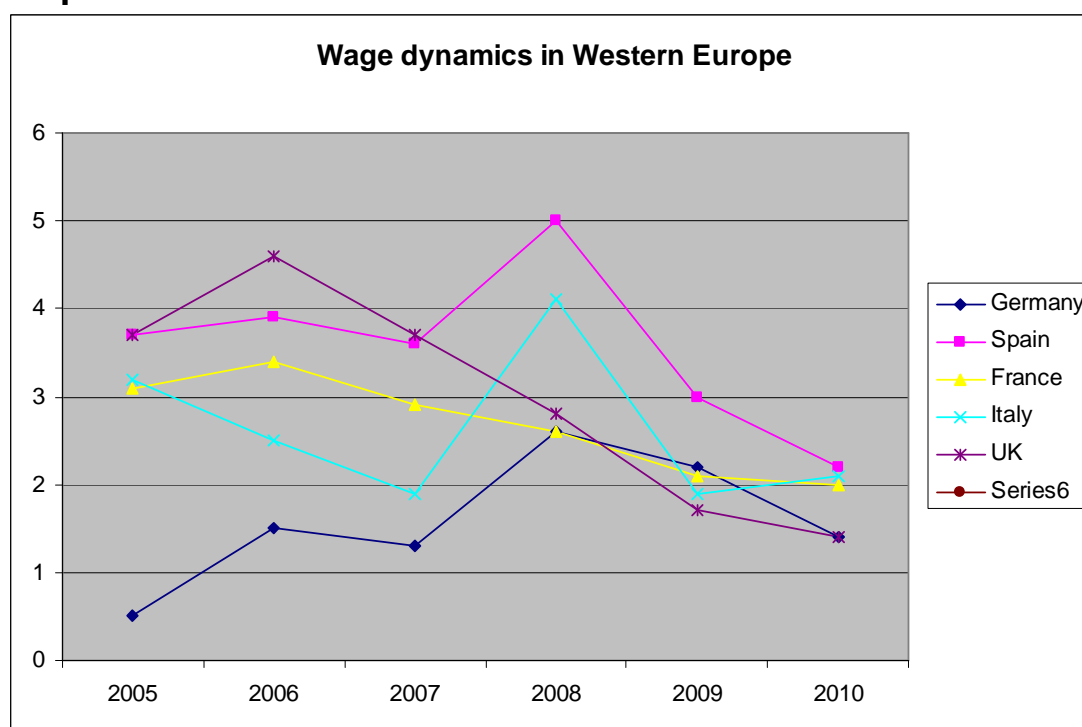
Wages is one of the key dominos that could fall. If too much downwards pressure is put on

wages, demand will weaken instead of recovering, deflation may appear and the 2009 recession will turn into a persistent slump. How much danger is there of excessive wage moderation undermining the recovery scenario?

The dynamics of nominal wages according to the Commission

The Commission's interim forecasts released in January show that wage dynamics are weakening everywhere, both in Western Europe as well as in Central and Eastern Europe (see graphs I and II)..

