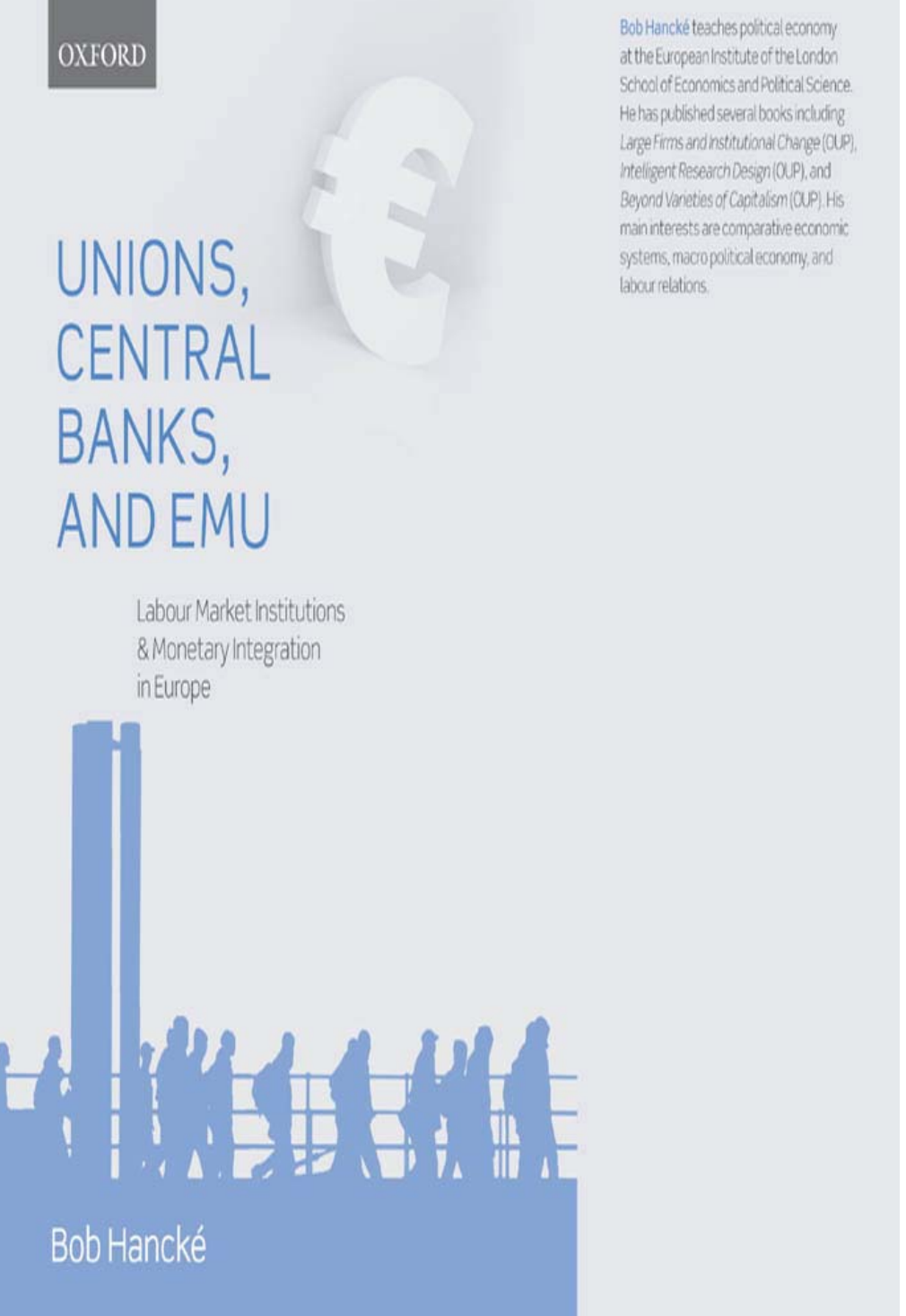

Unions, Central Banks, and EMU

Labour Market Institutions and Monetary Integration In Europe

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Preface

'There's something odd', a friend of mine said in the early summer of 2012, 'about seeing a crisis unfold, being an expert in that area, and still not knowing how it will end.' By that time, a few weeks before I finished this manuscript, the crisis of Economic and Monetary Union in Europe (EMU) was entering its third year, Greece had been bailed out twice, and a growing queue of others were standing at the Brussels gates, cap in hand, while Brussels itself had, along with a handful of other European capitals, been the scene of several summits to end all summits. And still we did not know in the summer of 2012 how this was all going to play out. Were we witnessing the scene in the movie where, at the very last moment, the unwilling hero is rescued and pulled up from the cliff where he was hanging after the villain pushed him there? Or was it more like Wiley Coyote in the Roadrunner comics having run off the cliff, not quite aware that the ground had disappeared under his feet, and hanging in mid-air before the inevitable fall?

I started thinking about the subject of this book in the late 1990s, when EMU was both a certainty and a complete stranger. There were many hypotheses about what the single currency would do to national economies, but not many data to go on. As a political–economic constellation, EMU was unique, and the few useful models that we had to understand what might happen, especially in the area of wage bargaining, were rooted in dynamics within countries, not between them. Moreover, wages were hardly the stuff that kept people awake at night: the cool debates in political economy (yes, these things exist) in the first half of the 2000s were about the Stability and Growth Pact in its first and second incarnations, and—sometimes—about the conservatism of the European Central Bank. With the exception of a few friends, possibly some who pitied me for being slightly delusional in my attention to wages, no one really considered the nature of labour relations, with their embeddedness in different varieties of capitalism, worthy of study, let alone important enough for a book that analysed EMU.

No one, that is, until the crisis arrived and the attention turned to differences between countries, and the readjustment problems that those differences produced. The project of this book took shape when it became clear that the slow-moving processes in labour markets and wage-setting systems

that I had been studying for over a decade turned out to be very good candidates for producing the EMU crisis that erupted in the late 2000s. The financial crisis may have precipitated things, and Greece and a few other countries may have had fiscal problems regardless, but the current account surpluses that had been building up in the north, and their mirror deficits in the south, which slowly led to the balance of payments problems at the heart of EMU's crisis in 2012, were the result of differences in the domestic organization of the economy, particularly of the differences in wage-setting systems.

The relevance of this book's topic therefore invited it to be written for an audience that is larger than just the standard fellow political economists: the text offers data and analysis, but the reader is referred to the literature that I draw on (including my own previous publications in this area) for more, and especially more technical, details of the analyisis. I have also tried to keep the text as much as possible free of jargon—although the subject of the book itself imposes a minimum of that, unfortunately.

My thanks go to many people who, in different roles, have helped me with this project. First and foremost, there is what I think of as the quality control team—the colleagues and friends who stop you from saying stupid things before you actually do so in public: Richard Bronk, Michel Goyer, Henrike Granzow, Dermot Hodson, Richard Jackman, Alison Johnston, Vassilis Monastiriotis, Waltraud Schelkle, Marco Simoni, and, perhaps most of all, David Soskice. But their role extended well beyond watching over me. Most of them have been forced to listen to my musings about the role of wage bargaining since (almost) the day we met. They probably know more about that now than they ever wanted to—but, that being said, if wage-setting and labour market institutions are as important as some of us now think, I hope that was not entirely useless. Then there are all the others with whom I discussed parts of this book in some form or other, and who helped me make my ideas clearer: Christopher Allsopp, David Andrews, Michael Artis, Nick Barr, Iain Begg, Giacomo Bei, David Brown, Willem Buiter, Wendy Carlin, Richard Carney, Damian Chalmers, Joseph Chwieroth, Stefan Collignon, Scott Cooper, Steven Coulter, Clara Crespo, Tom Cusack, Sebastian Dullien, Anil Duman, Max Freier, Donatella Gatti, Bela Greskovits, Peter Hall, Anke Hassel, Andrea Herrmann, Simon Hix, Joseph Jupille, Philippe Pochet, Martin Rhodes, Costanza Rodriguez-d'Acri, Oscar Molina Romero, Wolfgang Scheremet, Alessio Terzi, Sotiria Theodoropoulou, Christa Van Wijnbergen, Tim Vlandas, Andrew Watt, and Marco Zappalorto. I would also like to thank my students at the LSE over the last decade for the interesting discussions we had when these ideas began to take shape in the form they are in now, and which helped me clarify my thinking. Despite all this help, there will be faults with this book. Don't blame them.

A special word of thanks goes to all the people I interviewed for this project: they gave me insights into the mechanics of wage determination that were impossible to read off the statistics. Finally, the staff at the London School of Economics and Political Science, the European University Institute in Florence, and the Wissenschaftszentrum Berlin deserve a special mention. Without their help, and in the initial stages of this project especially Ilona Köhler's and Hannelore Minzlaff's, I would have been lost more than once. For financial, logistical, and intellectual support, I am grateful to (in chronological order) the Wissenschaftszentrum Berlin, the Hans-Böckler Foundation in Düsseldorf, the EUI, the LSE, and the Anglo-German Foundation. Adam Swallow and the production team at OUP deserve a special mention for their belief in this project and for the flexibility that they have shown.

Most of all, though, I thank my partner, Henni, who more or less lived with this book project since our first encounter, and meandered with me through its conception and execution. Now that this book is written, I can move on to my next project, on a comparative political economy of happiness—secure in the knowledge that I have found mine. And for those who wonder: yes, Bruce and Miles are still there to keep me company while I'm working.

London, July 2012

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1

Understanding EMU

The Role of Labour Market Institutions

On 1 January 1999, eleven member states of the European Union (EU) abandoned their domestic currencies to adopt a single currency, the euro. All these economies had gone through a sometimes dramatic economic adjustment programme to make them fit for Economic and Monetary Union (EMU) in Europe. A little over a decade later, EMU as it was conceived in the 1990s and born in the early hours of 1999 was facing a protracted existential crisis. It is unclear if EMU will survive this hurricane: there are at least as many plausible reasons for why it might as for why it might not. Yet one thing is certain: the EMU that we know today has little in common with the one that started life in 1999. The European Central Bank (ECB) has found a way to finance governments by stealth, member states have pooled funds to bail each other out, and both international organizations and other member states (primarily in the north, led by Germany)[1] are actively interfering in the domestic policy-making of the countries in debt.

Much of our understanding of EMU and of other experiments in deep economic and monetary integration, is informed by both high politics (the virtuous search for the common good) and high-level politics (politics by elites). In the case of EMU, the first has found its expression in the ideas that one market needs one currency, that a joint European currency would become one of the crucial building blocks for a single European polity and identity (Collignon 2003), and that exchange rate stability would become the basis for more prosperity, now that peace had followed the collapse of communism. High-level politics turned the attention to the Kohl-Mitterrand tandem, the precursors Helmut Schmidt and Valéry Giscard-d'Estaing, the Commission

[1] 'Germany' is used throughout this book for West Germany prior to 1991, and unified Germany after that.

president Jacques Delors, and the presidents of central banks (Dyson and Featherstone 1999; McNamara 1998; Marsh 2009).

While these accounts teach us a lot, they leave a slightly unsatisfactory feeling, because they blend out an important part of the EMU story that has resurfaced during the crisis of 2010–12 (and beyond, no doubt). The politics in these narratives has often been reduced to national interests, expressed through political elites (Moravscik 1998), and even more structural analyses (De Grauwe 2009; Carlin and Soskice 2006) are mostly of a functionalist bend, seeing EMU primarily as a solution to a set of problems that Europe faced. While some attention has gone to the domestic politics preceding and following EMU, very little has been said about the impact of EMU on different capitalist economies and vice versa, how the different varieties of capitalist economies influenced the emergence and evolution of EMU.

This book is, in that vein, an essay on those forgotten aspects of EMU, crucial in its formative past and likely to be at least as important in the problematic future. It asks the question how the variation in the organization of the labour market in different member states, and the institutions that govern the labour market, mattered for the trajectory of EMU, especially the role that variation in the organization of labour markets has played in the run-up to the crisis. Labour markets are important arenas in democratic capitalism, for economic and political reasons. Even in a world in which capital reigns—and there is little doubt that the period between the early 1980s and today has been a period in which (finance) capital and employers enjoyed structural advantages over labour—some form of accommodation with labour is necessary because of its control over two strategic assets: one, the functional requirement for skills in an advanced capitalist economy, and, two, labour's potential political power through labour unions and centre-left parties. Sophisticated goods and services require a skilled labour force that can produce them. That implies that some form of skills–wage nexus, with training as a preamble, needs to be organized if businesses are moving up-market. While this does not necessarily require labour unions to play a role, since they are there, and since the political economy of many countries in EMU is such that workers are organized in relatively strong labour unions, they are, especially in the north-west of EMU, crucial parties in economic decision-making, often from the company to the economy-wide level. Centre-left parties are also, almost everywhere, serious contenders for power, while conservative parties are reluctant to attack organized labour aggressively. Business thus has to find some settlement with organized labour, even when business holds the reins of the economy. The 'labour problem' in a democratic capitalist economy, thus the key assumption on which this book is built, never entirely disappears, even if labour is, as it has been since the late 1970s, a relatively weaker actor.

This has been just as true in EMU and in the monetary arrangements that preceded it. As we will see in the next chapters, the Deutschmark-bloc would be impossible to understand without a sense of how labour market institutions in the participating member states were reorganized in response. The Maastricht process in the 1990s initiated a continent-wide search for social pacts and income policies, and the post-2010 austerity regimes on the continent seem to herald a sharper, more militant labour movement in at least some of the EMU member states.

This book will reinterpret much of Europe's long history of monetary integration through this angle of the political economy of labour markets. In this first chapter I will set the stage for the rest of the book by offering a stylized approach to the key question that drives this analysis—why did things start to go wrong for EMU so dramatically in the late 2000s? It then lays out rapidly the limits of most of the existing explanations, before sketching the key argument. The final section offers a roadmap for the rest of the book.

1.1 The Puzzle of EMU

Economic and Monetary Union in Europe (EMU) has not been kind to its analysts. In 2008, champagne corks popped in Brussels and Frankfurt in self-congratulatory 'ten-year' parties. In 2009 a major anniversary publication (Buti 2010) was prepared which, remarkably—at least with hindsight—did not contain a single chapter on the possibility of the existential crisis that the currency union has faced since early 2010. While the country lambasted as late as 2007 for having excessively rigid labour markets and low economic growth, Germany, had become the poster child of adjustment to practically all eurozone observers by 2011, the previously fast-growing Spanish and Irish economies faced, each in its own way, a massive crisis of confidence in international markets and political self-confidence at home. Political attempts to resolve the economic and governance crises seemed likely to run into the same obstacles as the Constitutional and Lisbon Treaties in the previous decade: electorates showed a deep reticence toward transferring more sovereignty to Brussels, especially, it seemed, when the last few attempts, with EMU as the icing on the proverbial cake, were less than a complete success. This sudden crisis in EMU, has, rather unsurprisingly, led to major political tensions within the single currency bloc, perhaps best illustrated by the response to the fiscal crises of 2010 and 2011. While several of the EMU member states were, or at the very least appeared to be, unable to refinance their sovereign debt (Greece, Portugal, and Ireland), others (Germany, the Netherlands, and Austria) were pushing for stricter sanctions for what they regarded as fiscal profligacy, thus potentially making a bad situation worse in the short run.

On the principle that you look for a leak at the place where the tyre is flat, most attention initially went to fiscal policy, positing profligate southern Europeans versus prudent northerners, with most politicians, economists, and other commentators wading into the debate arguing for a stricter fiscal straightjacket. Very gradually, part of the debate shifted to a more sophisticated terrain, in which the key problem was that current accounts within an almost closed trading area such as EMU (and, a fortiori, the EU) had to mirror each other. If Germany had a current account surplus—technically a trade surplus and a bit more such as capital inflows and outflows—then someone, somewhere else, had to face a current account deficit. And if Germany managed to improve its current account by becoming more competitive, then someone else had to become less competitive in response. EMU, trapped in its low-growth regime, in effect turned increased trade into something close to a zero-sum game, revolving around relative competitiveness.

The literature on how to improve national competitiveness is vast and encompasses almost anything from infrastructure and education as public goods to organizational models and sectoral specialization. Yet whichever way one approaches this issue, it always entails increasing value-added per hour worked—because skills and investment in R&D increase the quality of human capital inputs, or better roads and organizational innovations lower the costs of transporting and producing goods or services, or simply because wages grow at a lower rate than labour productivity. Everything else equal, being able to control the growth of unit labour costs—the costs, expressed in wages, of producing a single unit of a good or service—faster than your trading partners in EMU implies an improvement in competitiveness.

Not every country has the domestic institutional set-up to contain the growth of unit labour costs (ULC) more than their neighbours, and thus engineer a depreciation of their real exchange rate (RER), which would make domestically produced goods less expensive.[2] Economies where wages are set in highly coordinated wage-bargaining systems perform considerably better in this regard than countries that lack such an orderly wage-setting arrangement (Calmfors and Driffill 1988; Soskice 1990). In effect, the crisis of EMU in 2010, therefore had its roots not in a lack of fiscal discipline—both Spain and Ireland had been running fiscal surpluses for several years before their crises—but in the way that political-economic actors within countries have been able to shift their real exchange rate downward through wage moderation.

[2] The RER is a crucial inter-country adjustment mechanism in EMU, in large measure as a result of the fixed nominal exchange rates. Think of it as a measure of relative country-level competitiveness. It expresses the price of foreign goods in the home currency, divided by the price of the same goods and services, produced at home and traded (see Carlin and Soskice 2006: 296 ff. for more details).

The big divide here, painted with broad brush strokes, is between two blocks of countries. The first consists of a group of countries organized around Germany since the early 1980s, and which reorganized their domestic macro-economic institutions to allow their currencies into a stable fixed exchange rate regime with the German Mark (DM) at its core (Germany, the Netherlands, Austria, Belgium enthusiastically, and France, but the latter more reluctantly), and for whom ULC have been falling consistently since the mid-1980s. The second consists of those countries that joined the Exchange Rate Mechanism (ERM) at the heart of the European Monetary System (EMS) later, and by and large were only propelled by the Maastricht Treaty to sort out their macro-economic policy frameworks (Portugal, Italy, Greece, and, to a lesser extent, Ireland and Spain). In these countries, the evolution of domestic ULC went through three stages: rising in the 1980s, a dramatic drop against the background of the Maastricht regime in the 1990s, and a slow rise in the 2000s after the adoption of the euro, culminating in the current account and fiscal crisis of 2009–10.

How did we get there? How was it possible that EMU, which was built on convergence among the economic fundamentals of its member states, the ultimate goal of the Maastricht criteria, led to such sharp divergences a decade after its launch? Why was everyone in the eurozone taken by surprise when the crisis erupted in 2009? None of the 'Euro at 10' chapters (Buti 2010) raised the possibility of current account and sovereign debt crises that would endanger the existence of the single currency. Nobody appeared to have anticipated that within a decade the Stability and Growth Pact (SGP), the rulebook of EMU, would have been thrown overboard, with several member states receiving financial support that scuppered both letter and spirit of the no bail-out clause, while the ECB was eager to find creative ways to monetize government deficits. And very few observers would have thought that the euro crisis was to drag on for several years: by the publication date of this book, the crisis has lasted well over three years, has seen the majority of member-states' governments collapse over its consequences (and, somewhat ironically, forced Belgian politicians to form a government after a year and a half without one), and has witnessed a dozen 'final' European summits. Before 2009, finally, you simply did not mention the possibility of a dramatic restructuring or even a break-up of EMU in polite company.

1.2 Understanding the Crisis of EMU

Key to the analyses of what caused the euro crisis is a set of debates about optimal currency areas (OCA—see Mundell 1961 and 1973; Kenen 1969, and De Grauwe 2009). This body of theory discusses the conditions under which it

makes sense for a group of sovereign countries (or regions) to share a currency and monetary policy. Its key insight, distilled for the purposes of the discussion here, is that differences in the broad economic performance and organization of member states of a currency union have to be compensated through flexibility in one of the two remaining macro-economic instruments—fiscal policy or wages.

Most explanations for the sudden divergence in the economic fate of the EMU member states concentrate on fiscal policies; the curtailment of the freedom that governments have in the area of exchange rate and monetary policies as a result of the establishment of EMU, thus the argument was compensated by activist and often irresponsible fiscal policy. The almost inevitable conclusion of these approaches is the claim that the SGP is too weak, both in terms of its rules and in terms of enforcement, and that the financial crisis that preceded the economic crisis has demonstrated the need for the ECB to play a more important role in financial supervision.

The main orthodox interpretations of the crisis—and the purveyor of many unpleasant newspaper headlines, especially in tabloids across the northern part of the continent during the crisis years—built on this. Fiscal mismanagement, possibly supported by aloof capital markets, was at the basis of the divergences. During most of the euro's first decade, interest rate differentials between Germany's baseline and Greek and Italian debt were negligible—at least as much a reflection of the lack of credibility of the no bail-out clause in the Maastricht Treaty as of the massive incompetence of rating agencies who were supposed to report on the relative risk in government debt. Governments in the south thus were able to run up a large public debt without paying a penalty in higher interest rates, which created the fiscal imbalances at the heart of the euro-crisis in 2010 and after. While this explanation may help understand the Greek situation, it meets its limits when used to understand the problems of Ireland and especially Spain, two countries that, in fact, ran budget surpluses until the financial crisis of 2008. In addition, as Martin Wolf of the *Financial Times* has pointed out (on 6 December 2011), during the period between the start of EMU in 1999 and the start of the financial crisis in late 2007, only Greece ran, averaged over that period, a public deficit considerably beyond the 3 per cent limit imposed by both Maastricht and the SGP—hardly a persuasive indication of widespread fiscal irresponsibility. Table 1.1 recapitulates the deficits of Germany and the GIIPS before the crisis, and leaves little doubt that fiscal positions were hardly the problem that they have been turned into since.

The second explanation is an old stalwart of orthodox economics: labour market regulation. The basic idea also harks back to theories of optimal currency areas. If all other macro-economic adjustment mechanisms—monetary and fiscal policies as well as exchange rates—are more or less fixed, as they are

in EMU, labour markets, and therefore wages, have to become more flexible. The lack of labour market flexibility in the south thus exacerbated the pre-existing problems in that region. This perspective certainly helps us understand part of the problem—although with an ironic twist, as I will argue later on. One observation, however, should give pause for thought: the at least equally inflexible labour markets in countries such as Germany and Austria have not produced the same adjustment problems. The highly organized ('rigid') wage-setting systems in the north have, in fact, been at the basis of their strong economic performance in the shape of low inflation (and relatively low unemployment) and of their micro-level counterpart, international competitiveness.