**Graph I**



Source: Commission

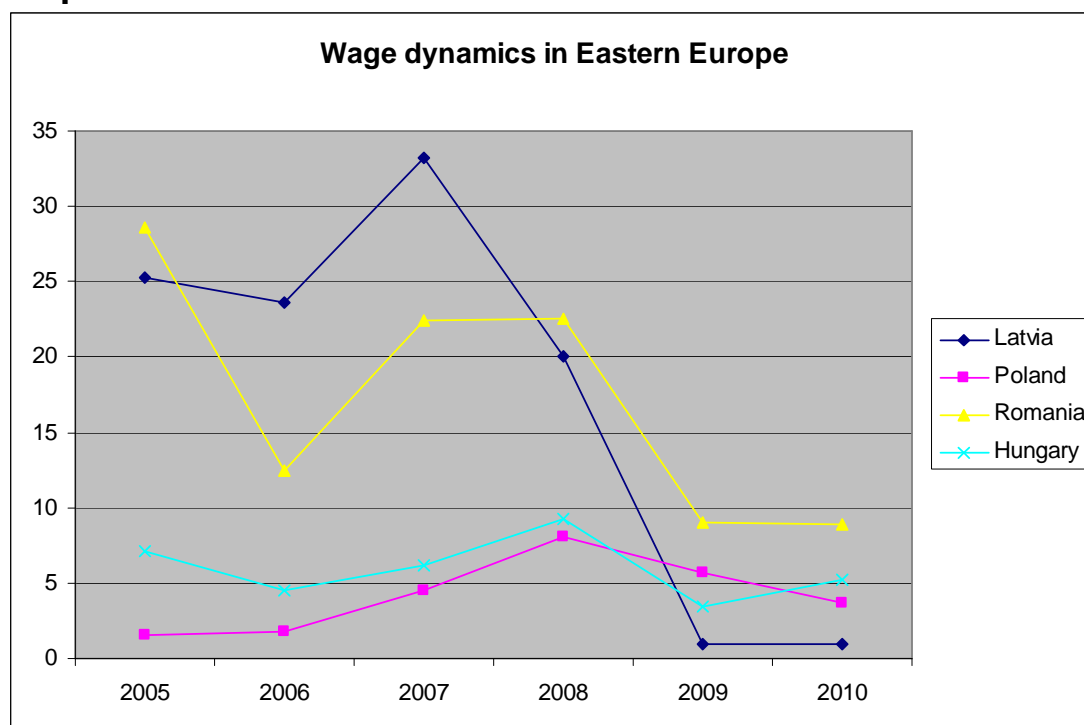
In Germany, the UK, Spain, Bulgaria, Romania and the Baltic countries, the weakening of wage dynamics is very marked. In Latvia and Lithuania for example, wage growth crashes down from 20% in 2008 to merely 1% in 2010. In Spain, with unemployment rates literally exploding from 11 to 18.7%, wage dynamics would be cut in half, from 5% in 2008 to 2.2% in 2010. Meanwhile, nominal wage growth in Germany is falling back from 2.6% to 1.4%, actually implying that Spanish (and others countries') cost competitiveness vis-à-vis Germany keeps on shrinking: Spanish wage dynamics collapse but so do

German wage dynamics...Very low (nominal) wage growth in Germany and Latvia is accompanied by similarly low growth in the UK where wages also decelerate sharply from 3.7 to 1.4%.

Wage growth in France and Italy, Netherlands, Austria, Belgium softens but still amounts to 2% in 2010.

In Greece, Finland, Denmark, Poland, Hungary, the Czech Republic, Slovakia and Slovenia wages rise between 4 and 6% and in Bulgaria and Romania even by around 10%.

**Graph II**



Source: Commission

Commission still counting on real wage growth

Nominal wage growth weakens substantially but with collapsing oil prices inflation is falling as well. This limits the incidence of real wage cuts and, in some cases, there's even the possibility of real wage increases. In fact, according to the Commission forecasts, the latter would be the case in many countries (Bulgaria, the Czech Republic, Denmark, France, Sweden, Finland, Poland, to some extent even the UK ...).

On the other hand, the purchasing power of wages would stagnate in Spain and Germany.

It is in Latvia, Lithuania and Ireland that real wage cuts would actually be made. Reports on real world developments confirm this. In Lithuania and Latvia, public sector wages are under strong pressure. In the absence of rules and processes to enforce collective bargaining agreements or in the simply absence of such agreements, private sector companies cut wages. In Ireland, the government is trying to contain the rising public deficit by targeting public sector wages.

### **The Euro Area: Moving from very low inflation....**

Although several euro area countries would still see some real wage growth by 2010, unit wage costs are nevertheless falling to levels that are not compatible with price stability as

defined by the ECB. Take the example of France, which would see in 2010 2% nominal wage growth, 1.5% inflation and 1.1% productivity growth. This translates into 0.5% real wage growth with a growth in unit wage costs limited to 0,9% and thus below the 2% price stability threshold.

In Germany and Spain, real wages stagnation implies zero growth in unit wage costs. This, by the way, begs the question whether the Commission's inflation forecasts are always that reliable. For Spain for example, it is hard to believe that inflation could be still as high as 2, 4% by 2010 while unit wage costs are stagnating.

Estonia and Latvia would be in a similar position of unit wage costs in 2010 almost stagnating (rising by only 0.5%).

Surprisingly, low unit wage costs are not noticeable in the UK. This is not because wage dynamics are so resilient but because productivity developments would be very dismal in 2010: The Commission forecasts 0.2% growth of GDP with a 0.6% increase in employment and this implies negative productivity growth of minus 0.4.

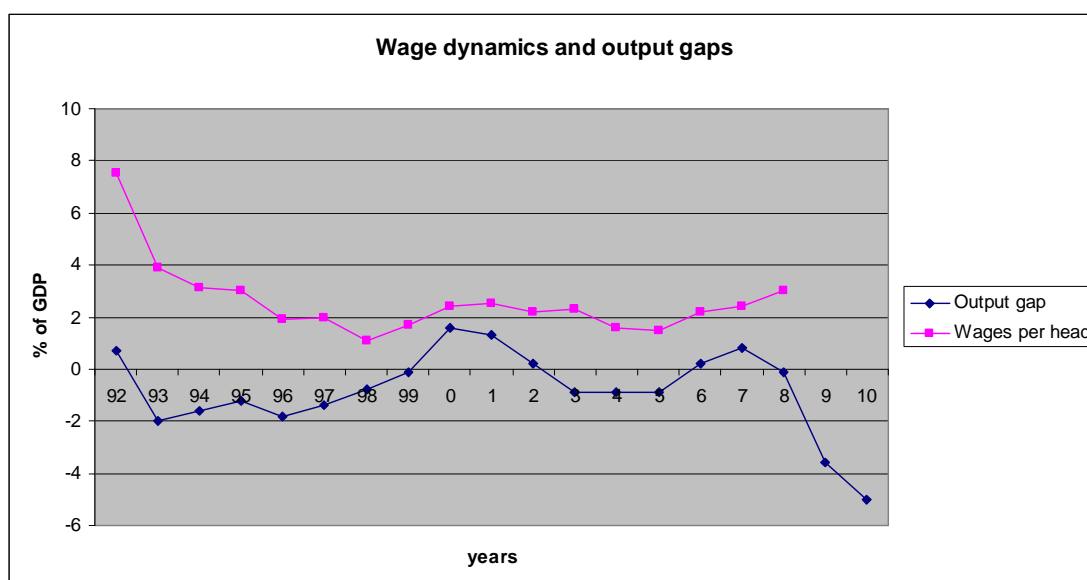
### **....into uncharted territory.**

So far we have based our analysis on the Commission's estimates of wages. However, can we take these figures for granted?

From past downturns, we know that workers' wages suffer when unemployment rises and idle economic capacity builds up (see graph III). At the beginning of the nineties for example, economic activity in the euro area went 2% under its potential level and wage growth weakened from 5 to 3%. The scenario was repeated at the beginning of this century: Output dived 1% under

potential output in 2003 and wage dynamics followed, coming down from 3% in 2001 to 2% growth in 2004 and afterwards. The rule of thumb appears to be that an output gap of minus 1% causes an almost parallel weakening of wage dynamics by 1%.

**Graph III**



**Source: OECD, December 2008 outlook, own calculations based on Commission Interim forecast January 2009**

This should raise an alarm bell. The economy is now facing a possible output gap of minus 5% of GDP by 2010. Idle capacity is spectacularly high and many companies all over the economy are or will be in serious trouble. Downwards pressure from business and public authorities on wages will therefore be enormous. Observe how the line tracking the output gap in graph III dives down.