Table 1.2 demonstrates that the growth of ULC in the manufacturing sector (a rough proxy for the export sector) in Germany and Austria, two of the key economies with so-called 'rigid' labour markets, was not only lower than the EU average, but also negative, in fact, throughout almost the entire EMU period. Remember that these are countries with strong labour unions and, for most of the period, both also had a high level of wage coordination.

Table 1.1. Average budget deficit in selected eurozone countries 1999–2007

	Average
Euro area	**–1.9**
Germany	**–2.2**
Greece	**–5.3**
Ireland	**1.5**
Italy	**–2.8**
Portugal	**–3.6**
Spain	**0.1**

Source: IMF World Economic Outlook

Table 1.2. Economic performance in Germany and Austria

Annual change in ULC, manufacturing	1999	2000	2001	2002	2003	2004	2005	2006	2007
Germany	–0.4	–1.4	0.9	0.6	–0.9	–4	–2.3	–2.8	–2.7
Austria	–2.1	–2.9	–0.9	0.9	0.8	–2.5	0.4	–2.2	0.8
EU average	6	1.9	4.3	3.2	1.2	1	0.5	0.6	1
Other indicators: Unemployment level									
Germany	8.6	8	7.8	8.7	9.7	10.5	11.2	10.2	8.7
Austria	3.4	3.6	3.6	4.2	4.3	4.9	5.2	4.8	4.4
Annual inflation rates									
Germany	0.6	1.4	1.9	1.3	1	1.79	1.9	1.8	2.2
Austria	0.5	1.9	2.3	1.7	1.3	1.2	2.1	1.7	2.2

Source: IMF World Economic Outlook

Unemployment rose in Germany—undoubtedly an effect of the low economic growth in the country, but fell sharply in the last boom year before the crisis and has stayed at a low level since. Inflation rates have simply never been a problem in either of the countries. Labour markets may have been inflexible in EMU, but it is difficult to see that as the key to the problem that the currency area as a whole faces today.

Spain and Ireland are, not surprisingly, at the basis of a third explanation, which revolves around asset price inflation and bursting bubbles. While headline consumer price inflation has hardly been problematic on the continent, both in the aggregate and in most individual member states, the ultra-low, mostly negative, real interest rates in some of the member states stoked an asset boom: low interest rates begot cheap mortgages, which begot massively rising housing prices and, on the back of that, a construction boom. This dynamic gets us closer to the problem, but it fails to understand outcomes in countries like Greece, Italy, and Portugal, whose sovereign debt problems could hardly have been fuelled by asset price inflation, since that was more or less absent in those countries.

The final possible explanation was poor financial regulation and a host of dangerous mistakes on the back of that. Ireland is the case in point here: lax regulation attracted risky capital, which maximized profits in the implicit knowledge of a government bail-out if and when things were to go wrong. Financial developments in Ireland without doubt were not as well regulated as they could have been, and the decision in 2008 by then Prime Minister Brian Cowan to guarantee all bank debt will certainly go down as one of history's largest self-inflicted policy mistakes. But the lack of financial acumen in Irish government circles hardly explains most of the other problematic cases. Regulation in Spain, for example, one of the only other countries with a sizeable, active, and open banking sector, was never considered a problematic aspect of the new Spanish model. And most other countries facing fiscal problems in 2010 and 2011 had, in fact, relatively strict regulation or, as in Italy, a relatively closed banking sector.

All four of these explanations help us understand pieces of the puzzle—but only pieces, unfortunately. Not only do all of them come up against at least one important, incontrovertible piece of empirical evidence, they have other shortcomings as well. On the whole, they consider the issues to be very similar everywhere, thus implicitly also suggesting that the problems (and the solutions) are primarily or even solely found at the national level. Labour market flexibility, fiscal rules, and better regulation remain subject to national policy-making, influenced but not steered by European institutions. This assumption is probably incorrect: even granting the arguable point that the problems were the same everywhere, the different organization of domestic economies in Europe means that they probably did not have the same

effects in every country. More importantly, there are reasons to believe that the new international political economy associated with EMU is itself part of the problem: some of the dynamics underlying the euro crisis, such as the massive current account divergences, almost perfectly coincide with the 1999 start of EMU. Combining these two insights—one loosely emanating from a 'Varieties of Capitalism' approach to comparative political economy, and the other inspired by New Keynesian macro-economics (Carlin and Soskice 2006)—suggests a more systemic explanation of the crisis.

1.3 Bringing Labour Markets Back In

Fiscal and monetary policies *are* important in a monetary union—but they are also, somewhat ironically, the policy areas that are least well suited as adjustment mechanisms. The critical characteristic of EMU is, after all, that it de jure and de facto fixed exchange rates and monetary policy, and de jure (and only slightly more weakly de facto) did something similar for fiscal policy with the SGP—most estimates agree that fiscal positions have improved across the eurozone since the activation of the SGP, even though admittedly not all assign a central role to the SGP in this process. Put differently, if countries within EMU face asymmetric shocks, fiscal, monetary, and exchange rate policies are no longer among the weapons at their disposal—that was precisely what the OCA critiques of EU had pointed out all along. If degrees of freedom existed, they were to be found in the labour market: Otmar Issing (2002), the first Chief Economist of the ECB and one of the architects of the euro, stated quite bluntly that, while the ECB could be trusted to keep inflation low, growth and unemployment were the domain of the social partners, and many others have suggested (or lamented) that the introduction of the euro forced adjustment through labour market deregulation and liberalization. If change were to occur, in other words, it would be in the labour markets, not outside, and it was likely to entail less, not more coordination.

This, of course, poses a problem: if the organization of the labour market is a cause of rigidities, why then did countries like Austria, Belgium, and Germany, with highly organized labour markets, where skills are acquired in long apprenticeship systems, wages are collectively bargained between strong, industry-wide labour unions and employers, and where employment protection is both formally and informally well developed, adjust much better to the crisis than other countries with equally but differently rigid labour markets? By most standards, these countries have, at most, reformed insignificant parts of their labour markets. According to the OECD score card, which measures changes in rules such as employment protection legislation (OECD Employment Outlook 2011, OECD Statistics Portal), almost nothing changed

in Austria, Belgium, and Germany during the EMU years, and while very little moved in this area in the other EMU economies, their record on economic performance and unemployment in particular diverged rather significantly between 1998 and 2008. The often (mis-) cited reforms in Germany associated with the labour market reform packages Hartz IV and Agenda 2010 not only are too small to have had the wide-ranging effects on the German economy attributed to them, but almost certainly targeted a category of low-skilled workers that played no role in the strong export sectors at the heart of Germany's recent economic successes. It is, in short, hard to argue that the strong economic performance during and after the financial crisis is explained by the deregulation of labour markets in north-western Europe. If anything, relatively well-organized labour markets and coordinated wage bargaining seem to have supported rather than hindered adjustment during the crisis.

Hence the somewhat surprising twist to the puzzle: the crisis of the euro has shed a new light on two important sets of arguments. The first one is that the attention to fiscal and monetary policies in the past completely missed the point that these were only the tip of the macro-economic policy iceberg, hiding far more serious problems in differences in labour market institutions and especially wage-setting systems as inter-country adjustment mechanisms. Second, the conceptualization of the problem as one of rigid labour markets missed the point that the countries that fared relatively well in the crisis of 2010 were those with coordinated wage-setting systems and relatively well-organized labour markets, while the more decentralized labour markets in countries as diverse as Portugal and Spain, with significant insider-outsider problems, and Ireland and the UK, supposedly without such sharp labour market divides, have not offered the flexible panacea that these arguments attributed to them. Both these stylized facts suggest that a closer look at the organization of labour markets and especially of wage-setting systems might help our understanding of EMU considerably.

Within EMU, two very different wage-setting logics exist (and a minor third one, which includes the hybrid Ireland with a decentralized labour market organization and social pact-driven centralized wage setting): the coordinated wage-setting systems in the north-west of Europe, where relatively strong trade unions and employers negotiate moderate wage increases (and in France, with a large-firm and state-driven functional equivalent), and a collection of considerably more decentrally organized systems in the rest of Europe, primarily the south and the east, without the wage-moderation effects that the first produces.

The first of these two systems, organized around the German wage-setting system, has led to systematic disinflation. Nominally, EMU may have become a symmetric structure in which every member state's voice counts the same, but de facto remained an asymmetric system with German wage-setters at

its core. In that set-up, however, the position of Germany has changed, in effect, from a wage and price setter for the rest of Europe (first in the DM-bloc regime of the 1980s and afterwards in its expansion of that regime to the rest of the EU through the Maastricht process) to a wage and price taker, in which it responds to developments outside its own border and even outside the previous DM-bloc. Germany is, as a last mover, forced to disinflate when others inflate in that new regime, since the ECB's 2 per cent inflation ceiling has forced it to compensate for above-target inflation elsewhere (thus carrying the other coordinated wage-setting systems with it, since ULC developments in these countries have been tied to German wages as a result of imposed wage norms that mirror German wage rates). The result has been the consistent fall of ULC in that group of countries and an ever-depreciating RER in its wake.

The second system truly mirrors the first: against the background of the ECB's 2 per cent inflation rate, which consists of the weighted average of the national inflation rates in the eurozone, these countries are in effect forced to inflate their economy to mirror the disinflation in the first. For every percentage drop in inflation in the northern economies, inflation in the southern countries rose. That, however, led to the perverse effect, again because of the 2 per cent inflation target that the ECB has adopted, that wage inflation in the south had to rise to compensate for the fall in the north. The hard 2 per cent inflation target then forced German ULC, and therefore the ULC of the countries within its wage orbit, to fall even faster to accommodate the rising inflation outside this densely interlinked wage-shadowing arrangement in the north. In theory, this process of disinflation in one group of countries triggering inflation in the other and vice versa could go on for ever, with the long-term outcome of a growing divergence of ULC and wage inflation across the eurozone (obviously in practice it ought to lead to a dramatic reorganization of EMU, not unlike the one we have been witnessing since late 2011). The competitiveness gains of the first, and the competitiveness problems of the second, which ultimately were reflected in massive trade and current account imbalances across EMU after 2009, and in accumulating public and private debt in the deficit countries, thus had their origins in the different evolution of wage-setting systems prior to the introduction of the euro in 1999.

1.4 The Argument in Brief

In this book I will retrace these developments and their effects back to the emergence of the DM-bloc in the 1980s, which introduced the wage-setting divide; this was temporarily neutralized by the Maastricht convergence process in the 1990s, but resurfaced with a vengeance in the 2000s, when the institution of EMU and the ECB lifted the tight national convergence constraints

that the Maastricht Treaty imposed and which were policed by the national central banks in a pegged exchange rate regime.

The book is organized loosely chronologically and uses the different stages in monetary integration in Europe as a way of exploring different dimensions of the broader question of how different labour markets have operated in an integrating Europe. In essence, the process of adjustment had two phases. The first was the institutional disciplining of the unions. The establishment of the Deutschmark-bloc, the institution of inflation-averse central banks, the Maastricht process leading to EMU, and the integration of product and capital markets forced trade unions and labour market institutions more generally into a position in which they responded to, rather than directed, changes. But the political and institutional subservience that followed these steps in monetary and economic integration was far from a foregone conclusion. Adjustment to the new macro-economic parameters often involved large-scale social conflict, between unions and employers or government, as well as within the trade unions between the inflation-sensitive export sectors and the relatively insulated public sectors. Constructing the new macro-economic framework therefore relied on a careful mix of sticks and carrots to bring trade unions on board.

Once 'tamed', however, trade unions became a crucial ingredient of the policy mix aimed at macro-economic stability, both in the run-up to EMU and after the introduction of the euro. First of all, and somewhat surprisingly, given the conventional wisdom formulated in the Maastricht Assignment, labour market institutions turned out to be important bulwarks against excessive inflation. In the DM-bloc in the 1980s, under the Maastricht process of the 1990s, and after the introduction of the euro in 1999, wage moderation became one of the primary means to pursue low inflation policies. Central wage coordination leading to wage moderation, in tandem with decentralized productivity coalitions in firms, allowed unions to negotiate rising (or at least non-decreasing) nominal and real wages without exceeding productivity growth, thus keeping unit labour cost growth well within a target range commensurate with low inflation.

That is, as it were, the story in northern Europe since the mid-1980s. In the 'south' (shorthand for what has become known as the periphery, including Ireland), something else happened: to cope with inflationary pressures during the Maastricht period running up to EMU, many countries with high inflation rates initiated incomes policies that emulated the wage disinflation in the north through social pacts and similar coordinated arrangements (Pochet and Fajertag 2000). This got them safely into EMU, but it also meant that once in EMU, the pressure to control inflation was significantly reduced—since there are no arrangements to leave EMU, voluntarily or involuntarily (at least until the EMU crisis came to a head in 2012), the external anchor provided by the

Maastricht criteria disappeared. The effect was that the powerful and effective national arrangements that had come into being in the 1990s slowly disintegrated, and inflation resurfaced, in many cases driven by public-sector wage increases that outpaced private, and especially manufacturing-sector, wage increases. Two Europes thus emerged, one with orderly wage-determination systems, where low wage and price inflation targets were internalized by the trade unions by means of inter-sectoral wage coordination, and another, where wages rose faster relative to productivity, competitiveness collapsed, and trade balances deteriorated sharply.

These processes will be the subject of four substantive chapters, each of which will start with a statement of the key analytical point that the chapter engages. Chapter 2 will analyse the pre-Maastricht setting that offered the blueprint for EMU. It will concentrate on the construction of the DM-bloc in the 1980s, and especially the social conflicts in the countries that were forced, through the exchange rate peg, to subject their monetary policy to the Bundesbank. Chapter 3 will examine the Maastricht period against the background of models that predicted profound adjustment problems because of the inconsistent character of the link between labour relations systems and central banks—decentralized, yet under one monetary authority. In Chapter 4, I will examine the internal reorganization of labour unions since the introduction of the euro in 1999, with special attention to the new cleavages that are emerging under EMU between different national unions and between export and public sectors. Chapter 5 shifts focus slightly and will assess three economic performance indicators against the background of the discussions in the preceding chapters. The first is the link between different macro-economic regimes and different labour market institutions. The basic point is that CMEs are forced into disinflation because of a restrictive macro-economic regime; however, this produces both a dependence on exports and the institutional means to be successful in them. The second explores these export profiles through the effect of wage coordination on product market profiles (or 'comparative advantage'). And the third section returns to their effect on current accounts and the implications for an understanding of the crisis of EMU in 2010. The final Chapter, 6, will conclude by bringing out the broader implications of the analysis.

Throughout that analysis a new interpretation of the political economy of Maastricht and EMU will emerge, more attuned to developments on the ground instead of the high-level (though not necessarily always 'high') politics that has characterized the standard narratives. Alongside many other adjustments in banking and fiscal policy, building EMU required a deep reorganization of wage-setting systems (as Enderlein 2006 suggested, though wrongly also saw emerging), which target real exchange rates as the domestically controlled adjustment mechanism. However, precisely because not every country

has had the institutions to do so effectively, EMU found itself on a track of ever-increasing divergence. In some countries, unions were unable or unwilling to reorganize their structures and rethink strategies, while in others they were forced to—and could rely on the institutions for wage setting, supported by company-level arrangements that increased productivity. The effect was a slow but inexorable decline of competitiveness in the first, and a parallel rise of competitiveness in the north, which then translated into debt in the former to finance economic growth and the balance of payment problems that were at the basis of EMU's crisis. This story, told in detail, will, I hope, unpack the monolithic nature of the elite-centred interpretations, bring the domestic political economies back into focus, and offer a more nuanced view of how EMU was constructed. And by doing so, it will shed a new light on the structural dynamics underlying the crisis of EMU since the late 2000s.

2

The Other Road to Maastricht

Currency Blocs, Wage Moderation, and Social Conflict

When the euro was introduced in 1999, most commentators reflected on the uniqueness and boldness of the project, how politics had trumped economics, and how monetary integration would herald deeper political integration on the European continent. To a large extent this initial assessment of EMU was correct, of course. Economic and Monetary Union is unique in the world, and it is also easily the most ambitious of the projects that the EU has been engaged in. It is important to recognize, though, that EMU followed on the heels of two earlier, at least equally crucial episodes of increased monetary and economic integration: the Maastricht process in the 1990s, and before that, between the late 1970s and the mid-1980s, the currency snake, and—possibly most importantly—the creation of the Deutschmark (DM) bloc. These monetary arrangements followed on the heels of the collapse of Bretton Woods in the early 1970s, which inaugurated a period of extreme exchange rate volatility and was widely seen to be at the basis of the extremely poor economic performance on the continent.

The aim of this chapter is to examine the political economy of the construction of the precursor of EMU, the DM-bloc, and reinterpret that as the 'primordial' period for EMU: the implicit rules that governed the DM-bloc essentially became the explicit rules that applied to Maastricht and later to the eurozone. The particular political-economic constellation that drove the Maastricht process and which was at the heart of EMU, with its conservative, often independent, central banks and restrictive macro-economic policies, had its precursor in the reorganization of national and international economic arrangements when the DM-bloc was constructed in the 1980s. History is important, therefore: understanding what happened under the DM-bloc arrangements almost two decades before the introduction of the euro offers important insights into the emergence and operation of both the Maastricht convergence process in the 1990s, and EMU afterwards.

Through membership of the DM-bloc, countries with a less than stellar monetary and exchange rate history—such as France, which had devalued the franc four times by 10 per cent or more between the Second World War and the 1970s (Hall 1986: 245), and Belgium and the Netherlands, both with a mediocre inflation record since the early 1970s—could borrow German monetary credibility. But that came at a price: pegging the guilder and the Belgian franc to the DM also implied either a domestic inflation rate roughly at the level of Germany, or higher interest rates to stabilize the currency—thus wiping out the expected credibility gains. And moving from a high to a low-inflation regime implied, everywhere, a profound reorganization of the domestic economy to keep upward price pressures emanating from the wage-setting systems under control.

Before the construction of the DM-bloc, the typical situation in the high-inflation countries usually involved powerful (or, at the very least, highly militant) labour unions that managed to extract high wages from employers, both in the public and in the private sector (high wages are defined here as wages that grow faster than labour productivity). Since employers passed on these wage increases through rising prices (or rising budgets), higher wages fed into the next inflationary cycle, where they would be raised again to reflect higher inflation, and so on, ad infinitum. In a floating exchange rate regime, currencies would devalue to take the pressure off; in a fixed exchange rate arrangement, however, these inflationary pressures would endanger the exchange rate peg. Entering the DM-bloc therefore meant disciplining the labour unions at home, and this involved a two-pronged approach. The first required imposing a non-inflationary wage target on the economy as a whole—in essence the work of a conservative central bank. Unions were forced to adopt a wage target that reflected labour productivity (wage increases reflected increases in output growth, which rendered them non-inflationary). Second, the adoption of such a disinflationary wage target required a reorganization of key wage-setting institutions in economies where unions were reasonably strong (and where the ruling political parties were hesitant to engage in all-out class warfare), in which the export sectors became leaders in wage setting. Public-sector wages as well as wages in the non-exposed private sector then had to be subjected to wage targets set in the export-sector-based leadership group, to avoid inflationary pressures in the economy as a whole.

This chapter examines this early precursor of EMU and the heritage it bequeathed on the process of European monetary integration. It covers the period from the early DM-bloc in the 1980s and the adoption of the Maastricht Treaty in 1991–92 to the efforts by prospective EMU member states to meet the EMU accession criteria embodied in that treaty. I will start with an analytical section dissecting the big shift in macro-economic policy-making after the second oil shock from full employment to monetary stability as the

key target, and the implications of this shift for the patterns of interaction between labour unions and central banks. The chapter then analyses empirically the two main pre-EMU episodes (the DM-bloc in the 1980s and the Maastricht process in the following decade). The final section offers a picture of the constellation of central banks and labour unions at the start of EMU.

2.1 The Big Shift: Labour Unions and Central Banks

It may well feel like an eternity ago today, but there was a time that macro-economic policy revolved around full employment, that central banks explicitly underwrote that policy, and that trade unions were enlisted as allies to keep inflation under control in the tight labour markets that resulted from such expansive economic policies. No longer. By the mid-1980s, the new macro-economic policy mix entailed a fixed exchange rate, fiscal discipline, and deregulation and liberalization of labour, product, and capital markets.

This way of thinking about the economy had its roots in a fundamental revision of macro-economics and what macro-economic policy could accomplish. What became known as 'New Classical' macro-economics after the mid-1970s started from the idea that the real economy, in which goods and services are produced, followed its own secular business cycles. Attempts by governments to engineer full employment through expansive macro-economic policies were therefore bound to fail: any short-term increase in growth would ultimately only lead to inflation, since workers, households, and firms adjusted their expectations. The effect, thus the theory, was that in real terms, output was the same, but produced with higher wages and consumed at higher prices. Since inflation was the outcome of government policies, their target should be monetary stability, not full employment. If the government, in the guise of a conservative independent central bank, pursued the goal of price stability, and markets were allowed to work their magic under this policy umbrella, growth and full employment would follow. It matters very little if this conception of the economy is wrong, as I think (with many others), or right. By 1990 it had come to dominate standard economics and especially macro-economics and monetary policy-making, and informed central bankers the world over.

This policy orientation was very different from the post-war Bretton Woods system, in which the international monetary regime was designed to give governments policy autonomy (Rodrik 2011: 67–88). Under that regime, exchange rates and currencies were used as tools that could be mixed with fiscal and wage policies to produce high growth against a background of moderate inflation. Once inflation became the key target of macro-economic policy, however, and central banks were entrusted with the pursuit of low inflation,

many of the tools of macro-economic policy were effectively neutralized (Iversen and Soskice 2006). Exchange rates, devaluations, and expansive fiscal policies lost their power, since they would immediately be counteracted by powerful central banks. That was the New Classical theory underlying the disciplining of governments through central banks (Skidelsky 2009: 29–51).