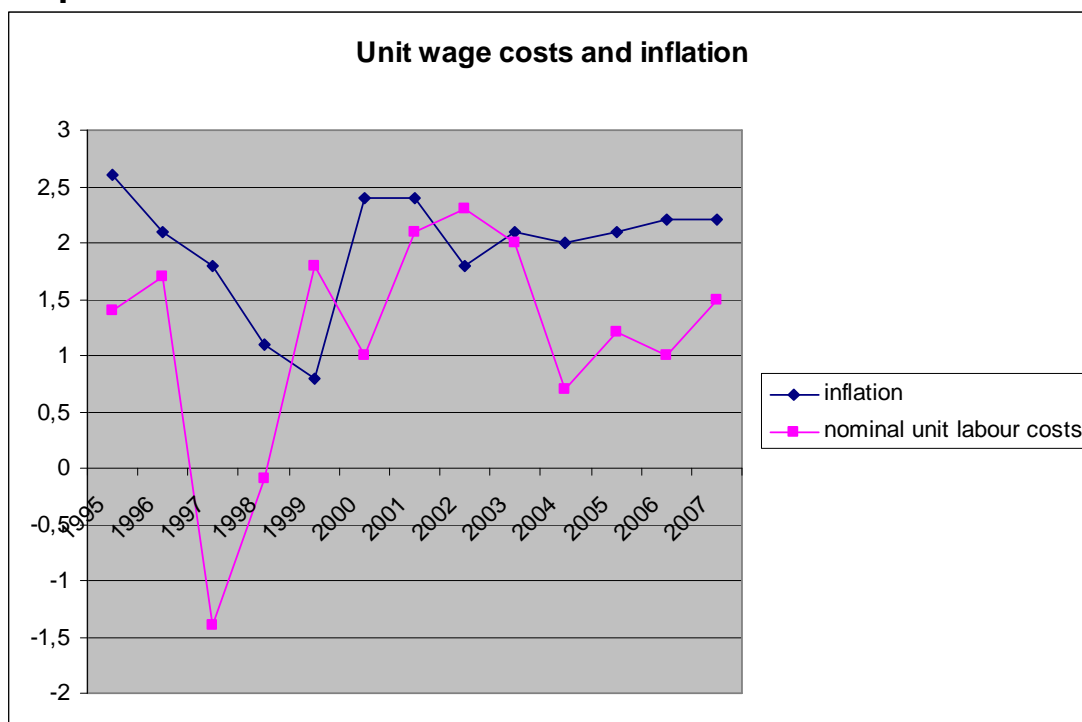
Moreover, this downwards pressure comes at a moment when wage bargaining institutions, after decades of structural reforms, have seriously been weakened. Institutional settings such as coverage of collective agreements, multi-level bargaining, solidarity strikes, unemployment benefits functioning as a reservation wage have been hollowed out by decentralisation of collective bargaining, 'make work pay' policies and by rulings of the

European Court of Justice allowing workers' mobility to undercut 'going wage rates'.

If the relationship of the recent past continues to hold (1% negative output gap causes wage dynamics to loose 1% of traction) and, starting from a rate of wage increases of 3% over 2008, a minus 5% output gap mechanically delivers average cuts in nominal wages of minus 2% for the euro area as a whole. Combining this with a trend productivity increase of, say, 1.5 %, results in unit wage costs falling by 3.5%.

This makes for a frightening picture. Graph IV shows what happened in the second half of the nineties when unit wage costs fell by 1,5% : They dragged inflation down from over 3% to below 1%. If, in the present crisis, unit wage costs now fall by double this amount, inflation will be pulled further downwards. Strong disinflation starting from an inflation rate which is already too low is threatening price stability from the downwards side. Deflation, for the euro area as a whole, is just around the corner.

**Graph IV**



Source: OECD, statistical database

## **Conclusion: Eyes wide shut for one of the worst forms of protectionism**

These days, the spectre of trade protectionism is haunting the European policy debate. The big fear is that protectionism would duplicate the experience of the Great Depression of the thirties.

However, it is surprising that little or no attention is given to one of the most perverse forms of protectionism: individual member states, even individual regions

and individual companies, trying to escape from the collapse of aggregate demand in the internal market by cutting their workers' wages. This should remind us of the Great Depression as well: At that time, a generalised policy of wage cuts caused the crisis to jump over into the goods and services market, thereby triggering prolonged depression and deflation.

Ronald Janssen  
ETUC  
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