Yet things are not quite that simple. A credible central bank is not just one that pulls the trigger (raises interest rates) each time prices threaten to rise faster than what it considers sustainably low inflation. In the limiting case, a credible central bank is one that has persuaded other economic actors to take its preferences actively into account when setting theirs. As Max Weber suggested over a century ago, if a ruler permanently has to impose order through violence, the legitimacy of the ruler and, as we would say today, his or her policy credibility, are low. The new macro-economic policy set-up requires more than a credible conservative bank alone for it to function: other political-economic actors also have to buy into the new regime—by conviction if possible, by credible threat if necessary, as long as they comply. Put differently, and in terms directly relevant to the theme here, if (nominal) wages are set at a moderate level, that is, not exceeding labour productivity growth, the job of the central bank is made easier and therefore more credible, since that implies that prices are stable, and the central bank does not have to retaliate against inflationary pressures emanating from the wage-bargaining system (Hall 1994; Hall and Franzese 1998; Iversen and Soskice 1998).

The big policy shift of the 1980s, from full-employment oriented corporatism to inflation-targeting monetarism, dramatically changed the underlying political-economic constellation. In the first regime, governments pursued low-inflation growth and full employment in a coalition with labour unions and employers, actively supported by a subordinate central bank. In the second regime, the central bank pursues low inflation and forces governments, labour unions, and employers to support this disinflation policy. How and where this shift emerged is unclear: orthodox economists point at the experience of stagflation in the 1970s, arguing that it demonstrated the inability of governments to manipulate the economy, which was, ultimately, better left on its own. Others argue that this probably overstates the case and may well (mis-)take the effect of a one-off shift in the economy from manufacturing to services for a structural feature of Keynesian economies (Iversen and Soskice 2006). With productivity being significantly lower in services than in manufacturing, wage-setting systems were slow to adapt and thus produced excessive inflation; by the mid-1980s, however, when governments and wage bargainers had understood the new rules of the game (although not without conflict as we will see below), inflation fell rapidly and stayed low.

This new paradigm of macro-economic policy-making had important consequences for domestic economies. A key effect of a pegged exchange rate

regime is that inflation rates have to converge across the different economies in the peg arrangement. Absent such convergence, financial markets respond by pushing up the interest rates of the inflation laggards to keep the exchange rate stable vis-à-vis the anchor currency. A conservative central bank, especially one that gains credibility through institutional and political independence, pre-empts this effect: if inflation rises, the central bank raises its key interest rate to counteract inflationary pressures. Since every economic actor knows that the central bank will do this, they factor this low-inflation outcome into their own actions, and the ironic effect is that while the central bank does not have to raise its interest rate, it still arrives at its preferred low-inflation outcome (Carlin and Soskice 2006: 27–201).

Again, though, things are slightly more complicated than this simple model suggests. The policies of the central bank may have *singular aggregate* effects in an economy, but they do not necessarily have *symmetric* effects across different parts of that economy. Think, for the sake of simplicity, of an advanced capitalist economy as consisting of two types of sectors: those that are exposed to international competition and those that are sheltered from it—each with different interests in the area of international political economy (Frieden 1988). And think of the aggregate wage inflation rate of that country as the weighted average of the inflation rates of these two sectors. All other things equal, inflation rises when nominal wage growth outstrips labour productivity growth, something that is more likely to occur in the low-productivity sheltered sector than in the high-productivity exposed sector. In fact, the exposed sector faces a strong, market-imposed competitiveness constraint on wage setting as a result of economic integration, and therefore does not necessarily require such a back-stop function by the central bank. If wages in country A, adjusted for labour productivity, rise faster than in country B, and both are members of the same pegged exchange rate arrangement, the exposed sector in A simply ends up pricing itself out of competition, and wages (or employment or both) fall as a result.

The sheltered sector, however, is very different. Market constraints are local for the private sector (think of restaurants or hairdressers), with the result that wages can rise in all companies without negative effects on an individual firm's competitiveness. Most of the domestic private services sector is, however, relatively weakly unionized: even on the European continent only a few sectors such as retail banking, other finance-related clerical occupations, and possibly the mass retail sector have relatively high organization rates. Wages in the bulk of the private service sector will, therefore, more or less reflect market forces, and grow at a moderate level. The only significant exception is the public sector, which is not exposed to such constraints: public services are usually not traded, they are relatively price inelastic, workers in principle have guaranteed lifetime employment, and unionization rates

are on the whole very high. Since public-sector workers can extract high wage settlements today, yet not pay for them with lower wages or unemployment tomorrow, wage inflation is, all other things equal, a considerably more likely outcome in the public sector.

This completes the triangle between central banks, governments, and labour unions. The two main sectors (exposed/export and sheltered/public) have a very different exposure to the power of the central bank. For the exposed sector, the central bank is, as it were, a second front, which opens in case they ignore, at their peril, a powerful competitiveness constraint. In the public (and private sheltered) sector, however, the central bank's threat is the main, and possibly the only, constraint on wage bargaining. Wage restraint policies imposed by central banks and governments may have been oriented to the economy as a whole, in other words, but actually targeted the sheltered sector, particularly the highly unionized public sector. Labour unions in the exposed sector, in turn, faced parallel incentives to keep public-sector wages under control. Since domestic inflation is the weighted average of inflation in the two sectors, wage inflation in the public sector forced the exposed sector to compensate for this by raising its productivity levels without raising wages at the same rate—or else its own wage moderation efforts came to naught because of rising aggregate inflation (assuming other countries remained at the same relative competitiveness level). Because such a scenario in which the manufacturing sector permanently mops up after wage excesses in the public sector is a distinct, horrible possibility from the perspective of labour unions in the exposed sector, the latter have faced strong incentives to keep the public-sector unions under control, and often could rely on a wide variety of political, legal, and other institutional means to accomplish that.

Stabilizing an economy under the new, monetarist regime thus requires a complex choreography of political-economic actors: a credible conservative central bank that imposes a restrictive monetary policy, governments that adhere to credible fiscal restraint, and coordinated wage setting hierarchically organized around the export sector as wage leader. This was more or less the regime at the basis of the DM-bloc that emerged in the 1980s. It was anchored on the German Bundesbank, which held both the government and the strong engineering labour union IG Metall in check, was exported to the other countries through the DM exchange rate peg, and became the basis of the Maastricht convergence regime. In all these instances, coordinated wage-setting systems provided crucial tools for adjustment, first as a buffer against rising inflation, and second also as stabilizers once the wage-setting systems had internalized the hard inflation target constraint imposed by the central bank.

The balance of this chapter examines how these political-economic dynamics played out in the evolution of early monetary integration in Europe. It

does so in three steps. The first looks back at the interaction between labour, governments, and central banks in the formation of the Deutschmark bloc in the first half of the 1980s. The second examines the parallel process in the 1990s, when the remainder of Western Europe prepared for EMU after the ratification of the Maastricht Treaty. The chapter ends with a stylized review of the relation between labour unions, wage-setting systems, and central banks at the threshold of EMU in 1999.

2.2 Constructing the Deutschmark-Bloc

In most essential ways, the design of EMU followed the macro-economic policy logic of the previously existing DM-bloc. It involved a conservative (and highly independent) central bank in Germany, fiscal restraint instead of Keynesian countercyclical policies, and wage moderation, all of them key elements of EMU since its inception. The system worked well, despite the inherent problem that both fiscal and wage restraint artificially restrain demand, because of its beneficial effects on export competitiveness, which raised aggregate demand, especially in the smaller economies in the DM-bloc. Precisely because it foreshadowed so many of EMU's defining political-economic characteristics, understanding the emergence and operation of the DM-bloc is crucial to making sense of the logic of wage setting and labour relations under the Maastricht regime, and possibly EMU.

The emergence and development of the DM-bloc was the result of a protracted process of institutional readjustment, which took place at several levels simultaneously. One part was the explicit linking of European currencies, first in the currency 'snake' of the late 1970s and afterwards through the Exchange Rate Mechanism (ERM) in the European Monetary System (EMS). The snake and the ERM were attempts to introduce exchange rate stability on the continent, compensating for the collapse of the Bretton Woods system earlier in the decade. Another part of the adjustment, largely hidden from view, dealt with the domestic processes of adjustment, which involved major social conflicts between trade unions and governments who were pursuing restrictive macro-economic policies that relied to a large extent on significant wage restraint. Disciplining the labour unions was a crucial precondition for regional monetary stability, and the process through which this happened in the early 1980s was a precursor for what was to happen elsewhere in the 1990s.

The close trade relations between the economies that were to join the DM-bloc and the German economy were at the basis of this informal but strong monetary arrangement. With small economies such as the Netherlands and Belgium, which traded a large part of their GDP with Germany, pegging their

currencies to the DM, a growing part of the GDP of other countries became linked to this de facto currency bloc through trade, thus inducing ever more economies to tie themselves to the DM through the network externalities associated with such a 'snowball' effect. As David Andrews (2001) explains, countries pegged their exchange rate when their volume of trade with a currency bloc of this kind exceeded trade outside the bloc. Since the Netherlands traded more with Germany than with its next two large trading partners, Belgium and France, it was the first to peg the Dutch guilder to the DM. That, in turn, meant that the volume that Belgium traded with the newly constituted virtual currency zone consisting of Germany and the Netherlands was larger than what it traded with France, which forced the country to peg the Belgian franc to the DM as well. This changed the situation for France, which now traded considerably more with the DM–Benelux currency bloc than with the rest of the EU and, in turn, adopted the DM as the currency peg for the French franc. The DM-bloc reflected, according to this logic, the increasing economic integration in the E(M)U.

Tying currencies closely together in such an asymmetric system required the swift adoption of the monetary stance of the country at the centre of the arrangement as a monetary anchor, which was provided by Germany's Bundesbank (Calmfors 1998; Soskice 2000). Ideas may have legitimized these shifts (McNamara 1998; 2006), but brute economic force was the mechanism. The German inflation rate thus became the target rate for all of these economies. After the Dutch guilder, the Belgian franc, the French franc, and the Danish crown had been pegged to the DM by 1985 (the Austrian schilling had been linked before the construction of the DM-bloc), the Bundesbank had become the de facto monetary authority for these countries. Inflation and interest rate movements in Germany had to be shadowed or adopted instantly in the other countries, lest the exchange rate peg came under pressure, which would lead to speculation against the currency.

Aligning inflation and interest rates was a complex political-economic process, however. Most of all, it required disciplining labour unions: since the Bundesbank had made inflation-fighting its primary target, a strategy that it implicitly transmitted to all other central banks, wage growth in all aspiring DM-bloc countries had to be symmetrically aligned with German wage developments as well, since upward price/wage movements beyond those of Germany forced the national central bank to raise interest rates in order to maintain the exchange rate peg. Labour unions in the export sector responded to this by instituting more or less institutionalized forms of wage shadowing (against German wages) to ensure that domestic wage developments followed wage developments in the anchor country. But it also required, perhaps more importantly, that wages in the sheltered sector, primarily in the public sector, followed wage developments in the exposed

(primarily manufacturing) sector, where external competitiveness remained a strong disinflationary anchor.

All countries aspiring to DM-bloc membership in the early 1980s faced a period of protracted social conflict when governments initiated policies to peg their currencies to the DM and, as a result, were forced to contain wage growth and public spending. Both the number of strikes and working days lost to strikes, in the public sector in particular, increased suddenly and significantly in the years leading up to the formal peg between the domestic currency and the DM. Belgium and the Netherlands faced a massive public-sector strike in the autumn of 1983, which paralysed large parts of the countries for several weeks. In Denmark the number of strikes jumped a massive 500 per cent from about 160 strikes on average in 1982, 1983, and 1984, to 820 in 1985, while working days lost to strikes increased from about 100,000 on average before 1985 to over 2 million in that year (source: ILO Labour Statistics). In France the high-strike years 1983–85, immediately following the Mitterrand U-turn on economic policy, the franc-DM peg, and the forced disinflation after 1982 (Taddéi and Coriat 1993), heralded the shift toward a regime where labour was, in effect, sidelined on the political-economic scene. Between 1980 and 1985, governments in Belgium, Denmark, France, and the Netherlands combined passed no fewer than thirteen laws that aimed at containing wage growth in the public sector (Table 2.1).

The strikes ultimately ended in defeat for the public-sector unions and led to the institutionalized subordination of wages in the public sector to those in the private exporting sector (cf. Crouch 1990). The public-sector unions in the prospective DM-bloc countries lost their battle precisely because the government policies associated with the peg had very different effects on employees in the public as opposed to the private exporting sector, the industry that produced the other large trade-union federations (primarily in the engineering and chemical industries, and in some countries also the textile industry). Pegged exchange rates of the sort that we saw in the ERM implied wage moderation in both types of sectors. As explained earlier in this chapter, the marginal cost of a fixed exchange-rate regime policed by the central bank was, all other things equal, very high for the public-sector unions in the sheltered sector and much less so for labour unions in the private export-oriented sectors. It is therefore no surprise that the public-sector unions were at the vanguard of the protests against the austerity regime induced by this shift in the exchange rate regime. But the considerably lower cost for manufacturing export unions of adopting such a regime also explains why they remained on the sidelines in the conflicts in places such as the Netherlands and Belgium in 1983, and imposed wage restraint on the other trade unions in many other countries.

The effects of this reorganization of wage setting were very important. While average annual real wage growth for government employees during

Table 2.1. Public-sector wage laws in Deutschmark-bloc member countries, early 1980s

1981
Netherlands: The Nederlandsche Bank abandons control of domestic liquidity and gears its monetary policy towards the external constraint (the DM exchange rate)
France: Temporary price and profit freeze

1982
Belgium: General price freeze until end of March; selective freeze thereafter; freeze of wage indexation (until May); also longer-run measures to impede complete wage indexation
France: Temporary freeze of prices, wages, rends, and dividends until October; reduction in 1983 budget deficit plans
Denmark: Comprehensive stabilization package: automatic wage indexation suspended; wage freeze until March 1983; tight fiscal policy; progressive dismantling of capital controls
Belgium: Selective price freeze extended until end of 1983

1983
France: Austerity programme aimed at bringing down inflation via monetary restraint, restoring external balance via foreign exchange controls, and reducing the public budget deficit by cutting expenditures and raising taxes
Denmark: Government announces further liberalization of capital movements to take place on 1 May.
Denmark: Government guidelines for an upper limit of 2% for the annual wage increase in the new two-year wage agreement

1985
France: Start of a 2-year transition of monetary policy operating procedures from quantitative credit controls to a more market-based system of reserve requirements
Denmark: Government enforces a 2% legal upper limit for the annual wage increase in the new two-year wage agreement

1986
France: Steps to slow nominal wage growth; plans to reduce government budget deficit; relaxation of exchange controls
Denmark: Wage indexation law (suspended in 1982) is abolished

Source: Weber 1991, cited in Johnston 2011

the 1970s had been 7.5 per cent in Belgium, 5.5 per cent in the Netherlands, and 5.4 per cent in Denmark, the average for the 1980s was 0 per cent in Belgium, negative in the Netherlands, and below 2 per cent in Denmark (Johnston 2011: 80–81). In France the 'competitive disinflation' policies inaugurated by the Left government in the mid-1980s saw the aggregate wage share fall more than ten percentage points over the next ten years (Taddéi and Coriat 1993) and public-sector wages stagnate.

By the mid-1980s, this series of social conflicts associated with the shift toward the DM-bloc came to an abrupt end. Strike figures dropped dramatically alongside inflation in the member states of the young DM-bloc, and exchange rates acquired a stability that lasted for over a decade in this group (almost surviving German unification and the 1992 ERM crisis). France offers perhaps the most surprising example: in the second half of the 1980s, strike figures converged on levels usually found in Germany (Boltho 1996), and inflation collapsed from a high of 13 per cent in the early Mitterrand years to 3 per cent by 1988. In fact, on the back of this massive disinflation in the

1980s, France was confident enough to vie for monetary leadership in the EU during the ERM crisis of 1992 (Marsh 2009: 162–75).

The outcome of this period of political-economic adjustment was a tightly organized system in which national central banks of the DM-bloc members were hierarchically linked to the Bundesbank, labour unions (and wages) in the exposed sector hierarchically linked to German wage setting, and public-sector wages in each country hierarchically linked to exposed sector wages. The first of these linkages assured the credibility of the peg: national central banks made clear to domestic audiences that they would defend the currency, even if that entailed raising interest rates to a prohibitively high level. The second linkage, between the key German trade unions and their counterparts elsewhere, assured that the German set-up with a strong conservative central bank that disciplined excessive wages was transmitted to all other countries in the currency bloc. Wages outside Germany thus were kept under control through two mechanisms: one was direct wage shadowing, whereby wages outside Germany grew, adjusting for labour productivity, at a similar rate to German wages; the other was provided by credible conservative monetary policies as the back stop in case of excessive wage settlements. The third linkage, between the export and public sectors, subjected wages in the latter to limits set by the former to assure moderate aggregate wage inflation, thus appeasing the national central banks.

By the late 1980s, two important conditions for the next stage in European monetary integration were met. One was that a stable DM-bloc now existed, built on the mechanisms analysed above. The other was that at the same time, the architect of the stabilization of the French franc in the early 1980s, Jacques Delors, had become the president of the European Commission and, in that capacity, revamped existing plans for a European Monetary Union. The late 1980s saw a flurry of activity in this regard: White Papers, pre-assessment reports, debates in the Council of Ministers (the top decision-making body of the EU), in central banks and political parties, trade unions and business groups, and in academic circles and the press, and a treaty draft, signed in December 1991 in the small Dutch town of Maastricht. Despite some hiccups, such as the negotiation of an opt-out for Britain by then Prime Minister John Major, and referendums in France and Denmark that produced potentially devastating negative outcomes, the Treaty entered into force in 1992. With that, the curtain opened on the second act in the EMU drama.

2.3 The Maastricht Treaty and Social Pacts

The Treaty of European Union, concluded in Maastricht in 1991, generalized the broad disinflationary macro-economic regime associated with the Deutschmark and the Deutschmark (DM)-bloc to the other economies of

Europe. In many regards, the Maastricht project of the 1990s leading to EMU was a simple extension of the DM-bloc's policy priorities. The Treaty imposed what became known as the 'convergence criteria', a set of target scores that member states had to meet in order to be considered 'fit' for EMU. The criteria were both institutional—stable membership of the ERM and having delegated monetary policy to an independent central bank were among the goals—and numerical: inflation and interest rates less than 1 per cent above the average of the three best performers, a budget deficit below 3 per cent of GDP, and a debt level below 60 per cent of GDP. Because of their interconnectedness, countries that were working toward the adoption of the Maastricht criteria could concentrate on two key indicators: low inflation (producing stable exchange rates, which assured a convergence of domestic interest rates), and a reduction in the public deficit (which would lead to a falling and sustainable debt level).

Most of the literature on the run-up to the Treaty and on the work that had to be done afterwards to meet the convergence criteria has, quite rightly, concentrated on the economic diplomacy aspects (e.g. Dyson and Featherstone 1999), and more broadly on the elite character of the project (e.g. McNamara 1998). Given the nature of EMU, this attention to elite action is both understandable and helpful. EMU as we know it today would simply not exist without German unification, which tied Helmut Kohl and François Mitterrand into a policy toward monetary unification, the European Commission President Jacques Delors, and the central bankers in Germany and France that offered the monetarist blueprint for monetary union and the place of the central bank in that set-up (Marsh 2009). Yet the Maastricht project required political mobilization on the ground as well. Because of the political-economic organization of many European economies, in which labour unions and employers have been handed a large role in economic policy-making, this process entailed, as it did across the DM-bloc countries in the previous decade, some form of engagement—either cooperation or confrontation—with the social partners (Martin and Ross 2004). The instruments of choice for many governments in prospective member states to meet the Maastricht convergence criteria were social pacts, in which organized labour, employers, and governments hammered out adjustment packages. In Italy and Portugal social partners negotiated pacts with a significant wage moderation component (and in Spain the government tried). In Austria, Belgium, France, Germany, and the Netherlands, however, wage moderation existed without pacts. What explains these differences in policy instruments against the background of similar challenges: why did some countries adopt pacts during the Maastricht convergence period while others did not?

Answering that question requires a short detour on different types of social pacts. Pacts are perhaps best understood not in a dichotomous (i.e.

Table 2.2. Types of social pacts

Narrow, highly integrated INCOMES POLICIES
Wide, highly integrated embedded NEO-CORPORATIST cooperation
Wide, weakly integrated HEADLINE pacts
Narrow, weakly integrated, SHADOW pacts

present/absent) way, but along a distribution from shallow topical conversations between social partners (and government), to the other extreme of fully fledged, quasi-constitutional neo-corporatist cooperation. Two dimensions seem to organize this distribution of pacts. The first is the type of issues and the number of policy areas covered—from relatively few unimportant ones to several critical ones; the second is the degree of integration and mutual articulation of relevant levels of political-economic governance, ranging from a situation of several disjointed and fragmented levels to one in which all governance levels are closely integrated and support each other (an example of the latter is when labour union policies in companies fully complement organized labour's macro-orientations). Dichotomizing these dimensions leads to the four types of social pacts in Table 2.2 (Avdagic et al. 2005: 6–7).

In terms of their effects on wage inflation, these four types of pacts more or less naturally collapse into two broader categories. The first is the one that we associate with the north-western European economies, where wage setting has been highly coordinated and/or embedded in wider neo-corporatist social dialogue between the social partners (sometimes also including government)—what I call 'incomes policies' and 'neo-corporatist' cooperation above. Wage inflation problems were rare in this group of countries during the 1990s, since the wage-bargaining systems were already reorganized in the previous decade, when the DM-bloc was formed. But where they existed, they were addressed through stable and strong institutional frameworks that were relatively easily mobilized to handle the wage pressures. The second type of pacts has a different underlying logic. First of all, they specifically addressed the problems associated with the Maastricht process, and often did not exist before. Second, instead of relying on a wide arsenal of embedded arrangements for wage moderation, these pact-like arrangements addressed several issue areas in the domestic political economy simultaneously, and did so through public declarations. At the same time, though, they were often also weaker arrangements in the sense that they were not embedded in a broader mode of coordination in the economy, and thus had a relatively fragile institutional basis. Where such headline social pacts failed, governments adopted the back-up solution of *shadow pacts*, 'in which consultation and negotiation [took] place for political or functional reasons at separate tables without explicit (or often even implicit) links between them, but with effects

that [were] very similar to those of headline pacts, e.g., disinflation, fiscal consolidation and coordinated reform' (Avdagic et al. 2005: 6–7; Hancké and Rhodes 2005: 201).

In what follows I will, in line with the central theme of this book, concentrate on the struggle to bring inflation down to the Maastricht target levels (note, however, that the debt and deficit reduction programmes implied in the Maastricht Treaty followed a broadly similar logic—Hancké and Rhodes 2005: 211–15). To a large extent, the basic variation in policy options can be explained concentrating on those countries that had already reconfigured their domestic institutions in the 1980s to produce low inflation. That pitted the former DM-bloc countries against the others: in the DM-bloc, average inflation was low and tightly controlled as a result of the disciplining power of the Bundesbank. In the other countries, Italy, Spain, Portugal, Greece, and to some extent Ireland, inflation was well above the target range in the early 1990s.

This latter group of countries with inflation rates well above the Maastricht Treaty target varied in terms of the key institutions that governed the supply side of the labour market—what we could call the micro-foundations of their political economy (the Appendix to Hancké and Rhodes 2005 gives details on the operationalizations of this idea of micro-foundations). In the first of the two groups, the organization of the labour market contained some modicum of inter-firm wage coordination, skills were informally acquired and transferable across firms, and workplaces had been relatively peaceful after an earlier period of conflict. In the other group of countries, wage setting was decentralized, the labour market deregulated, and skills were of a general rather than a specific nature, that is, more portable and codifiable rather than based in technological and organizational processes associated with industries or firms. While in the first group the existing micro-level proto-institutions provided a foundation for and thus supported macro-social pacts, in the second group of countries, the requisite micro-foundations for such wide-ranging wage coordination and wage moderation were largely absent or very weak. That implied that, when social partners (and government) built a central institution where they negotiated a wage agreement, very little of that was reinforced from the bottom up, through supportive practices in firms, sectors, municipalities, or regions. In these cases, pacts were almost purely top-down arrangements with very few direct mutually reinforcing links to other elements of the institutional framework that governed the labour market. They may have had wide-ranging consequences—assuring participation in the first wave of EMU is no mean feat—but they had only limited impact on, and provided limited support for, arrangements on the ground.

To illustrate how this variation in micro-foundations conditioned the construction of macro-arrangements, a comparison between Italy and Ireland might be helpful. Italian labour markets have traditionally had a strong

organized, though often regionally based and highly informal, wage setting and training component. When the national social pact was agreed in 1993 in Italy, the existing informal arrangements relatively quickly offered a local and firm-level organizational framework for the national pact, thus forging a new link between industry contracts (setting pay norms) and company contracts (redistributing productivity gains). A new system of workplace representation was also constructed, providing for a stronger company-based representation of unions and management and a foundation for a more articulated and coordinated wage-setting system. The result was that the national social pact became sustained by a micro-dynamic, often built around territorial and firm-level agreements that governed skill production, work organization, and the management of technological, organizational, and regional policy innovation.

The Irish social pacts were much weaker in that regard. On most measures, the Irish labour market and its voluntarist industrial relations system are as decentralized and disorganized as those of the UK, based as they are on rapid hiring and firing mechanisms and an emphasis on general (instead of firm or industry-specific) skills. The few experiments with social partnership at the company level have been stunted by the absence of a strong, supporting legal framework, and local-level bargaining continues to prevail (Roche, 1998; Teague, 2004). Talks among the partners in the Irish social pact resemble the regular wage contract negotiations found in many unionized sectors in Anglo-Saxon economies, which are regularly contested and subject to frequent wholesale reiteration, because the macro-institution is not underpinned by micro-mechanisms. Irish pacts are therefore always relatively long, with detailed conditions and periods covered, and ultimately quite tenuous arrangements that fail to produce a sustainable momentum over time.

The key difference between Italy and Ireland was not the historical ability or inability of labour unions and employers to conclude national-level collective bargaining agreements that included a disinflationary income policy. In fact, as Italian observers (Regini 1984; Salvati 1981) have often suggested, looking back over experiments with incomes policies in the 1970s, the central trade unions in Italy lacked the capacity to deliver wage restraint that was also missing in decentralized economies such as the UK. The key difference between Ireland and Italy was that in the latter *sub-national* arrangements existed (often called into life to fill the vacuum left by the absence of national rules and institutions) that governed crucial aspects of the local labour market (Locke 1995; Rodriguez-d'Acri 2011). That patchwork, inexistent in Ireland but crucial for the performance of the Italian economy, was reorganized and streamlined to support the national pact in the early 1990s.

We can now put together the different pieces of the puzzle. *Incomes policies* and *embedded, neo-corporatist cooperation* containing incomes policy accords emerged in those countries with inflation rates at the start of the

1990s that were roughly at the level of Germany (the Netherlands, Belgium, France, Austria, Denmark, Ireland, and Finland). Where weak yet salient micro-foundations existed, these were reinforced and reorganized to support, from the bottom up, the move towards central coordination of wage bargaining. Political economies that could build on these tended towards trying and/or adopting *headline* social pacts—Italy is an example of this. In the last group of countries, which faced high inflation but were unable to rely on or build strong labour market micro-foundations, explicit headline pacts were impossible to construct, and instead some form of consultation and negotiation took place in parallel but disconnected areas—a configuration labelled *shadow pacts*. These led to falling inflation as well, but without explicit central bargaining. Spain fits this category. Finally, in Ireland, where central wage guidelines had been in existence since the mid-1980s, sustaining social pacts is an increasingly cumbersome process because of the decentralized and fragmented nature of the labour market. Table 2.3 presents these different outcomes analytically.

The importance of meeting the Maastricht convergence criteria cannot be underestimated. First of all, since the criteria were considerably harder to meet in a period of slow growth than in the period of higher (but also inflationary) growth that surrounded German unification and its immediate aftermath (the Maastricht Treaty was signed and ratified before the 1992 ERM crisis and the recession that followed), it was hard work for the prospective member states. But not meeting them was also considered a minor catastrophe at the time: the hard sanction was exclusion from EMU, with all the perceived benefits that this would bring. While some fudging was inevitable in the process—lest EMU would go ahead without two of the founding EU members, Italy and Belgium, because of their high budget deficits—member states invented and reinvented innovative political-economic technology to bring inflation (and budgets) in line with the Maastricht Treaty's requirements.

Table 2.3. Inflation and social pacts in the 1990s

High inflation countries (above 5% in 1992)	Low inflation countries
Potential micro-foundations	Austria (incomes policies)
Italy (1993 headline pact)	Belgium (incomes policies)
	Denmark (embedded pact)
No micro-foundations	Germany (incomes policies)
Portugal (1996 and 1997 headline pacts)	France (incomes policies)
	Netherlands (embedded pact)
Spain (shadow pact)	Finland (social pacts)
Greece (no pact)	Sweden (embedded pact)
	Ireland (social pacts)

Source: Hancké and Rhodes 2005

Every member state that signed up to the Maastricht Treaty also introduced some form of wage moderation. Where the problems were small (i.e. inflation low) and some form of central incomes policy already existed, things could be sorted out by relying on the usual forms of centrally coordinated wage setting. Where inflation was high at the start of the 1990s, however, and such central institutions were relatively weak (these two usually went hand in hand, with the weak institutions at the basis of the high inflation rates), governments and central partners searched and found new instruments to bring inflation under control: (headline and shadow) social pacts, which introduced a form of incomes policy that led to the same outcome as the more embedded arrangements in the coordinated economies. By 1998 the hard work paid off: with the exception of Greece, which joined a few years later, all initial hopefuls were admitted to the club. An era, characterized by disciplined trade unions kept in check by strong national central banks, came to an end. With EMU a new, unknown era started. But before turning to the shift in wage setting that EMU generated, the next section takes stock of the world that was left behind.

2.4 Central Banks and Labour Unions at the Threshold of EMU

The run-up period to EMU in the mid and late 1990s saw inflation across all the member states fall fast and converge on the low levels traditionally associated with Germany and the DM-bloc. The Maastricht convergence criteria imposed these developments: the penalty for failing to meet these norms—non-membership of EMU—was both credible and tough. Greece was not accepted as a member until later (in 2001) and Lithuania and Estonia were denied membership in 2007 on somewhat dubious inflation-related grounds (Buiter 2007). The Maastricht criteria, however, were targets, not mechanisms, and it was in effect left to all prospective member states to design their own path to meet the criteria. The trajectory that each member state adopted was given through a combination of government policies, central bank threats, and negotiations between social partners. Perhaps the most intriguing part of this 'Maastricht' process, was, with hindsight, how much governments relied on social pacts—voluntary agreements on welfare, labour market, and other politically sensitive reforms between social partners and governments to bring inflation under control (and do the same for budget deficits and public debt). In fact, social pacts, or at the very least serious attempts at pacts, emerged almost everywhere in the prospective EMU states, even in the seemingly anarchic southern member states. While they may not have led to successful institutional outcomes everywhere, they dramatically changed the place of labour unions in the domestic political economies during the period when Maastricht-induced pacts emerged.

At the time of the inauguration of EMU in 1998–99, when the future members of the single currency zone were selected and the euro introduced, this period of adjustment had produced a very effective, stable political-economic arrangement. It was built on a mutual articulation of domestic and international elements, relying on a series of hierarchically nested arrangements, with Germany at the top, and in its most parsimonious form, contained the following elements. The central banks of the member states followed the Bundesbank and the labour unions in the export sector shadowed the German engineering union IG Metall. Domestically, the unions in the exposed sector imposed wage discipline on the sheltered sector unions, particularly upon the strong public-sector unions. National central banks closed the circle with the threat of retaliation if domestic inflation rose relative to Germany. Crucially, the central banks were the anchors in the system because of their powerful position as both first and last mover: they set the target *ex ante* and had the tools to enforce it *ex post*.

While the key relation in this set-up was between the Bundesbank in Germany and the main exporting union in that country, the IG Metall (Hall 1994), the arrangement was more complex because the central bank acted as a second (but, since it was highly credible, not necessarily a secondary) constraint on the union. Through a variety of means, the bank would make public a rough inflation target range that it deemed commensurable with price stability. Whatever IG Metall's wage ambitions, if they threatened that inflation target, the Bundesbank would respond with an interest rate hike, thus bringing inflation under control again. Since both knew that this was a likely outcome of an inflationary wage agreement, German wage setting was effectively constrained by a combination of competition (the real effective exchange rate) and the Bundesbank's low-inflation strategy.

Through the ERM (membership of which was one of the institutional criteria included in the Maastricht process), this disinflationary regime was transmitted to the other economies in the European Monetary System. The rules of the ERM implied that the other member states took a key inflation rate, almost always the German one, as an implicit target. This mechanism operated via the foreign exchange markets, which penalized countries that maintained higher inflation rates and thus threatened their ERM limits against the euro's predecessor, the ECU (European Currency Unit, a basket of European currencies). The other member states thus needed to ensure that their inflation rates were sufficiently low. The institutional mechanism for this entailed a subordination of wage setting in the other countries to German wage setting, alongside the de facto subordination of the central banks to the Bundesbank. On one side of this arrangement, central banks were tied into a hub and spokes configuration, with the Bundesbank at the centre. On the other side, all unions in the exposed (that is, the export, and usually the manufacturing)

sector were caught in a similar set-up revolving around IG Metall: their wage rates started to reflect the IG Metall's negotiated wages (adjusted upwards or downwards to reflect higher or lower labour productivity).

Wage inflation in a given country is not set in the exposed sector only, however, but is the aggregation (a weighted average, in fact) of potentially different wage inflation rates in the exposed and sheltered sectors. Export-sector labour unions had two options when wages in the sheltered sector become inflationary. They could compensate (by roughly the inverse of the relative size of the public sector multiplied by the difference, in percentage, between wage and productivity growth in the public sector). Or they could impose some form of wage moderation on the public sector, through legal, political, or institutional means, to keep inflation under control.

The export unions, backed up by government and central banks, were very effective in this: throughout the 1990s, wage moderation in the public sector (i.e. nominal wage growth minus the implied productivity growth) was almost perfectly correlated with wage moderation in the exposed sector. With the exception of France, simple correlation coefficients of wage moderation between the manufacturing sector (a proxy for the exposed sector) and the public sector were of the order of 0.90 (and in France it was still a very respectable 0.53) (Johnston and Hancké 2009: 609; see section 4.2 for more detail). There is little doubt that wage moderation was imposed through coordination: growth rates of nominal wages are what labour unions actually negotiate—wage moderation as defined here is an outcome variable, not an explicit target—and the correlation coefficients between nominal wage growth rates in the export and the public sectors were of the same order (0.80–0.90, again with the exception of France with 0.47).

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 restraint. Usually this meant shadowing the evolution of wages in Germany, the main trading partner of most EMU countries, and imposing a relatively strict wage norm that set an upper limit on wage negotiations (the next chapter goes into more detail on how these wage norms operated). 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. ULC growth was low everywhere during the Maastricht regime, and more or less converged throughout the decade, even among the countries that had previously had problems with wage restraint (Scharpf 2011: Figure 2; see also the analysis in section 4.2).

While variation existed in the exact institutional mechanisms at work (as Tables 2.3 earlier and 2.4 below suggest), the effect of these institutional innovations in the prospective EMU member states in response to the Maastricht

Table 2.4. Wage-setting systems in selected prospective EMU member states around 1999

Country	Type of wage norm (law, social pact, agreement, . . .)	Effective control of wage setting (late 1990s)
Austria	hard, via social pact	central
Belgium	hard, via law	central industry level
Finland	hard, via social pact	central
France	informal, via large firms	mix: decentral, and central via state
Germany	soft, tacit understanding between unions and employers	central industry level
Greece	soft	centralized wage bargaining
Ireland	hard, via social pact	central inter-industry
Italy	hard, via law and social pact	centralized
Netherlands	soft, via social pact	central
Spain	soft	central

Source: Own research based on Hassel and Ebbinghaus n.d.

criteria 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. Correlation coefficients between wages in Germany and other would-be members of the eurozone were invariably extremely high, almost perfect: in Austria, Belgium, and the Netherlands they were above 0.90, and above 0.80 in France (Chapter 4, which analyses the shift between Maastricht and EMU, discusses these outcomes in light of the institution of EMU).

By the late 1990s, the Bundesbank thus effectively controlled wage setting in Germany directly, and through its control over central bank policies in the rest of Europe, elsewhere indirectly as well, supported by the wage target that the IG Metall offered (and which the Bundesbank had implicitly imposed). If export unions outside Germany were to negotiate inflationary wage settlements, the national central bank and the government would be forced to intervene to bring inflation back in line with a stable exchange rate against the DM. The same was true for unions in the sheltered and particularly the public sector, where wages were kept under control by an implicit coalition of exposed sector unions and governments. Central banks, led by the German Bundesbank, thus both led by setting an inflation target and policed the arrangement by credibly threatening retaliation against inflationary wage bargains.

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 eurozone inflation rates (HICP) fell from 3.8 per cent to 1.1 per cent, while the variation around the mean decreased to within two percentage points.

Conclusion

By 1998, almost all EU members that had initially expressed their desire to join the eurozone also qualified for membership. Only Greece failed to make it in the very first round, and for some of the candidates a rather liberal view of the Maastricht criteria had to be agreed—Belgium and Italy both had a public debt stock well above the 60 per cent of GDP norm that was agreed in Maastricht—but the Maastricht process was considered a major success. Not only did it herald the coming of the single currency, it also demonstrated that all European economies could, with the right combination of sticks and carrots, be made fit to join a select club of advanced capitalist democracies with a single currency. There were some dark linings in the silver clouds, though, not the least of which was that the Maastricht process had instituted a deeply conservative macro-economic policy regime, with its blind faith in nominal, monetary indicators. However, many considered that a price worth paying for monetary union and for the possibility of an escape from the deflationary straightjacket that the Bundesbank had imposed regardless of the needs of other economies and the European economy as a whole.

The road to get to EMU was, in retrospect, surprisingly and remarkably smooth. Some of the southern economies witnessed resistance to the associated austerity, of course. French workers and unions especially showed some anger about the consequences of signing up to Maastricht: *The Economist* ran a cover in 1995 depicting French public workers on one of their largest and longest strikes since the DM-bloc conflicts with the caption 'France prepares for EMU'. And in quite a few other countries, the inevitable fiscal stringency that accompanied the low public deficit and debt criteria led to stand-offs between governments keen on entry and public-sector employees equally keen on preserving their status. But what is perhaps most remarkable, looking back over the 1990s, is that social conflict was considerably less than what could have been expected given (a) the history of southern European labour's militancy, and (b) northern Europe's far more conflict-ridden pathway into the DM-bloc in the 1980s. By the mid-1990s, labour unions in north and south had accepted the inevitability of EMU—a few ended up enthusiastically campaigning for the single currency—and many took the opportunity to recast their strategies and organizational structures in light of the new reality that was looming. Wage-bargaining systems were streamlined and governments invited labour to macro-political bargaining. All boded well for a successful EMU, precisely because, it seemed, domestic political economies had been reorganized to address the new constraints (and opportunities) that the single currency imposed.

The next two chapters will examine two important aspects of the transition from the Maastricht process to EMU: the reorganization of wage-setting systems and industrial relations more broadly after a decade of disinflationary

wage benchmarking, and the political economy of labour's adjustment to a new international monetary regime. Chapter 3 will explore the problems that labour faced in the new regime, and suggest that the solutions were far from obvious. In Chapter 4, the focus shifts to the perverse effects of EMU for both domestic wage setting and the hierarchical arrangements that revolved around Germany. Together, they leaves us with the conclusion that there was a darker side to the Maastricht process, one that illustrated, in fact, the lack of adjustment of labour market institutions to the new world of the euro. And that world would come to haunt the single currency in the late 2000s.

3

The Perils of Coordination

Wages and Labour Relations from the European Monetary System to EMU

The advent of EMU dramatically changed the wage-bargaining environment in its member states. The tight organization of wage setting in some member states, and the increased coordination of wage setting in others, which allowed central banks and governments to address single wage-setting actors or their equivalent in each of the prospective eurozone member states directly, gave way to a political economy with one central bank, a weakly coordinated fiscal regime (through the Stability and Growth Pact), and a multitude of trade unions and employers' associations. The implicit, coercive coordination that emerged under the DM-bloc in the 1980s and through the social pacts during the Maastricht period of the 1990s, had hidden the fact that trade unions, employers' associations and wage-setting systems essentially were, and remained, nationally organized. With the introduction of the euro, these two worlds would begin to collide.

In 1999, EMU transformed most of Western Europe, from one day to the next, into a considerably more chaotic political economy than it had been since the mid-1980s. Where central banks and government policy addressed a single union or, at worst, a handful, in each country until the introduction of the euro, the ECB now addressed twelve wage setters (or more, in fact, since about half of the initial member states had more than one union confederation). The world in which central banks kept strong wage setters under control through direct one-on-one monitoring and export-sector-led wage setting had irrevocably disappeared.

This chapter examines that shift in the environment of the labour market from the later years of the Maastricht regime in the 1990s to EMU in the early 2000s. Its main aim is to map the reorganization of labour relations in the initial years of EMU. The starting point consists of the attempts by labour unions to find some form of international wage coordination—depending

on the perspective, either because they feared wage competition or the ECB's retaliation against wage-push inflation. These attempts were not a big success: international wage coordination is weakly developed and perennially subject to defections. What appears to have come about in most EMU member states instead was that wage setting re-centralized, and that technical committees that were backed up by law or informal coercion within the trade unions proposed hard or soft wage norms for all unions to follow. And those wage targets often reflected existing differences in terms of labour productivity and inflation rates, thus giving the impression of wage coordination.

The chapter starts with a section outlining the analytics of the problem that EMU faces, through a well-known model in political economy that discusses economic performance and wage-bargaining structure: the so-called Calmfors-Driffill model (Calmfors and Driffill 1988; Driffill 2006). It then goes on to document, against this analytical background, the attempts by European labour unions to institute some form of cross-border coordination of collective bargaining and analyse why these failed. Section 3.3 discusses how, instead of international wage coordination, the EMU period saw a re-emergence of central *national-level* wage coordination in many (though not all) EMU member states, and links that to the emergence of plant-level 'productivity coalitions' (Streeck 1984; Windolf 1989). The conclusion builds a bridge to the next chapter.

3.1 National Labour Relations in a Single Currency Union

The basic problem that labour unions face in EMU is reasonably well understood, both in economic theory and in comparative political economy and labour relations studies. The economic set-up starts from the simple but powerful Calmfors–Driffill model (1988), which argued that both highly decentralized and fully centralized wage-setting systems were able to achieve low inflation, low unemployment, and high growth. In the limiting case, in a highly decentralized system every worker is exposed to all the negative externalities of his or her wage-setting behaviour: if wages rise too fast, prices rise, and real wages or employment, or both, fall in response. In fully centralized systems, the labour unions represent all workers and thus are subject to the same internalization of wage-setting externalities, since inflationary wages will lead to rising prices and lower employment. In both these extreme instances, workers and their representatives will be very cautious, moderate wages and inflation will remain subdued. The problem, according to this model, is found in wage-setting systems that are centralized at an intermediate level, that is, where labour unions are strong enough to extract wage concessions from their employers, but small enough not to bear the full

inflationary or employment cost of high wages. Compared to the other two possibilities, inflation will be highest in these intermediate systems.

In a thoughtful critique, Soskice (1990 and 1991) argued that what mattered was not necessarily the degree of centralization of wage bargaining, as Calmfors and Driffill (1988) had argued, but of (central) coordination of wage bargaining—that is, the degree to which many formally autonomous labour unions and employers agreed to adopt a common wage target. A complementary critique introduced the central bank into the model and argued that a world with a small number of strong labour unions, but more than one, forced the central bank to impose wage moderation through wage coordination (Soskice and Iversen 2000; see also section 5.2 below for more details). If the number of labour unions is higher than one, then the small-N problem that Calmfors and Driffill had identified, and which led to significant inflation externalities, reappeared because of the central bank's inability to target any individual union without hurting the others that are, in fact, playing by the rules set by the central bank. This can be true, even in systems with a high degree of wage coordination (in fact, the transmission of inflationary wage settlements is almost guaranteed in those systems). But the central bank can impose a moderate wage target on the leading union(s) and then rely on the coordinated wage-setting system to have a similar wage rate in the rest of the economy.

The comparative political economy and industrial relations literature approached the issue from another, complementary angle. In his *Rise of the National Trade Union*, Lloyd Ulman (1958) argued that the organization of labour unions followed the pattern of product market integration. As the product market expanded, unions covered more and more of the associated labour market in an attempt to take wages out of competition. The idea behind the national union was that employers in one region would be unable to gain a competitive advantage over their counterparts in another part of the country who produce the same goods through lower wages. Building on this insight, Turner (2000) and Martin and Ross (1999) tried to understand how European economic integration more generally—essentially nothing more than such an extension of the relevant product markets—influenced the organization and strategies of trade unions and concluded that one of the strategic priorities for the European Trade Union Confederation (ETUC) and its national and industry affiliates should be to develop structures to counter the international neo-liberal inspired European political economy that was emerging. Erne (2008), in fact, attributed a broader, democratizing role to the pan-European labour unions in this new political economy.

Whatever the substantive concern of these debates, a consensus slowly emerged that EMU was in a weak position, with its combination of a central monetary authority and multiple wage-setting systems—at least one

per country, sometimes more if additional divisions between sheltered and exposed sectors, public and private sectors, or ideologically diverse labour union confederations were taken into account. In one version of the argument, associated with the Calmfors–Driffill model, EMU would herald an inflationary scramble, since every individual labour union, relatively small compared to the overall size of the monetary union, would be able to externalize the inflationary costs of high wages set in their sector or country onto the monetary union as a whole (Hall and Franzese 1998; Iversen and Soskice 1998). Even if the central bank retaliated, the pain would be distributed across the entire continent, thus inviting every union to set wages for its workers opportunistically above the inflation-compatible rate. In another version, the one that labour unions themselves were most concerned about, competing collective bargaining systems would lead to a downward spiral in wages and working conditions (Martin 1999).

In an effort to avoid monetary retaliation or deflationary wage competition (or possibly both), labour unions across Europe set out on a quest for international wage coordination, whereby wage setters in one country would take into account relative wage levels in other countries. The idea behind this was relatively simple: constructing a pan-European wage-setting system organized around a national nominal wage target consisting of inflation and labour productivity would produce macro-economic stability (through low inflation) and prevent competition on wages and working conditions. The first of these two terms covers the cost of living adjustments, while the latter tries to balance two processes: disinflation and the distributive effects between labour and capital of productivity growth. Note that a nominal wage target in each country that reflects national inflation and productivity is not a fixed numerical target, but a relative one, which stabilizes the growth of relative unit labour costs across countries.

Such a wage coordination system built on relative targets also produces, beside low inflation and low wage competition, the important longer-term benefit of rewarding rising labour productivity. In countries with high labour productivity, it raises the feasible negotiable wage; in low-productivity countries it creates incentives for business and labour to adopt a trajectory based on productivity growth rather than low wages, which often involves paying more attention to skills and work organization (this mechanism that operates through a hard, sector-wide floor on wages is known as a productivity whip). Wage coordination of this kind thus controls inflationary wage growth, competition on wages, and has important positive effects on the demand as well as the supply side of the economy.

Examining the results of over a decade of attempts at international wage coordination leads to sobering insights, however. *Ex ante* wage coordination, whereby unions actively use wages in other countries as binding guidelines

for domestic arrangements is, by and large, inexistent. There have been a few isolated attempts to establish some direct synchronicity between wages in different countries—not least during the Maastricht process in the 1990s, when wages everywhere were shadowing German wages—but there are, perhaps surprisingly considering the energy spent, very few instances of direct and organized links between wages in two EMU member states. Even the Belgian unions, constrained by law to set wages at home as a function of wages elsewhere, have been reluctant to allow too much 'Europe' into wage negotiations and overshadow domestic concerns. A look at wage outcomes averaged over several years and across different countries, however, suggests that, *ex post*, some common targets appeared to have been adopted.

How do we reconcile the absence of active credible *ex ante* international coordination of wage setting with an outcome that suggests some measure of convergence? The key problem here is to determine to what extent this convergence of wage rates on a common level reflecting inflation and productivity is due to wage coordination across countries around a common target: what would the outcome have looked like if these attempts at wage coordination had been absent? The answer to that question is, perhaps somewhat surprisingly, that it may well have looked very similar. Start with what existed before EMU-related processes induced some form of coordination. During the 1990s, wage-setting systems in the prospective EMU member states were, as we saw in the previous chapter, increasingly organized as hierarchically nested arrangements. German wages were at the centre of a pan-European web made up of labour unions in the export sectors that shadowed German wage rates almost religiously. Within each one of the member states, in turn, other sectors subjected their wages to those of the export-sector unions. The upshot was that wages in country B followed wages in country A, adjusted for productivity (lest workers in country B priced themselves out of the markets where A and B competed), and that export unions in B carefully assured that other sectors also kept wage rates under control. Such a system of wage alignments could obviously be called 'wage coordination', but it is a peculiar form of wage coordination: imposed by international product markets and implemented through coercion at the domestic level. A more appropriate term for this process might, in fact, be competitive wage benchmarking: wage rates are set in one country and then adopted in other countries—roughly the situation that has prevailed in EMU since its inception. Wage coordination would imply that wage setters in different countries *ex ante* agree on (upper and lower bounds of) wage growth levels and then follow through on that agreement—a situation that we have probably never known in EMU or before.

But why, then, is wage coordination so difficult to organize? The target that the European trade unions have set—the sum of inflation and productivity

as the wage ceiling—is highly transparent and easily justifiable on grounds of fairness and, by focusing on labour productivity as the term defining the wage ceiling, on grounds of efficiency as well. It is, in other words, not difficult to sell as being in everybody's interest. Germany's fear of social dumping through wage competition that would undercut its social model is assuaged. Poorer countries have incentives to raise labour productivity and thus long-term growth through investment in skills and technology. And both governments and the ECB receive low inflation in return.

Pan-European wage coordination is, even when it is in everybody's interest, hard to organize for two related reasons. The first is that it poses an almost generic collective action problem. The example of oil cartels illustrates what this means. Members of oil cartels can gain tremendously if everyone sticks to production quotas, since it keeps the price of oil artificially high. But that produces a prisoners' dilemma situation in which the lure of short-term defections is greater than stable, long-term discipline: country A dumps oil on the world market to benefit from the higher prices following output restrictions in countries B, C, and D. The others face in principle the same situation, and coordination collapses despite being in the collective interest. Because successful and effective coordination to restrain output almost always invites defections, it is intrinsically unstable, especially in the absence of hard sanctions such as exclusion from the club.

In the world of trade unions nothing less is the case—but with a perverse twist. Assume for a moment that trade unions can assess the effects of their actions on other trade unions and on wages in other countries. This assumption is theoretically somewhat problematic because of the complexity and endogeneity of the problem,[1] but empirically considerably less so, because many unions in fact do have quite detailed (though admittedly not always perfect) information about the relevant parameters, such as wage, inflation, and productivity rates in other countries, and on how wages are set across sectors elsewhere. In this world, and against the background of a generally quite restrictive macro-economic policy setting, every labour union has a serious incentive to use that information to improve, in the short term, the terms of trade for the products within its sector by engineering a depreciation of the real exchange rate, but only, and importantly, as long as the others do not do so. In other words, wage restraint beyond what was agreed will have beneficial

[1] The (theoretical) problem is that the de facto target for a union is the real exchange rate (RER, the ratio of relative unit labour costs in countries A and B), which is as much a result of what a labour union in A does as of what a union in B does. If union A keeps ULC stable with an eye to maintaining a favourable (i.e. competitive) RER, B can still manipulate productivity and wage rates, on the basis of the information on A, so that B gains a competitive advantage. Essentially, this was the strategy that strong unions in small economies have systematically adopted vis-à-vis Germany in the 1980s and 1990s.

employment effects, and possibly even raise real wages for the workforce in one country, as long as labour unions in all other trading partners stick to the agreed level.

Second, this collective action problem is exacerbated by the interaction between the one-size-fits-all monetary policy of the central bank that governs the single currency, and the national responses to its interest rate decisions. If the economy grows fast in country A but not in B, the labour unions in A may be unable to keep wage demands by the rank and file under control. Given that a single central bank for A and B is unable to discipline wages in A without imposing large costs on B as well, A is likely to face an inflationary spike. Trade unions in country B, on the other hand, may be forced (or tempted) to moderate wages and gain a substantial competitive advantage as a result: exports rise, aggregate demand as well, and unemployment falls. In fact, if the export sector is the wage leader, as has increasingly become the case since the 1990s in many EMU member states, such short-term downward defections from an agreed target are more, not less, likely, precisely because of that sector's sensitivity to short-term trade shocks. (Of course, since labour unions in every country can play this game, these defections may, averaged over many years, well cancel each other out in the long run or, worse, lead to a deflationary spiral.)

Coordination of wage bargaining is, therefore, intrinsically difficult to achieve in such a highly interdependent system, despite the potential (average) gains that it might offer to all participants. Keeping in mind that the transaction costs of voluntary coordination increase exponentially with the number of participants, and that the benefits from short-term defections are not symmetrically distributed across sectors and countries, there are simply too many unknowns, both 'known and unknown', running through the system for it to produce a stable coordination equilibrium. If, despite this, the outcomes of wage setting suggest an alignment of wages and some measure of convergence, bear in mind that this may be at least as much, if not more, a result of market forces as of strategic coordination among labour unions in different countries. Deeper economic integration simply imposes competitive wage discipline in the exporting sectors, and that will look very much like *ex post* wage coordination to the naked eye.

The balance of this chapter will explore in detail what happened in wage-bargaining systems during the transition from the ERM/EMS to EMU after the introduction of the euro. How did unions handle the shift from the multiple parallel arrangements in the 1990s to the asymmetric world of a single central bank and multiple wage-setting systems? Most of them, as we will see, have stuck with tightly organized national systems of wage determination, coupled with tacit or explicit support for organizational innovations in the workplaces that raised labour productivity and which increased the degrees

of freedom for wage negotiations nationally. Others have not—and that difference has slowly manifested itself as one of the key drivers of the macro-economic divergences during the first decade of EMU. In the next chapter, I will extend that analysis and examine the interaction between the international and the domestic political economies of EMU to complete the picture.

3.2 The Elusive Quest for International Wage Coordination

International wage coordination has long been on the agenda of the European labour unions. It regularly emerged in discussions in the 1970s and 1980s, and in the early 1990s, after the Maastricht Treaty was ratified, the European Metalworkers Federation (EMF), attempted to orchestrate coordination on wages and working conditions among its member unions. Early initiatives involved working time in the car industry, as well as pre-emptive discussions about capacity utilization across plants during a time of restructuring and workforce reduction (Hancké 2000), but by 1993 wages themselves appeared on the agenda. That the EMF has been the most active of all the industry federations is hardly a surprise: the union organizes industries such as steel [which probably only survives today because of the European steel plans of the 1970s (Mény et al. 1987)], and automobiles, where increased competition and restructuring involving plant closures and mergers have been rampant since the recession of the early 1990s. (Dufresne 2009 offers a useful, succinct analysis of the history and analytics of wage coordination in the EU and EMU.)

After these initial attempts by what is almost certainly the European labour union federation most exposed to the challenges that international economic integration poses, and probably among the most strongly organized national federations throughout the continent, labour unions in other sectors, such as textiles and chemicals as well as the construction sector, followed suit, ultimately leading to a European federation for practically every sector, including the public sector. In actual attempts at the coordination of wage setting, the unions that organized metalworkers were also the first to lead, and other sectors to follow (Dufresne and Mermet 2002: 17). As the product markets integrated on the continent, unions started to cover the relevant labour market as well—or so it seemed. Some commentators, both inside the labour unions and without, lamented the absence of a strong legal framework for European labour relations (Streeck 1998; Dufresne 2009), but many envisioned this to be either a short-term problem (i.e. legal change would follow) or unnecessary, since labour unions would ultimately cover European sectors as they grew with the EU.

The year 1997 heralded another milestone, with the so-called Doorn agreement, named after the Dutch town where it was signed, which involved

labour unions from the Netherlands, Belgium, France, and Germany as partners who would observe and learn about wage setting in the other countries. The Doorn agreement was instigated by the Belgian unions who, having seen their bargaining space significantly reduced by the 1996 law on competitiveness, were eager to synchronize wages across their main trading partners. The idea behind the cooperation was to exchange information on how wages were set in the different countries and, more importantly, to assure that wage competition would be minimized, as all unions would use the same basic calculus (inflation plus productivity) when negotiating domestic wages. The Maastricht process itself, as we saw in the previous chapter, also implied that some form of leader–follower structure would emerge across the prospective EMU member states (Dufresne 2009: 105; Glassner and Pochet 2011).

Initially, these coordination structures seemed to have the desired effect. Averaged over a few years, in order to account for differences in bargaining power and cycles in the different countries, wages indeed grew roughly at the combined rate of inflation and labour productivity (Schulten 2002: 384–6). Table 3.1 presents the four-year average of the sum of inflation and labour productivity growth (the wage ceiling), of the actually negotiated nominal wage for each of the original EMU member states, and the difference between the two for the years 1999–2002 (minus signs mean that wages are set below the implied wage ceiling).

In half of the economies that joined EMU in the first wave, the difference between the total sum of inflation and productivity rates (the wage ceiling) on the one hand, and the actual negotiated nominal wage, was within a few tenths of a percentage point of zero on either side, and when not, the

Table 3.1. Inflation, productivity, and wages 1999–2002

	Average sum inflation + productivity 1999–2002	Average nominal wage growth 1999–2002	Difference between wage growth and average sum of inflation + productivity growth 1999–2002
AT	3.3	2.4	–0.9
BE	3.0	3.1	0.0
DE	2.2	1.6	–0.6
ES	3.6	3.5	–0.2
FI	3.9	3.5	–0.4
FR	1.9	2.2	0.3
IR	8.5	7.9	–0.7
IT	3.1	2.7	–0.4
LU	3.0	4.2	1.2
NL	3.7	4.4	0.8
PT	4.3	5.2	0.9
EMU 11	3.7	3.7	0.0

Source: European Commission; own calculations

deviation was usually on the downward side. Wages in Luxemburg were the only ones that showed a significant (upward) deviation from the EU 11 average (excluding Greece, which did not join EMU until 2001 and whose national accounts are notoriously unreliable). By all accounts, it seemed, wages in different European countries began to move in tandem—forming a wage snake (Dufresne and Mermet 2002), paralleling the currency snake of the early post-Bretton Woods years in Europe (when currencies moved against each other in narrow, pre-specified bands). Unit labour cost growth was aligned across most of the EU, and most sectors avoided corrosive wage competition. Labour union leaders heralded this as a major step forward in avoiding deflationary responses from governments and central banks, and as a means of preventing social dumping. It also demonstrated, they suggested, that pan-European labour union action was not a utopian pipe dream but something that could be built given the right institutions (Erne 2008; Dufresne 2009).

There are two—or perhaps better, at least two—problems with this interpretation. The first is that for many unions international coalitions are as much a tool to coordinate action across borders as a tool for safeguarding their interests at home. Labour unions in southern Europe, for example, took a long time before being persuaded that working time flexibility—which saved jobs in such capital-intensive industries as automotive and steel—should not be used as a competitive tool against more 'rigid' northern unions for whom working time reduction and stable working-day length was a crucial part of their identity (Locke and Thelen 1995). Similarly, European Works Councillors in the car industry have used the information in their meetings at least as much as means to think about a common position as ways to improve their bargaining position in capacity redistribution across European operations (Hancké 2000). And even in wage setting, the bias that coordination imparted upon the system was downward, not up: instead of collective action problems leading to inflationary spirals across different wage-setting systems, the externalities went the other way. Export-sector unions in smaller countries, such as the Netherlands and Belgium, systematically set wages below German wages (adjusted for productivity), thus exporting their unemployment to their larger neighbour. The action that we have seen on the European scene is therefore something of a double-edged sword, with cooperation, often instigated by the German unions who saw their social model eroded from without, on one side, and competition, following rational self-interest, on the other (Streeck 1998; Bernaciak 2010).

The second problem is slightly more complicated. Even if we accept that some measure of wage alignment has taken place, the assumption that this necessarily followed from increased wage coordination is slightly heroic. Convergence of wage rates, adjusted for labour productivity, has been around

since at least the mid-1980s in the DM-bloc and across almost all of EMU since the Maastricht Treaty in 1992—long before wage coordination as we understand it today was even on the agenda. The question is, in other words, what else but wage alignment we would have expected in the early years of EMU, given the pre-EMU system.

The main reason why this competitive form of wage benchmarking has prevailed has to do with the asymmetric effects of such a wage snake. Given the relative sizes of the Austrian, Dutch, and Belgian export sectors compared to Germany's, the latter may not even be all that aware of real exchange rate depreciations engineered by the export sectors in its smaller neighbours. And, even if labour unions in Germany did notice, they would probably not be able to do much about it, since the others are always in a position to impose wage moderation in a second round if a German reaction led to a loss of competitiveness. The Belgian unions are effectively forced to do so by law, and the others have more or less built that into their wage-setting arrangements as well. The upshot: not only could these small open economies manipulate their real exchange rate toward Germany, but because of the wage benchmarking, they also ended up as extensions of the German wage-setting system, moving more or less in tandem with German wage rates.

There has, in fact, been very little enthusiasm for strict wage coordination among unionists, despite the lip service: when I interviewed labour union economists and wage negotiators across all of EMU in the early 2000s, most admitted that they usually took wage-setting systems and their outcomes elsewhere for information only, not as hard or even soft guidelines. Strict coordination was problematic, they explained, even in straight-jacketed Belgium, because it upset the local bargaining culture with its particular gives and takes—and especially its nationally embedded 'holy cows', that is, those areas of the labour market where collective bargaining simply did not venture, or where one of the parties extracted a high price if the other one attempted to renegotiate. Precisely because not every area in collective bargaining has the same salience everywhere (Locke and Thelen 1995), top-down coordination would be likely to upset the local rules of the game, with unpredictable consequences.

The lack of enthusiasm among unionists is further nourished by the simple realization that wage coordination with a relatively strict target also played into the hands of employers in those countries where unions were relatively strong, since it gave employers essentially the outcome of wage negotiations by telling them what the floor and ceiling were that unions were willing to accept. Erne (2008) even goes so far as to suggest that social pacts have been deeply problematic for workers, since they reduced the share of national income going to wages (but see also Baccaro 2009).

While Glassner and Pochet (2011) record a very slow increase in wage coordination across Europe until the onset of the crisis, they conclude that it is not very significant in practice. In fact, coordination, even ex post coordination, has broken down at least as often as it has seemed to occur. In a prescient analysis, Martin Rhodes analysed such pay deals in the 1990s, alerting us to the competitive dynamic at their basis. In this new 'competitive corporatism' (Rhodes 1998), wages, set in a dense institutional framework for collective bargaining, were used explicitly as a means of improving the competitive position of the national economy by keeping wage growth and associated costs under control. Some countries thus improved their competitiveness considerably in a few wage rounds, while for others it deteriorated dramatically.

German wage rates offer an excellent illustration of this process. From the mid-1990s until the EMU crisis that erupted in late 2009, German wages, expressed in ULC terms, grew more slowly than those in practically every other economy in EMU. This followed a very rough patch for German competitiveness. Between the onset of German unification in 1990 and the engagement of the Maastricht process in the mid-1990s, Germany's real exchange rate appreciated dramatically as a result of several processes and events: German unification and the parity exchange rate with the Ost-mark, the ERM crisis during which almost all other economies in the EMS devalued against the Deutschmark, and the institutionalized nominal convergence of the Maastricht process which forced a convergence of ULC growth on the German level. Some estimates put the drop in German competitiveness around 20 per cent in the space of five years following the fall of the Berlin wall (Carlin and Soskice 2006: 714). Finally, Germany entered EMU with a highly overvalued exchange rate. German wage moderation over the fifteen years between 1995 and the EMU crisis was, in this light, not much more than a correction to these accumulated problems. Whatever the reason for wage moderation, by targeting a significant improvement in the German real exchange rate, it did imply that Germany's labour unions bailed out of the international wage coordination system that they had asked others to follow. (Figure 3.1, demonstrates how sharply Germany's real exchange rate improved against the southern EMU members since the introduction of the euro.)

The Netherlands has actually been one of the few northern countries to suffer periodic falls in competitiveness since the introduction of the single currency. During the first five years of EMU, wages in the Netherlands went on a rollercoaster ride, with periods of high inflation followed by emergency wage tightening (Johnston 2009). The explanation for these wild swings is quite simple. The introduction of the euro coincided with a shift in the Dutch wage-bargaining system that slowly freed local wage bargainers from central oversight in both the public and the private sector. Wages thus followed the

business cycle more closely, growing moderately in periods of slow economic activity, but rising fast in boom periods, pushing up the overall inflation rate and thus compromising competitiveness through a rising real exchange rate (Johnston 2009: 30–31). On those occasions, the government responded with emergency wage negotiations to bring the real exchange rate back in line with those of its main trading partners.

Developments in Austria were, in many regards, a mirror image of those in the Netherlands. Adjusted for productivity, Austrian wages systematically remained slightly below Germany's for the first five years of EMU. Austrian wages witnessed neither spikes nor emergency wage measures, but wage moderation, imposed on all sectors through pattern bargaining (Johnston 2009: 25–6). The Austrian trade union confederation ÖGB kept tight control over wage setting in the country, both through legal means and through political control over its affiliates, with the effect that wages in the entire economy followed the export-sector determined wage target very closely.

As alluded to earlier, both the Netherlands and Belgium have used real exchange rate depreciations to export unemployment, mainly to Germany. However, whereas the Netherlands occasionally lost the wage discipline it had built up over the last decades, Belgium did not, and used that to grow faster and, on the back of high growth, export its unemployment rate to its large trading partners. There is admittedly a bit of a puzzle here, since Belgium has had a rather high unemployment rate (especially for a northern European economy) for much of the period since the second oil shock (hovering around 10 per cent for several decades, when unemployment in Austria, the Netherlands and Germany often was three, four and sometimes five or more percentage points lower). However, this high national rate hides vastly different regional unemployment rates within the country: the rate for Flanders has been of the order of 5 per cent for most of the 1990s and 2000s, while unemployment in Wallonia (and Brussels) has consistently been above 15 per cent since the mid-1990s. While there are very few studies on this large inter-regional discrepancy, the available data suggest that the unemployment rate in the two regions developed very differently because of the way similar (nationally determined) moderate wage settlements have interacted with the export structure of the country. Since Flanders accounts for over 75 per cent of Belgian exports, wage moderation, which leads 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 because of its relatively weak export sector (the policies may, in fact, have made things worse in Wallonia, since low real wages depressed private consumption). This interpretation is supported by the considerably higher sensitivity of Flemish unemployment to the business cycle: it rose sharply with the 2001 downturn in Flanders but remained stable in Wallonia. Flanders has, as

this suggests, adopted a regime based on economic growth through a favourable real exchange rate, as the Dutch did in the 1990s.

While the northern EMU member states reorganized their wage-bargaining systems to take full advantage of their wage moderation capabilities, none of this happened in most of the peripheral European economies, particularly in the south. The story can be told quickly: where persuasive wage coordination existed, as in Italy, it was dismantled by the right-wing Berlusconi government, supported by myopic, opportunistic employers who rapidly forgot the benefits of coordination that they had praised a few years earlier (Simoni 2012). Of the other countries politely referred to as GIPS, none had a sustainable wage-setting system, with the exception, perhaps, of Ireland. The effect was that the relatively healthy position that these countries had built up over the previous decade, deteriorated rapidly. Relative unit labour costs of the southern economies skyrocketed in comparison with Germany. In the decade following 1999, unit labour costs in the south increased by 33 per cent: in Greece by almost 40 per cent, in Portugal by 25 per cent, and in Spain by about 35 per cent, while Germany saw a modest 5–7 per cent rise, concentrated in 2008–9 (the source for these data is the OECD). Their real exchange rate followed an even more dramatic divergence: Figure 3.1, borrowed from Scharpf's (2011) excellent analysis, shows how the real exchange rate of Germany and the peripheral economies converged dramatically until 1999—that is, under the Maastricht Treaty's convergence criteria—and then diverged equally dramatically since the introduction of the euro. These two facts suggest that German neo-mercantilism may have something to do with these divergences, but it is far from the whole story. The sharp rise of unit labour costs in the southern economies while the north kept them under control leaves little doubt that the problem has been probably as much home-made in the south as it has been simply a result of Germany's macro-level productivity coalition of strong trade unions and employers.

Europe—EMU Europe—thus began to resemble a sharply divided regional political economy after the collapse of wage coordination in the periphery and its increase in the north. The northern EMU members (including Austria) increasingly became a fully integrated political economy—with each one of them seemingly competing for the title of the seventeenth Bundesland. Wages and real exchange rates were aligned, and their export profiles converged as well. There were small problems, such as the Dutch inflation spikes in the first few years of the single currency, or the grotesque inability of Belgium to form a government twice in a handful of years, but the northern system, relying on a tightly organized wage snake, survived easily. Against this background of 'ever closer union' in the north, based on German-led disinflation, the southern member states witnessed an increase in average inflation on the back of sharply rising unit labour costs, and thus sharply appreciating real

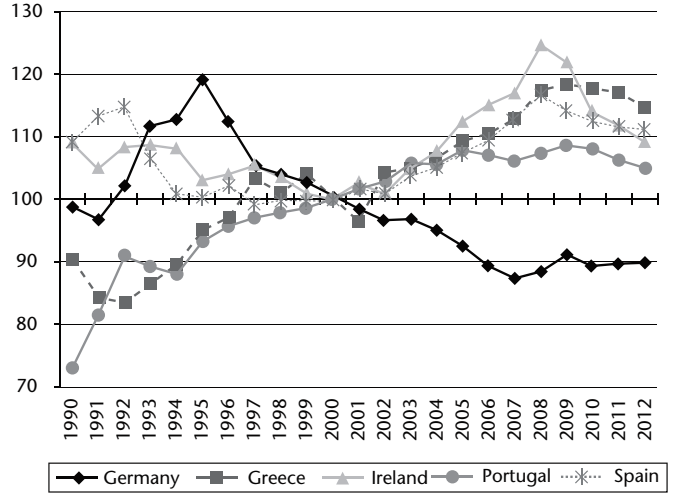

Figure 3.1. Real effective exchange rates, Germany v. GIPS, 1990–2012

Source: Ameco Database

exchange rates. The gains in wage moderation that they had made during the Maastricht process in the 1990s had been lost, in large measure because their wage-setting systems were unable to contain wage inflation when the economies were growing fast.

What, then, happened in the north: how and why did the northern countries align wages so much more strongly than in the south? The next section explores the mechanisms at the basis of the northern convergence. In essence, the system consisted of two mutually reinforcing movements: a centralization of wage determination and a significant decentralization of other issues in the labour market. The first imposed the wage ceiling that had become so important in northern wages; the second raised that ceiling by producing plant-level 'productivity coalitions'.

3.3 Central Wage Determination and Decentralized Labour Relations

One of the surprises of the 1990s was that, after a decade of widespread decentralization in collective bargaining systems (Katz 1993; Katz and Darbishire 1999), many European countries preparing for EMU witnessed

a remarkable re-centralization of their wage-bargaining systems. While it took different forms in the different countries, and often was hidden under the rhetoric of decentralization, labour unions appeared to take control of wage bargaining again, and the coverage of collective bargaining increased (or was stable at a high level) in the countries preparing for EMU (see Pochet and Fajertag 2000). But centralization—or, perhaps better: central coordination—of wage bargaining meant different things in different settings. Even though governments played a large role in the redesign of wage setting everywhere, the outcome was almost invariably a mixture between specific new policies and the institutional history of the country's wage-setting arrangements.

In the first group of countries, wage-bargaining systems re-centralized rather dramatically, a process often accompanied by changes in the statutory framework to enforce centralization as well as wage moderation. Belgium, Ireland, and to some extent Spain, are examples of this: at the latest from the mid-90s onwards, wage rates started to follow strict central guidelines, a process in which government and union (con)federations as well as employers' federations played a central role. In Belgium, wages have been set according to a centrally negotiated wage norm. 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 organizations have been left with very small negotiation margins. The Irish social pacts, which included an important wage restraint component as well, always transferred authority to the central level at the expense of the slightly less disciplined industry federations.

The second group of countries is made up of those where, despite clamours of decentralization, the practice of wage setting has de facto remained highly coordinated and centralized: the Netherlands and Germany. While prima facie wages in the Netherlands are negotiated in the companies, up until 2001, final approval of a local 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. After the introduction of the euro, the Netherlands formally decentralized wage setting, but immediately reverted to central wage agreements when wage inflation appeared to spin out of control in 2003 (Johnston 2009: 7).

The German wage-setting system has always operated in a different way. Despite some elements of decentralization, its key orientation points are pilot negotiations in the export/tradable goods sector, which are then transferred to

the rest of the economy to become the benchmark for further company-level bargaining. 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 rates in the metal-working sector became the norm for all sectors. According to data compiled by the German trade unions (WSI-Tarifarchiv, various years), up until very recently IG Metall set the pace; since 2000, the chemical union has occasionally taken over this leadership role. Other sectors followed, with wage settlements that rarely deviated by more than one percentage point from the initial agreement in the sector that was the wage leader. In large measure, this relative stability of the German wage-setting system is supported by 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 2007). Central wage moderation has kept labour costs down while local bargaining on such 'qualitative' issues as working time, skills, and work organization has allowed firms to reorganize their internal operations.

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 have consistently been very weak since the second oil shock—too weak, by most accounts, to play a critical role in collective bargaining—but that the bargaining coverage rate (the proportion of eligible workers covered by collective bargaining) has, for many years now, been one of the highest in the OECD countries, higher, in fact, than the traditionally highly organized systems in Scandinavia or Belgium. The key to this mystery is that the wage-bargaining system is largely organized around the needs of the large firms in France, who have 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 organization. These wages were then proposed to the unions in branch-level bargaining rounds, and extended by the Ministry of Labour to cover the sector as a whole.

Thus, pressures from two sides led to the re-centralization of wage setting during the 1990s. One was the run-up to EMU, when 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 employers' concerns.

Organizational centralization of wage bargaining has been one crucial shift in the northern eurozone. Wage benchmarking has been the other. By the early 2000s, the authority for setting wage demands had increasingly shifted from the pre-existing (at least formally) more or less democratic model, whereby wage demands were ratified by the rank-and-file or their

representatives on national labour union boards, to a small group of centrally appointed wage experts, inside and outside the labour unions, whose task it is to define 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-)centralization of wage bargaining: it allowed governments and wage negotiators to set wage targets commensurate with inflation.

The arrangement itself has taken 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 on economic competitiveness, a small expert group in the Central Economic Council (CRB-CEC) has set a wage norm that is binding for all negotiations. Since Belgium is the only EMU member state left with a statutory wage indexation mechanism, the wage norm concentrates on competitiveness (as the law prescribes). The outcome of wage negotiations, therefore, increasingly follows 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 Ireland, the 1987 social pact de facto transferred the determination of wages to a small group of experts. As these national cases suggest, wage norms can be more or less binding. However, even where the wage norm is not binding, it offers a strong authoritative framework since it is de facto used by governments, employers, and unions.

In another group of countries, the labour unions have kept control of the process, but have internally delegated the decision-making to a small group of 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, the central labour union board officially sanctioned every contract (even though it was formally signed at the company level), relying on current labour productivity and the changes in producers'

prices as the key parameters for their calculations. 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 Jacques Delors imposed a de facto ceiling on wages (as part of his policy of 'competitive disinflation' which was linked to the political decision in the early 1980s 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 persuasive) signals about what it considered appropriate wage growth levels. Combined, these aggressive wage benchmarking regimes, underpinned by centralized wage determination in different guises, help shed more light on the convergence of wage rates captured in Table 3.1 than pan-European wage coordination does. Since all look across borders when setting wages, it is hardly surprising that wages grow at a similar rate when labour productivity is taken into account.

However, this picture of developments in the EMU member states everywhere but particularly in the north simply as a re-centralization of wage bargaining, substantively guided by a centrally defined wage norm, fails to capture the complexity of labour and employment relations after the introduction of the euro in one important respect. The turn towards decentralized labour relations that many of the current EMU member states witnessed in the late 1980s and early 1990s (Katz 1993; Katz and Derbyshire 1999) has left its traces in the post-EMU wage-setting systems. Since the late 1980s, many so-called 'qualitative' issues in labour relations, such as work organization, training, working time, and job design had acquired a central status on company and plant-level industrial relations agendas. This interaction between central wage coordination and decentralized employment relations has produced a deep divergence between different wage-setting systems in north and south.

The current regime reinforces this arrangement, since it produces strong incentives for labour unions to cooperate in firm-level productivity drives. Since the centrally coordinated wage-setting systems all over the eurozone take productivity growth as the de facto ceiling for wage demands, this implies (under the current low inflation regime) that faster productivity growth allows labour unions to claim higher nominal and real wage increases without endangering competitiveness or low inflation. This explains the division of labour between the central and the local unions and, especially, the centrally sanctioned incentive to join in local productivity drives. Company and firm-level labour unions and works councils in most northern EMU member states have turned their attention to training where they had not done so already, have started to cooperate in new company-level quality control

systems, and on the whole contribute eagerly to local productivity drives. The IG Metall even has developed proposals for a new wage-setting system that does away with the blue and white-collar distinction in how wages are set (hourly versus monthly), and which would be primarily based on the skills acquired rather than the actual job done. Companies in economies with a centrally coordinated wage system have, in turn, faced a very different environment than elsewhere in the eurozone for the better part of two decades now, as I will explain in more detail in Chapter 5: they spend more time and money on employee training, have more decentralized decision-making structures involving employees, have a slightly more stable workforce and face fewer social conflicts.

The aggregate effect of this activity at the local level has been significant: average annual unit labour cost growth over the 1990s in the northern EMU member states has been a quarter of that in the south (1.3 per cent versus 5.4 per cent), driven equally by higher labour productivity growth and wage moderation (Hancké and Herrmann 2007: 132).

Ultimately this has led to a convergence of different industrial relations systems in the north on the one that we have traditionally associated with the German model, in which wages are set centrally, and unions play an active role in the internal management of the company. The shift in the macro-economic regime associated with EMU, therefore, seems to have produced a shift in the micro-economic logic of the different models of capitalism in Europe as well. The result: in many countries unions have become active partners in the formation and development of skills, or have strengthened that role. The only exception is France, where this process took place not via unions, but via a functional equivalent of employer-led plant-level institutions that dramatically improved productivity in the 1980s and 90s and has the structural potential to do so in the future (Hancké 2002).

In sum, the new wage-bargaining regime thus appears to have institutionalized a strict division between wages, which are bargained centrally, and productivity- or competitiveness-enhancing measures, including skill formation, organized at the local level. This has led to a reorganization of trade union structures, especially in those countries where firm-level unionism was not highly developed, in order to accommodate these local labour productivity drives.

Conclusion

When EMU was designed, labour unions in the wealthy West-European economies attempted to build a parallel system of international, cross-border coordination of wage setting. Wages in country A and B, thus the idea,

would be set simultaneously, using a similar set of guiding parameters—with inflation as the floor and labour productivity as the ceiling for wages. This avoided both wage competition, since real wages rose, and an inflationary wage push, because wage growth remained below labour productivity. Yet coordination of wages, defined as *ex ante* agreement on wage levels between unions in different countries, never really developed: defection problems beset this soft form of coordination without hard sanctions, and labour union negotiators were not very keen to give up their autonomy. But *ex post* wages did converge on the levels implied by the sum of inflation plus productivity, because labour unions all over Europe had used the Maastricht period to build systems of wage benchmarking, ultimately shadowing German wage rates. This tightly linked system of wage benchmarking and shadowing was, to a large extent, a hangover from the system that had emerged in the 1990s—but it survived in this guise only in the north. The peripheral economies abandoned their relatively disciplined systems relatively soon after the introduction of the euro, as we will see in the next chapter. While the north by and large shadowed wages (expressed in ULC) in Germany—although admittedly within wider margins than during the Maastricht period—wages in the south (and even Ireland) diverged considerably from the implicit German target.

The relatively tight linking of wages (again, in unit labour cost terms) had one important beneficial effect: it produced strong incentives for unions to address issues of labour productivity, since that allowed them to negotiate rising real wages without producing inflationary pressures. Labour in the north thus started to build local productivity coalitions—not a new phenomenon per se (Windolf 1989)—but this time around it was sanctioned by the central labour union confederations, precisely because of how it increased their degrees of freedom in central wage negotiations. The decentralization of labour relations that had started in the 1980s thus had a new face by the early 2000s, in which wages were set centrally and productivity-enhancing elements of the political economy were organized locally.

The aggregate effect in the northern—but not the southern—EMU member states was that of a slow-moving tanker making a U-turn: this interaction between micro and macro-level structures slowly but certainly increased competitiveness in the north (while their absence did the opposite in the south) of Europe. Eventually the discrepancies between the two led to the massive current account imbalances that we saw in the late 2000s. Chapters 4 and 5 explore these and other perverse dynamics within, and produced by, EMU.

4

Diversity without Unity

Labour Unions and Wage Setting in EMU

EMU is, as many have pointed out, a unique experiment: it involves a voluntary but partial transfer of economic sovereignty, combining a centralized monetary policy with decentralized fiscal policies and wage-setting systems. As the 2010–12 fiscal crises in EMU, which morphed into a crisis of the currency union itself by the end of that year, have made abundantly clear, these discrepancies between different policy levels create their own problems. Most attention during the crisis of EMU has gone to the relative ability of countries to finance their sovereign debt—often to bail out banking systems that had become very fragile after the financial crisis of 2007–8. While this was certainly the most immediate manifestation of the crisis during those years, a slightly longer retrospective look suggests that an equally complicated process of adjustment, or perhaps better, of mis-adjustment was playing out in wage-setting systems.

This chapter will explore several dimensions of the adjustment of labour market institutions and wage-setting systems against the background of the introduction of the euro in 1999. It starts with one of the key mechanisms underlying the north–south divergence in inflation rates, real exchange rates, and competitiveness: the relation between wages in the sheltered (primarily public) and exposed (primarily export) sectors. EMU has produced deeply perverse effects for the relation between these two (Johnston 2012). Recall that the alignment of macro-economic policies under the fixed exchange rate regimes of the DM-bloc and the Maastricht process (ERM/EMS) required a disciplining of trade unions, both in the exposed and the sheltered sectors. The institution of EMU (and the disappearance of national central banks) changed the set-up within which these two types of trade unions operate. Contrary to the standard understanding, it did not, in fact, open the possibility for across-the-board wage explosions, but only in the domestic (sheltered) sector. The exposed sector still faces a hard constraint in the shape of

external competitiveness, and is therefore compelled to keep its wage growth under control. However, since this is no longer the case for the sheltered sector, which faces neither competitiveness nor monetary policy constraints, wage militancy increases in these sectors, particularly in countries where public-sector unions exploit their independence from unions in the exposed sectors.

While public-sector wage setting is on the whole still firmly tied to wages in the export sectors in the northern CMEs, this is much less the case in the southern economies and Ireland. Within the eurozone today, two large blocks of economies therefore exist: a highly integrated northern block where coordinated wage bargaining keeps wage costs under control in all sectors of the economy, and the southern European countries, where labour costs have risen relative to the north. Since real exchange rates are the main adjustment mechanism within EMU, this set-up leads to a growing divergence between these two sub-economies within EMU.

4.1 Labour Unions in a Monetary Union

The literature that has tried to evaluate the effect of EMU on wage-bargaining systems and wage setting revolved around three scenarios. The first, as we saw in Chapter 3, was the somewhat idealistic pan-European wage coordination system envisioned by the European trade unions. The second was a deregulation of the labour market, either forced by competition between different labour jurisdictions, or imposed by governments in a search for flexibility and competitiveness now that currencies no longer obfuscated or were able to hide price differentials. The final, and probably most realistic one at the time, was an all-out inflationary scramble: all trade unions, relieved of the constraints imposed by their national central banks and too small to be directly affected by the ECB, would go for higher wages.

None of these scenarios ensued, however—with the possible exception of Germany's marginal, and probably insignificant, labour administration reforms in the mid-2000s. The OECD's evaluation of its own Jobs Strategy, dating back to the early 1990s (OECD 1999, OECD Statistics Portal), essentially a strategy for labour market liberalization, indicated that very few of the liberalizing reforms that they had proposed as necessary in their 1994 report had actually taken place, and that some countries even went in the opposite direction. Labour market liberalization, if it happened at all on the continent, was therefore not very important on the whole. EMU-wide wage coordination, in turn, never really took off because of the endemic collective action problems associated with it. Trade unions may have developed an understanding of what their counterparts in other countries were doing; yet

when wage negotiations started, national considerations easily trumped any other considerations. Perhaps most surprisingly, Europe did not witness massive and persistent wage inflation across the continent either: while inflation rates in the different EMU member states diverged after 1999, from a spread of about 1 per cent in 1998 to a spread of about 6 per cent by the onset of the crisis, and the average inflation rate remained close to the ECB's target range of 2 per cent, the highest inflation rate recorded was hardly excessive: in Slovenia, inflation went up to about 5½ per cent in 2008.

The analyses that predicted EMU-wide liberalization, pan-European wage coordination, or an inflationary scramble, missed two key dynamics in the wage-setting systems of the continent: one was the extent of wage shadowing in this new monetary union—the process whereby wages in one member state reflected wage settlements in another—which itself was a remnant of the tightly linked wage systems in existence during the previous decades. The other was the implicit tension between wage setters in the exposed and sheltered sectors, a tension subdued by the institution of the DM-bloc and the Maastricht process, but resuscitated by the introduction of the euro. Combined, these two dynamics produced a very different set of outcomes from the ones that the dominant views had predicted.

Wage shadowing in some form or other had been around for a long time by the early 2000s. It was part and parcel of the responses by labour unions to the EMU convergence criteria imposed as a result of the Maastricht Treaty, especially in the DM-bloc, and the institutions that underpinned it, such as wage norms, central wage coordination, and a strict separation between wages and other issues in labour relations were also carried over into EMU. There were important differences, however, between the forms of wage shadowing that existed before and after the introduction of the euro. In essence, the DM-bloc and the Maastricht-based wage shadowing were coercive in nature because of the imposition by the domestic central banks. The central bank made sure that wages did not exceed inflation targets—but these were given by the Bundesbank, and shadowing German wages was the only way to keep domestic wage inflation in line with Germany. The post-EMU one was, in that sense, voluntary, since no one was able to impose wage restraint on individual labour unions any more.

Second, in the 1990s all EU countries that had expressed their intention to join EMU adopted some form of wage shadowing, for the simple reason that German inflation was, more or less, the Maastricht target, and because stable, low inflation resolved many other problems associated with the Maastricht criteria as well: it stabilized exchange rates against Germany, kept interest rates under control as a result, and even helped bring debt levels down because of the beneficial effect of prospective EMU membership on the risk premium incorporated in the government interest rate (Bronk 2002). But

EMU was asymmetric in that respect: while it was necessary to meet stringent macro-economic convergence criteria to enter the eurozone, after the adoption of the single currency, the hard sanctions for excessive inflation or debt became at best (or worst, if you want) soft sanctions—the equivalent of a raised eyebrow, not of the handcuffed escort out of the bar. Wage shadowing therefore remained important for some countries while it lost its significance for others.

Finally, and in part reflecting the two previous points, economies with a high degree of embedded wage coordination, either through stable incomes policies or through broad neo-corporatist frameworks, were able to mobilize those to carry on shadowing German wages (admittedly within wider bands than in the 1990s), while the others, in the south of Europe (and, to some extent, even Ireland with relatively strong wage coordination) adopted wage targets that did not reflect wage developments elsewhere. The northern, coordinated, market economies remained in Germany's wage orbit, while the peripheral economies decoupled from the EMU-wide target that had dominated wage setting in the Maastricht years.

The increased tension between wage setters in exposed and sheltered sectors, largely a consequence of the shift from national to a pan-European central bank, was the second dynamic that many previous analyses missed. Because of the institutional subordination of public-sector wages to export-sector wages, which happened in the early 1980s in the DM-bloc and elsewhere under the Maastricht aegis, many observers quite reasonably bracketed out wage developments in the former when contemplating the future of wages and wage inflation in EMU. But that tacit assumption was incorrect: public sector unions were kept in check by an implicit coalition of unions in the export sector, governments, and central banks, with the latter wielding the largest baton. Taking the national central bank out of the picture therefore implied that, all other things equal, the overall effectiveness of constraining wage inflation in the public sector diminished sharply. Export unions and governments may still have preferred public-sector wages to grow moderately under EMU, but they were suddenly less likely to obtain that, since the national central bank no longer wielded the power associated with the last-mover position that it had under the ERM. (This probably explains why the Stability and Growth Pact, the SGP, adopted in Amsterdam in 1997, says very little about inflation, but a lot about government deficits: rising wages in the public sector might relatively rapidly lead to unsustainable government finances, while rising inflation only hurts the inflationary parties themselves by making their export goods more expensive abroad).

If the strong trade unions in the sheltered sector started to exploit their newly found power, however, the fragile balance between different countries and between different sectors within one country that was at the basis of the

Maastricht regime, would come unstuck (Garrett and Way 1999). Inflationary pressures thus increased in countries where the public sector escaped the constraints imposed by the Maastricht regime, both as a result of inflationary wages in the public sector (usually 30–40 per cent of wages in the economy as a whole), and as something like a reverse Balassa-Samuelson effect, in which relatively attractive wages and working conditions in the public sector force employers in the export sector to raise wages, as happened in Sweden in the 1980s and early 1990s (Ahlén 1989; Pontusson and Swensson 1996).

The poignant, stylized fact that accompanies this short theoretical discussion is that the escape by the public sector from centrally imposed wage discipline more or less coincides with the north–south divide in Europe. Southern European public-sector wages diverged significantly from those in the export sector after 1999. At the same time, wage shadowing also became less important in the south than it had been in the Maastricht years. The two mechanisms that had been at the basis of the successful adjustment to the Maastricht process disappeared, almost simultaneously, practically overnight, and the stage was set for the current account divergences that fed the crisis of EMU. The following section analyses empirically the first of these points, related to sheltered and exposed sectors, through an analysis of wage restraint in the public and manufacturing sectors as proxies. Section 4.3 does the same for the earlier point on wage shadowing. The final section concludes.

4.2 Trade Unions in Exposed and Sheltered Sectors

The single most important institutional change from the ERM to EMU was, almost by definition, the disappearance of the national central banks as monetary policy-makers and their summary replacement by the European Central Bank (ECB). Recall how, in the fixed exchange rate regimes, central banks policed inflation rates, in a very strict form in the DM-bloc in the 1980s and in a slightly looser form during the Maastricht process in the 1990s. If wage-setters systematically exceeded wage targets that were implied by the exchange rate, banks raised interest rates to force inflation back in line—these restrictive policies rapidly fed into falling economic activity and thus lower wages. Since most trade unions were well aware of the reaction of the central bank to excessive wages, they anticipated, by internalizing, the central bank's interest rate response (Hall 1994). The result was a tightly integrated system, in which central banks were linked to each other through the fixed exchange rate against the DM, and unions through the shadowing of German wage rates.

The introduction of the euro changed that. Trade unions that had figured prominently in the world of conservative central banks in the 1990s suddenly were reduced to one among many, even in countries where wage

bargaining was highly coordinated. In the limiting case, even the powerful German engineering union IG Metall, without question one of the key factors in the German Bundesbank's understanding of the world in the 1980s and 1990s, would see its weight in the ECB's reaction function decrease quite dramatically. In abstract arithmetic terms, it fell from close to 100 per cent of the Bundesbank's reaction function prior to 1999, reflecting the central place of the union in coordinated wage setting in the country, to about 10 per cent in the new set-up (since Germany accounts for about one third of EMU's GDP, and the engineering sector accounts for slightly less than one-third of Germany's employment, that is, $1/3 \times 1/3 = 1/9 = 11$ per cent).

At the same time, and mirroring this development, labour unions that had been forced to set their wages reflecting the low-inflation engineering and other export sectors, suddenly discovered degrees of freedom that had lain dormant for more than a decade in most countries. The replacement of national monetary authorities by the ECB had the inadvertent effect of releasing trade unions in the public sector from the tight wage-setting constraints that they had faced since the 1980s and early 1990s. While national central banks were able to keep those sectors in check before EMU, the institution of the ECB lifted the monetary lid on wage demands in the sheltered sectors that the central banks had directly or indirectly imposed.

The institution of EMU would therefore have led to inflationary pressures everywhere, in other words—with the exception, perhaps, of the weakly organized private services sector. Since national central banks no longer were able to impose a hard constraint on individual labour unions, and any of them counted for too little in the ECB's reaction function, unions were, freed from those constraints, able to pursue higher wages everywhere. But all other things were not equal: the regained freedom was, in fact, not symmetrically distributed across the different unions. Labour unions in the export sector (shorthand for the sector that produces tradable goods and is therefore exposed to international competition) may have rid themselves of the constraints of the central bank, yet they still faced a tough competitiveness constraint as a result of deeper economic integration. If, adjusted for labour productivity, their wages rose faster than those in the export sectors of their main trading partners, the loss of competitiveness would rapidly lead to falling employment, lower wages, or both. For these unions, the constraints that central banks imposed may have disappeared, but only to be replaced by a second hard constraint, built on market discipline.

That was not the case in the public sector, which faced no, or negligible, competition, and for which the main external constraint was the relatively weak SGP. For trade unions in this sector, the introduction of the euro heralded a massive increase in the degrees of freedom that they faced with regard to wage setting. And these unions exploited those newfound degrees

of freedom. Compare the data on wages in the two sectors for the 1990s with those for the 2000s in Table 4.1 (reflecting the periods before and after the introduction of the euro). The table lists the correlation between three-year moving averages of 'wage moderation' (nominal wages minus labour productivity) for the two periods in the manufacturing and the public sector (the latter covers public administration, health and social care, education, and defence). In the 1990s, when all the countries listed prepared for EMU, nominal wages followed the same path of moderation in their export and public sectors almost everywhere. The correlation coefficients, which measure the degree of co-variation between wages in the two sectors, were very high, in

Table 4.1. Wage restraint in the manufacturing and public sectors 1991–2005

	Manufacturing and Non-Market Services 1991–98	Manufacturing and Non-Market Services 1999–2005	Real wage growth in public sector minus total factor productivity growth 2000–8
Austria	0.91***	–0.84**	–11.61
	(0.002)	(0.017)	
Belgium	0.85***	0.06	19.22
	(0.008)	(0.904)	
Finland	0.91***	–0.42	14.95
	(0.002)	(0.352)	
France	0.53	0.49	10.03
	(0.172)	(0.263)	
Germany	0.95***	0.15	–17.89
	(0.000)	(0.750)	
Ireland	0.15	–0.03	104.99
	(0.720)	(0.952)	
Italy	0.93***	0.88***	18.28
	(0.001)	(0.009)	
Netherlands	0.86***	0.40	10.77
	(0.006)	(0.375)	
Portugal	0.99***	0.90***	–2.25
	(0.000)	(0.006)	
Spain	0.97***	0.63	52.32
	(0.000)	(0.126)	
EMU AVERAGE	*0.81*	*0.22*	10.04
Denmark	0.90***	0.70*	
	(0.002)	(0.081)	
Sweden	0.92***	0.79	
	(0.001)	(0.034)	
NON-EMU AVERAGE	*0.91*	*0.74*	

Source: Compiled from Johnston and Hancké 2009: 609–10 and, for the last column, the AMECO database.

P-values in parenthesis. *, **, and *** indicate significance on a 90%, 95%, and 99% confidence interval.

Note: Table 4.1 presents the pair-wise correlations between the 3-year moving average annual 'wage restraint' indicator (see below) in the exposed sector (proxied by manufacturing) and the sheltered sector (non-market services). Data are from the EU KLEMS database; the 3-year moving average was computed to account for discrepancies in the timing of wage bargaining in the different sectors. 'Wage restraint' reflects the difference between the annual change in nominal wage growth and the annual change in productivity growth: a negative sign thus indicates wage restraint, since wages grow more slowly than productivity.

the vast majority of the cases around 0.90—close to perfect correlations, in other words. Both the export and the public sectors thus set wages in ways that reflected their respective productivity developments, and in doing so kept wage inflation under control.

That changed, quite dramatically in some instances, after 1999 (Johnston 2012). The correlation coefficients collapse completely or even change sign in five out of the eight countries where public-sector wages closely followed wages in the export sector during the 1990s: this is the case in Austria, Belgium, Germany, Finland, and the Netherlands. The divergence in the coefficients between the two periods in effect means that the rise of wage inflation in the public sector is compensated by wage deflation in the export sector, with labour productivity growth outpacing wages. In Italy and Portugal, where the correlation coefficients between the two sectors remain high, they reflect the fact that both sectors were actually setting wages well above productivity, thus leading to the rising inflation rates that were feared earlier. The comparison with Sweden and Denmark, at the bottom of the table, is very instructive, since it suggests that an autonomous national central bank is an important domestic institution in such a set-up: while the correlation coefficients between wage moderation in the manufacturing and the public sectors for the two periods also fall slightly in these countries, they remain much higher than in almost any of the other highly coordinated north-west European economies. These data therefore suggest that after the introduction of the euro, wages set by trade unions in the public sector and in the export sector, expressed in ULC terms, no longer co-varied. Considering that, on the whole, export-sector unions still have to make sure that their wage rates do not exceed productivity growth rates, this can only mean that, where the correlations do change dramatically, wages in the public sector no longer follow the moderate path that they had been on for over a decade by the time the single currency was introduced. And most importantly, perhaps, this divergence is not just a symptom of fading wage coordination: similar correlation coefficients for nominal wage *growth* in the two sectors (which is what unions target in pattern-bargaining arrangements and similar forms of wage coordination) remained high and stable (Johnston and Hancké 2009: 611).

This is an important finding, and the timing leaves little doubt about the causes and the mechanism: once the national central banks disappeared as the local economic police, the logic and organization of wage setting in many EMU member states changed dramatically. The export sector retained a fundamentally disinflationary wage-setting system, with wages rarely growing above productivity, while wages in the public sector began to exceed sector-level productivity growth in many cases. (Here I pragmatically define public sector productivity growth as the residual after subtracting from aggregate total factor productivity the productivity [i.e. Gross Value Added] that

is accounted for in other sectors. See the discussion on the methodology in Johnston (2011: 43–7), on which I rely here).

Why did not all countries witness such a significant divergence between wages in the public and the export sector? Most of the conditions identified earlier have, after all, been or become almost identical everywhere. Both sectors have strong trade unions in all member states. National central banks disappeared as the monetary policy-maker in all eurozone economies. And public-sector unions in all of EMU had a lot of catching up to do after more than a decade of austere wage settlements. Yet, since the introduction of the euro, one group of countries—Austria, Belgium, Finland, France, and Germany—has maintained aggregate wage restraint (below the EU average), whereas Italy, Spain, the Netherlands, Ireland, and Portugal have not. One usual suspect can be dealt with quickly: high economic growth might explain part of this divergence among EMU member states after the introduction of the euro. In high-growth countries such as Ireland and Spain, this growth led to asset inflation, which was reflected in wages. Growth was also very high in Finland, however, but without leading to an inflationary shock, while Portugal and Italy, where growth was much slower, witnessed expansive wage settlements. High growth thus explains, at best, only a small part of the variation in wage inflation within EMU.

A more systematic comparison between the countries with and without coordinated wage restraint suggests a different explanation. In Austria, France, and Germany, wage inflation in the sheltered sector has been constrained by productivity growth, and the overall effect has been that aggregate wage moderation remained high, without extraordinary efforts by the exporting sector to compensate for high wage inflation in the public sector (which would jeopardize the efforts by the export sector). In countries such as Portugal, Ireland, Italy, and Spain, in contrast, wage growth in the sheltered sectors, especially in the public sector, has, adjusted for productivity, diverged significantly from that in the export sector. The third column in Table 4.1 reports the difference between real wage growth in the public sector and aggregate growth (expressed here as total factor productivity growth) covering the period 2000–8 (Johnston 2011: 260–2). While that difference was positive in almost every country in the single currency bloc, Ireland and Spain (and Greece, which is not reported in the table) witnessed the largest increase in the public sector wage bill. Public sector wage setters in northern Europe were, on the whole, considerably more restrained. Public sector wages thus not only had less of an overall inflationary effect in the north, the export sector was also more easily able to compensate public sector wage inflation through relative disinflation in the sectors it controlled. That ability was not only lower in many southern European economies because of the smaller relative size of the export sector, but the gap to bridge was significantly larger.

These differences in public sector wage levels and their consequences are best understood as effects of the institutions that govern wage setting in the different (groups of) countries.

In a first group of countries, labour unions in the sheltered (public) sector have exercised wage restraint because of persisting domestic legal and institutional constraints, even in the absence of a national conservative central bank that could punish excesses. Austria, Belgium, and Germany are, in different ways, cases of this. The 1996 law on competitiveness in Belgium has established a hard wage for all sectors and the synchronization of wage growth between the sheltered and exposed sectors (predictably) increased substantially after 1999. In other countries, inter-industry coordination of wage bargaining has remained strong, often despite rumbling noises from strong sectoral labour unions in the public sector. Austria and Germany, for example, both have pattern-bargaining arrangements whereby wage setters in all sectors shadow the leading metalworking or chemical sectors. In these countries, the relation between wage-growth cycles in the manufacturing and non-market services sectors has remained strong under EMU because of the strong domestic institutional arrangements that have survived the transition to EMU.

The second scenario deals with the politics of wage divergence. The sheltered sector could push for wage increases above labour productivity, but not receive them. This is likely to lead to wage militancy and possibly protracted social conflicts in the public sector, and would be particularly relevant to unions in countries where governments have imposed hard fiscal constraints through domestic rules or have had them imposed through compliance with the Stability and Growth Pact. The unions thus do not receive the higher wages they demand, and the ensuing conflict runs the risk of becoming politicized because of the government policies. Finally, the sheltered and public sectors could push for excessive wage increases and receive them, as happened in Ireland and the Netherlands after 2000. However, both countries introduced emergency measures in social pacts in 2003 to curb wage growth, forcing wage rates in the sheltered sector down to levels prevailing in the exposed sector. Call this the emergency wage policies scenario.

Two processes thus seem to drive the divergence in wages between the exposed and the sheltered sectors across EMU member states. One is competitiveness-linked wage restraint in the exposed sector; the other wage increases beyond productivity in the sheltered sector. If wage inflation in the sheltered sector is relatively low, it can be compensated by much higher productivity gains in the exposed sector, thus re-balancing the aggregate level of wage restraint (wage inflation) in an economy. Higher levels of wage inflation in the sheltered sectors, however, are more problematic as they impose higher disinflation—nominal wages growing considerably more slowly than

Table 4.2. Wage moderation under different wage-bargaining regimes

High wage moderation[a]	Low wage moderation[b]
Austria: exposed sector-led pattern bargaining	*Ireland:* irregular, disembedded incomes policies (social pact)
Belgium: state-imposed wage law	*Italy:* inter-associational bargaining
Finland: timed, regular incomes policies	*Portugal:* intra-associational bargaining
Germany: exposed sector-led pattern bargaining	*Spain:* inter-associational bargaining

Source: Elaborated from Johnston and Hancké 2009

Notes:
[a] Difference in nominal wage growth and labour productivity growth is less than the EMU average minus 2 per cent
[b] Difference in nominal wage growth and labour productivity growth is more than the EMU average minus 2 per cent

productivity—on the exposed sector or falling competitiveness. The exact mix between the two sectoral inflation rates is, to a large extent, determined by the relative power of wage-setters in the exposed and sheltered sector, and especially by the extent to which the leadership role of the exposed sector is institutionalized in wage-bargaining systems.

To test the proposition that institutional frameworks have remained important in explaining levels of wage moderation, Table 4.2 compares different countries, organized along the type of wage-bargaining system (the typology of wage-setting systems is borrowed from Traxler et al. 2001). The table lists four member states with high levels of wage moderation and four with low levels: Austria, Belgium, Finland, and Germany for the first, and Ireland, Italy, Portugal, and Spain for the second. While wages in all eight countries are subject to some form of coordination, it is immediately evident that the *type* of wage coordination and its effects are very different across the two sub-groups. The high wage moderation countries all have strong legal and institutional frameworks that contain wage growth in the sheltered sector. In Austria and Germany, one of the export sector unions (IG Metall in Germany and GMT in Austria) has led negotiations, demanding wage increases equal to the increase in the national aggregate labour productivity rate, and the remaining industry unions then have shadowed these increases in a pattern-bargaining model (backed up, in Austria, with legal bargaining monopolies for the ÖGB unions). Belgium has a state-imposed wage moderation law, while Finland falls squarely within the corporatist tradition of regular incomes negotiations. The countries where average wage moderation is weak, in contrast, have much weaker safeguards on wages: Italy, Portugal, and Spain in essence have adopted voluntary wage-bargaining coordination, and the Irish social pacts are increasingly cumbersome to negotiate. Let us examine some of these cases in more detail.

The key restraints in Belgium reflect the law on competitiveness introduced in 1996 after the social partners failed to arrive at voluntary wage moderation under the aegis of the previous (softer) Law on Competitiveness in 1989 and

the failed social pact of the early 1990s (Pochet 2004). This law imposed a wage ceiling, mandating that annual increases should not exceed the average wage increases of Belgium's largest trading partners—France, Germany, and the Netherlands (Pochet 2004)—and has remained in place after the introduction of the euro. Belgian wages have been extremely moderate since, and the ties between wage growth in the exposed and the sheltered sectors grew much stronger under EMU.

Centralized income policies in Finland have been the key element in the institutional framework that has produced the country's sustained wage moderation since 1999 (Johansson 2006). Social partners agreed upon four two-year incomes policies under EMU, with each of these covering approximately 90 per cent of the workforce. Because these policies set pay increases for the economy as a whole, high wage inflation in the sheltered sector (due to its lower productivity), is compensated by wage restraint in the export sector (as a result of its potential for higher productivity growth). Since 1999, this disinflationary component has become quite apparent in sectoral wage restraint. Differences in nominal wage restraint between the manufacturing and the public services sector have increased considerably under EMU, compared to the ERM period.

In contrast to these countries where wage moderation is high, the countries that experienced lower nominal wage restraint have much weaker institutional frameworks that fail to bind wage setters in the sheltered sector. Italy has had neither a permanent nor a temporary constraint on wage setters in the sheltered sector, and the competitiveness constraint on wages for exposed sector unions was not particularly effective either: in ULC terms, wage growth in the manufacturing sector sometimes even exceeded that in the public sector. Both exposed and sheltered sector unions have consistently overshot the annual inflation targets set by the government in the Document for Economic and Financial Planning as targets for wage increases. Not surprisingly, the lack of constraints on wage setters in the sheltered sector and the ineffectiveness of the competitiveness constraint on wage setters in the exposed sector have contributed to Italy's poor economic performance in terms of wage moderation.

Ireland, Portugal, and Spain have faced the same problem of weak wage constraint on the sheltered sector, but in a different form than Italy. Ireland has, on paper at least, a high level of wage coordination, but this is of the top-down type, without having become an institutionally embedded part of wage bargaining. The effect is that the country encounters occasional bouts of wage inflation, which were compensated through exchange rate adjustments before EMU (Hodson 2003) and emergency social pacts afterwards. Spain and Portugal have a different type of problem: these countries have an almost voluntary system of wage coordination where the public sector can opt out of central agreements, and often does.

The comparison between the two groups of EMU member states in Table 4.2 leads to the conclusion that a stable institutional framework of wage bargaining is a necessary condition for keeping strong trade unions in the sheltered sector—and thus also excessive wage inflation in that sector—under control. The absence of this condition almost certainly implies that periods of wage moderation and wage excess alternate, usually depending on the emergency measures taken to keep wage developments in check. These mechanisms have ranged from legal and quasi-legal wage leadership of export-sector unions, over central agreements that limit wage increases, to pattern bargaining, whereby follower sectors adopt wage rates set in the leading wage sectors. Where such mechanisms were absent, wages in the public sector diverged rapidly from wage rates (controlling for productivity) in the export sector, and the aggregate inflation rate rose.

These struggles between different sectors within EMU member states took place against an equally dramatic redesign of the international regime that EMU had introduced and which revolved around Germany. The wage-shadowing arrangements that existed prior to EMU, which were so important in aligning wage rates across the ERM in the 1990s and before, fared very differently in the two parts of Europe: while the highly coordinated economies around Germany managed to keep their real exchange rates under control through coordinated wage bargaining in the shadow of Germany, the peripheral, mostly southern part of Europe, abandoned the emerging wage snake. The combination of the reorganization of the international political economy associated with EMU and the national differences in wage setting ultimately produced the two different parts of EMU that have been facing off since the crisis of the single currency broke.

4.3 Wage Shadowing, Competitiveness, and Dual Europe

By design, EMU was and is formally a symmetric system, in which all previously existing currencies opted into the euro on an equal footing. The politics of the Maastricht Treaty (Dyson and Featherstone 1999) guaranteed this: France's aim was to end German domination of the European economy through the Bundesbank, and therefore imposed the current EMU onto Germany in exchange for the country's unification in 1991 (see also Marsh 2009). The symmetry and implicit equality of all EMU participants was expressed in the 'one country one vote' structure of the governing board of the ECB.

This does not imply, of course, that EMU (and the Maastricht criteria) were 'French' in inspiration. Nominal targets, as good as absolute central bank independence, and fiscal restraint were almost certainly not the main things that Mitterrand had in mind when imagining a future EMU. What

the French president, his advisors, and probably also the main opposition politicians such as Jacques Chirac, wanted to avoid was a Europe-wide replication of the Bundesbank policies, which, the French negotiators thought, had kept economic growth on the continent artificially low. Yet the Maastricht Treaty and its subsequent additions, such as the SGP negotiated in Amsterdam in 1997, had a clear German imprimatur, and lacked the economic government that France regarded as necessary to counterbalance the highly independent ECB. When the dust from the Maastricht and Amsterdam treaties had settled, all that was left of the initial French ambitions was the demise of the Bundesbank and the formal intergovernmental symmetry in the governance of EMU.

Real symmetry rarely exists in international monetary politics, however. In its simplest form, every currency union requires a nominal anchor to stabilize the currency system. Gold and other precious metals played that role in the past, and since the Second World War, a key currency—the US dollar in the world, the DM in Europe (Eichengreen 2011)—has been in that position, usually as a result of economic, political and, in the case of the dollar, military power. In EMU that role is played, as in the Maastricht regime and the ERM before that, by Germany—but, importantly, without the sovereign power of the DM to back that up. The country ended up as the anchor again in EMU, but as a *regime-taker* instead of a regime-setter this time, largely because of the absence of an autonomous currency. The size of Germany's economy, as well as the volume that other EMU member states trade with the country, makes it a natural target for any real exchange rate (RER) adjustment strategy of other countries. A depreciation of the RER through disinflation against Germany will have proportionately larger positive demand effects for a smaller economy with a high export share than it would have for a large economy against a smaller trading partner. Small economies thus prefer the German anchor, since it allows them to gain competitiveness through wage moderation—and, compared to Germany, remember, practically every other economy in EMU is small.

This upside-down system, with Germany at the centre but as a regime-taker, has produced one particularly perverse effect when inflation rates outside Germany began to rise, as they did in the early 2000s. Since the ECB's EMU-wide 2 per cent inflation target is the composite weighted inflation rate across the eurozone, a rise of inflation in some member states above this target, for example as a result of rapid economic growth, necessarily implies that some other member states have to deflate to the parallel (weighted) extent to bring the aggregate inflation rate back down to the target 2 per cent. The mechanism is simple: the ECB's single (nominal) interest rate interacts with different domestic inflation rates to produce a high real interest rate in the low inflation countries (thus deflating their economies) and vice versa (Allsopp 2002). Since Germany provides the anchor, it is in this position of being forced to deflate.

Note that in principle any country or even a group of small countries could play this anchor role and deflate when others inflate. However, collective action problems make coordination difficult for a larger group of countries and therefore invite free riding on the German position. One could also imagine that Germany plays this stabilizing role once and then abandons it, leaving the others to sort out their high inflation rates. Nobody likes to pay for benefits that accrue unilaterally to others, after all. But the ECB's last-mover position makes it very likely that the bank will adopt a restrictive policy at the first sign of inflationary pressures (a scenario which is certain to ensue when Germany inflates or even refuses to bring down its inflation rate alongside others). Put differently, against the background of a hard constraint imposed by the ECB's 2 per cent inflation target, Germany has been structurally forced to maintain very low inflation when others inflate (Hancké and Soskice 2003). In an ideal 'symmetrical' world, all countries would share this disinflationary burden by rotating the cost of adjustment. In EMU, however, the largest economy, which also happened to be the stabilizing anchor in the ERM regime, bears this burden more or less alone (Ramskogler 2012).

This structural background, combining restrictive macro-economic policies and Germany's regime-taking position in EMU and its Maastricht-based predecessor, was reinforced by a series of more strategic considerations among economic elites in Germany after a dramatic reversal of Germany's economic fate in the 1990s. Earlier in the decade, the DM appreciated by over 20 per cent against the other currencies in the EMS as a result of German monetary unification in 1990 and the crisis of the ERM that followed the Bundesbank's response. Fearing for its reputation, the German central bank pushed interest rates up to a post-war high of 8.25 per cent in 1992, thus exacerbating German competitiveness as a result of an engineered exchange rate appreciation. Alongside, the central bank also produced a huge shock to the European economy, which resulted in the ERM crisis of 1992. In response, most other currencies in Europe, which make up most of Germany's exports, devalued their currencies substantially, thus denting Germany's rapidly falling competitiveness even more. The Maastricht process, which played out over a longer time span, in turn neutralized the institutional advantages that Germany had developed before 1990. By imposing on all of Germany's trading partners a low-inflation regime organized around income policies and social pacts, the Maastricht regime in effect forced all other prospective EMU member states to emulate German macro-economic policy outcomes such as low inflation, and stable exchange and interest rates. But these policies often produced unintended beneficial outcomes on the supply side of the economy as well (acting as a productivity whip, as I will discuss in more detail in the next chapter), and, therefore, in relative terms, negative effects for Germany. The more the other prospective member states reorganized their institutional

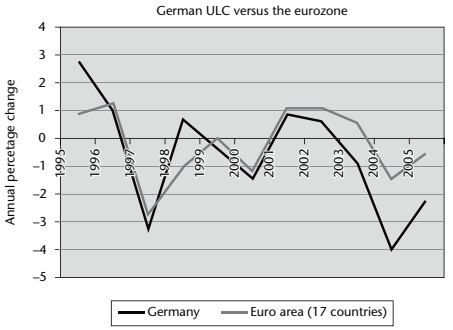

Figure 4.1. Growth in German and eurozone unit labour costs, 1995–2005
Source: OECD

framework to resemble Germany's, the less Germany could exploit the particular and almost unique comparative institutional advantage that had been at the basis of the country's post-war economic successes. When, after the Maastricht process had run its course, Germany entered EMU in 1999, it did so with a significantly overvalued exchange rate, which, again, took a bite out of relative competitiveness. And, finally, fluctuations in the euro's external exchange rate, especially against the US dollar, hit Germany more than other EMU economies: not only has Germany exported more outside the eurozone than many others in absolute terms, it has also exported more capital goods to countries that, in turn, export outside the eurozone. One estimate of this effect is that Germany's direct exposure to the euro's external exchange rate is of the order of 5 per cent of GDP, while its indirect exposure (via exports of primarily capital goods to other countries within EMU who themselves are exposed to the external exchange rate) raises that to 12–15 per cent of German GDP. Currency appreciations thus have a considerably more significant effect on Germany than on others in the eurozone.

The response by Germany's wage setters to these persistent and massive appreciations of the real exchange rate was to assure that unit labour costs (ULC) fell faster at home than in the country's main trading partners in order to regain lost competitiveness. Between 1995 and 2005, as Figure 4.1 demonstrates, Germany witnessed a huge improvement in its competitiveness (expressed in relative ULC growth), roughly returning the country, by the start of the worldwide financial and economic crisis, to the relative position that it held at the end of the 1990s.

This shift in German wages had profound implications for the new eurozone. Most of Germany's immediate neighbours had been shadowing German wage rates (allowing them to target a more competitive real exchange rate)

Table 4.3. Correlations of national and German nominal wage restraint 3-year moving averages, 1991–98 and 1999–2006

	1991–98	1999–2006
Austria	0.96	0.41
Belgium	0.93	0.22
France	0.83	–0.08
Netherlands	0.98	0.66
Finland	–0.54	0.42
Ireland	–0.33	–0.33
Italy	–0.64	0.07
Portugal	0.30	0.58
Spain	–0.04	0.37

Source: Johnston and Hancké 2009

since the mid-1980s. Fluctuations existed, as the Dutch example showed, but averaged over several years, the wages in Germany and ex-Deutschmark bloc economies moved, adjusting for labour productivity, more or less in tandem, since these countries had become de facto extensions of Germany in the broad area of wages. Data in Table 4.3 present the pair-wise correlations with Germany for the Maastricht/ERM and the EMU pre-crisis periods: what it demonstrates quite convincingly is that the core DM-bloc was a clear operational reality for most of its members (with almost perfect correlations in terms of wage restraint for the Maastricht period, in fact), and considerably less so for the other economies vying for EMU membership. The weaker relation in the 2000s between the core EMU member states (the top four in the table) and Germany is almost entirely explained by the public sector wage dynamics analysed earlier in this chapter. Similar correlation coefficients on wage restraint calculated for the export sector (using manufacturing as a proxy) remained stable across the pre-EMU and EMU periods. Germany and its neighbours thus acted, even under EMU, very much like a single wage bloc, with only minor real exchange rate fluctuations among them.

This tighter integration in the north was mirrored by a growing distance between wages in the north and wages in the peripheral economies. As Germany's competitive position improved and that of most its satellites as well, as a result of this close wage shadowing, the position of the others deteriorated. To a large extent, this is the symmetric result of the same structural dynamic that has forced Germany to deflate when inflation rates rose in other EMU member states: other countries have thus been forced to inflate to balance their domestic inflation rate against Germany's lower rate (more or less by the inverse of their weight in the eurozone). Arithmetically, when DE (Germany and its economic satellites) deflates, RE (for Rest of Europe) is forced to inflate to reach the ECB's aggregate 2 per cent inflation target (which

is the weighted average of the many different domestic inflation rates); as RE inflates, however, DE is forced to deflate again because of the same mechanism. DE's deflation, in turn, triggers RE's next round of inflation, and the process starts again, but with a wider fork between the two wage inflation levels. The outcome is that the eurozone increasingly has two very different and continually diverging systems: one systemically biased towards deflation (DE), and another systemically biased towards inflation (RE) (see Hancké and Soskice 2003 for a more formal version of the argument).

Wage shadowing, therefore, was the mechanism through which economies were closely tied together in the different monetary arrangements that preceded EMU. German wages became the target for all other economies in the emerging monetary bloc, while wage setters everywhere were forced to coordinate wages within their economies in order to stabilize their nominal exchange rate with respect to Germany. Under the DM-bloc and the Maastricht regimes, all prospective EMU economies followed this alignment process quite closely—although more in the former DM-bloc than outside of it. After the introduction of the euro, however, wage rates, adjusted for productivity, diverged rather significantly, and EMU rapidly fell apart in two groups: those that managed their wages, and thus their real exchange rates, in an orderly fashion, following Germany, and those that failed to do so. Wage shadowing remained important, in other words, for the countries that are now known as the 'core' creditors, mainly in the north of Western Europe, and disappeared as an adjustment tool in most other EMU member states. That divergence was one of the key mechanisms that led to the current account problems that surfaced so violently in the late 2000s.

Conclusion

Before 1998, no one anticipated the effect of EMU on domestic economies, or knew what the interaction between this novel international monetary regime and the domestic economies would entail. Today, we have a much better sense of this. In essence, the institutions of EMU produced two perverse effects with dramatic consequences. The first one is that it reopened a cleavage within the labour unions that the previous stages of monetary integration—the DM-bloc and the Maastricht process—had closed, or at the very least had contained. In the triangular set-up prior to EMU, which involved (ideal-typically) one central bank and one labour union organizing the exposed and one organizing the sheltered sectors, wage developments in the latter were controlled by the export unions, backed up with the iron fist of the central bank. Since the central bank's iron fist, when it came down, hit both sectors, the unions in the exposed sector faced steep incentives to do everything in their might

to keep wage inflation in the sheltered sector, particularly in the public sector, in check. In fact, they faced a double punishment if they did not: rising wage inflation first, which made their products less competitive, and rising interest rates in response, which dampened investment and growth.

EMU lifted this hard monetary constraint by removing the strong disciplining capacity of the national central banks and replacing it with the much weaker disciplining capacity of the ECB—somewhat ironical given its constitutionally enshrined conservatism and independence. Whereas national central banks could credibly threaten action against inflationary wages in one country, the ECB is constrained by its mandate to target an EMU-wide aggregate inflation rate. It cannot, therefore, punish individual unions who no longer play a disinflationary game. With the monetary lid lifted, the strongly organized public sector went for higher wages—wages above what its (implied) productivity rate would permit. In countries where the export unions remained strong and the institutional framework continued to impose formal and informal constraints on wage setting, the wage demands of the public sector were reined in. Elsewhere, wage inflation in the sheltered sector increased dramatically. That divergence—between those countries where wages across different sectors were still coordinated (in ULC terms) and the others, where wage rates (again in ULC terms) in different sectors no longer followed central wage guidelines—systematically overlapped with the divergence between the north-west European economies and the (mainly southern) peripheral ones that manifested itself so dramatically in the late 2000s.

The second outcome of introducing the single currency, with a novel international political economy framework that accompanied it, was that it imposed two very different regimes on the economies of the member states: deflation on Germany, still the anchor in the system (especially for its satellites), *and* inflation on the others. The mechanism is simple. The inflation rate in EMU is the weighted average of all domestic inflation rates. Against the background of a single ECB interest rate reflecting (the distance from) its 2 per cent target, inflation above 2 per cent in country A implies a parallel reduction in inflation (weighted by the size of A in the monetary union) for all others; the same happens if inflation in countries A and B is above 2 per cent; ditto for a high inflation rate in A, B, and C, etc. Ultimately Germany—the anchor—is the last one left standing, and has to absorb the inflation elsewhere by deflating to compensate for the other EMU member states. This, then, triggered another perverse mechanism. The ECB's single nominal interest rate led to diverging real interest rates because of the inflation differentials. Low-inflation countries faced a high real interest rate, and most high-inflation economies a low, often negative one. This is the opposite of what we would expect in a system governed by national central banks, which adjust real interest rates in line with inflation: low when inflation is low and

vice versa. When DE was forced to deflate, it was punished with a high real interest rate, pushing down growth. When the countries in RE had high inflation rates, they were rewarded with low real interest rates. Growth stalled in DE, and inflationary growth emerged in RE. The mechanism was, ironically, symmetric: when Germany deflated to regain the competitiveness it lost, others were forced to inflate. The result was a continuing divergence in inflation between, on the one hand, Germany and its economic satellites, and, on the other, the remaining, high-inflation countries in EMU—a divergence that, again, overlaps systematically with the cleavages that have emerged in the eurozone since the late 2000s.

This analysis has put flesh on the bones of the current account imbalances that have led to the sovereign debt crisis in EMU. The divergence between a group of countries with apparently permanent current account surpluses and a group with perennial deficits is fed by these two self-reinforcing dynamics: faltering wage discipline in the sheltered (public) sector, and a pro-cyclical monetary regime that, perversely, has rewarded high inflation (through a lower real interest rate) and punished wage discipline through the opposite mechanism.

The next chapter reinforces this diagnosis. It focuses on the economic performance effects of wage-bargaining systems, through an analysis of macroeconomic policies and supply-side adjustment. The chapter arrives at the same point as this one—current account imbalances—albeit from the opposite direction. Competitiveness in the north is, to a large extent, underpinned by labour market institutions; again, the absence of strong labour unions who negotiate wages in coordinated wage-bargaining systems in the peripheral economies were at the basis of poor economic performance in general, and falling competitiveness in particular.

5

The Perverse Effects of Beneficial Constraints

Labour Market Institutions and Economic Performance in Europe

Since the monetarist revolution of the late 1970s and early 1980s, a lot of attention in academia and policy-making has gone to the supply side of advanced capitalist economies. Management of aggregate demand is important, but ultimately only in the very short run, thus the position of the New Classical economics. Turning Keynes's idea that we should concentrate on the short run because we are all dead in the long run on its head, the search for long-term determinants of growth received a new impetus. Beside such obvious candidates as education and R&D, the debate quickly focused on labour market structures: wage rigidities which follow from strong labour unions negotiating wages in coordinated wage-bargaining systems, employment protection legislation that makes it impossible for employers to adjust their workforce as they deem necessary, unemployment benefits that lower incentives for workers to look for jobs, and other institutions of this sort, were no longer regarded as solutions to protect workers against the vagaries of the market, but as obstacles to dynamic adjustment.

European economies in general, and economies in the eurozone in particular, have, over the post-war years, adopted many such institutional arrangements. Wages have often been set in relatively centralized wage-bargaining systems, workers have enjoyed strong guarantees against dismissals, and labour unions have, to varying degrees across the continent, acquired information, consultation, and bargaining rights at different levels of the economy, from the plant or the firm to the economy as a whole. The low growth of the EMU and EU member states on the continent, when compared with the Anglo-Saxon and the neo-capitalist economies in Central and Eastern Europe, was, according to the dominant frameworks in political economy, a direct consequence of these institutional arrangements in the labour market

that protected workers. Rigidities produced adjustment problems, and those were the cause of low growth and especially of high unemployment.

In this chapter I will analyse some of these arguments in light of the discussion in the previous chapters. I start with the key analytics underlying the debate on labour markets, their governance, and economic performance. The basic point there is that the quick link between labour market institutions and economic performance was almost certainly too fast. I will then address the relation between wage bargaining and trade unions, on the one hand, and aggregate demand on the other, and conclude, somewhat counterintuitively, that macro political-economic institutions such as conservative central banks and strong trade unions actually interact in logical, and mostly beneficial ways (at least within the confines of one economy). The third section in this chapter explores the effect of the institutional changes in wage bargaining associated with the Maastricht regime on company strategies. The conclusion is that centralized systems actually fared better, since their attempts to keep inflation under control were based on labour productivity increases, not on wage control as in the more decentralized systems. The final section in this chapter, however, suggests that the beneficial constraints within one economy almost equally certainly produce perverse external effects, which found their expression in the crisis of EMU that we have witnessed since 2010.

5.1 Labour Market Institutions and Economic Performance

Since the second oil shock, when it became clear that the Golden Age of capitalism, combining high economic growth, low unemployment, and low inflation, was a thing of the past, growth and unemployment rates have varied dramatically across the advanced capitalist economies. Countries such as France, Belgium, and Spain seem to have an unemployment rate that is permanently stuck in the mid to high range, while unemployment in Sweden, Germany, the Netherlands, and Austria is lower, and followed the business cycle more closely. Differences in labour markets and the institutions that govern them have often been invoked to explain differences in economic performance, particularly employment and unemployment performance. In the late 1980s and the early 1990s, by the time EMU was in an advanced embryonic stage, a consensus was gaining ground among economists that precisely the institutions of the labour market were responsible for the variations in unemployment across the OECD (Layard et al. 1991).

These interpretations also found their way into the political debate on EMU. The centre-Right has espoused the New Classical view, explained in more detail earlier in section 2.1, and probably best represented by Otmar Issing

(2002 and 2008). In essence, the argument is, monetary and fiscal authorities cannot fundamentally influence the real economy (i.e. growth and unemployment). They can create short-term bursts of activity, but not deliver a higher long-term growth rate. Instead they produce inflation. Effects on the real economy can only come about as a result of structural reform, especially in the labour market. That, thus the New Classical view, is work for the social partners. What central banks can do to help is deliver price stability.

The political Left has, not surprisingly, a somewhat different view of EMU. It points out that EMU artificially imposes a policy straightjacket that can only lead to falling living standards and job insecurity for the vast majority of the population. By freezing the exchange rate (at least for the bulk of trade within the eurozone), imposing a restrictive unitary monetary policy and a 3 per cent limit on budget deficits through the Stability and Growth Pact, the institutional framework of the single currency forces adjustment onto wages and the labour market. EMU is, in this view, a neo-liberal plot to impose structural reforms on reluctant electorates and unwilling labour unions. What domestic governments have been unable to do because of political and electoral reasons, had to be imposed through supranational arrangements that lack electoral accountability.

While these two views on the economic performance effects of labour market institutions in EMU may differ on the desirability of supply-side reforms, they seem to agree on the key mechanisms driving them, and where these reforms will lead. In both cases, broad macro political-economic pressures for adjustment force the protection for groups in and outside labour markets to be broken up, labour markets to be made more flexible, and welfare arrangements to be dismantled, with particular attention to unemployment benefits. And both also agree that the future will bring less secure jobs for the majority of workers, with real wages more determined by market forces than was the case in the recent past, and generally a more incentive-based and less generous welfare state.

The main problem with these views is that none of this has come to pass. Start with the spectre haunting the Left. Social dumping, the supposed inevitable outcome of simultaneous deregulation and economic integration, is hard to find in the eurozone or even in the EU. A lot is made of individual cases, such as the infamous Laval decision, in which the protection offered by labour law in one country was undermined through the implied extraterritoriality of labour law in another country within the single market. Large multinationals often seem to go regime shopping when deciding on the location for a new plant. And in some industries, working time regimes and relative wages are subject to competition from abroad. But in all, this fear of social dumping seems exaggerated. The vast majority of companies in the EU and EMU abide by the labour law in the countries where they operate.

They may sometimes need a persistent nudge to do so, or they may try to find and develop rule-free areas, but on the whole, this socio-legal landscape is relatively stable. It is also rare for multinationals to open brand new plants outside their well-known jurisdictions; and when they did, as German companies discovered when they located east of the former Iron Curtain in the early 1990s, they found a barren socio-economic infrastructure that more than compensated—negatively—for the perceived wage advantages. Finally, most actually occurring regime competition, however deplorable it may be, takes place in industries, such as car assembly or construction, where labour unions are often sufficiently well organized to police major transgressions (Bernaciak 2010). Social dumping has been on European labour's horizon for over a generation—since the first discussions about economic integration beyond the Treaty of Rome, in fact—but standards of living have risen everywhere throughout that period. In short, social dumping and regime competition are considerably less rampant than we are often led to believe.

Wages, working conditions, and employment relations more generally have therefore not gone the way the Left feared—and the Right anticipated. In fact, the argument against the centre-Right view is not only that things have not changed nearly as much as they thought, desired, or hoped: the sad irony, for them, is that the economies with more (not less) organized labour markets and coordinated wage-setting systems, where wages are more rigid and workers on the whole better protected, have adjusted considerably better, both to the early years of EMU and to the crisis of the late 2000s, than the others. The steep fall in output and growth in Germany and its neighbours after 2008 was followed by an equally impressive rebound that pushed Germany and north-western Europe toward the top of the OECD's growth league, well ahead of more liberal economies such as the UK. If it had not been for the self-inflicted pain following the adoption of anti-Keynesian growth-destroying policies during EMU's sovereign debt crisis, Germany and a large part of northern Europe might well be looking back at the crisis as a short unpleasant blip on the road to prosperity.

Impeccable as their logic may seem, especially since they arrive at more or less the same place from opposite starting points, these views on EMU have serious problems. None of their predictions seem to have come true—in fact, to some extent the opposite of what was expected appears to have happened. Economic integration has not systematically led to deregulation and liberalization across Europe, with negative effects on working conditions and wages. And even the logic itself has problems. If economic integration leads to a larger market, then, according to a principle first expressed by Adam Smith, the division of labour (i.e. specialization) will also increase. Since the institutional frameworks that govern economies to a large extent determine the type of specialization in global product markets, countries will, *ceteris paribus*,

reinforce those institutional frameworks in the face of increased competition, precisely because they have served them so well in the past (Hall and Soskice 2001). Strong economic performance, in turn, can be the result of both strong and weak trade unions and high as well as low levels of wage coordination. Since the latter construct of weak trade unions and low levels of wage coordination approaches a textbook neo-classical labour market, it does not require detailed exposition. The former, however, is somewhat counterintuitive: how can constraints on the freedom of companies to organize themselves as they see fit lead to better economic performance?

The answer to this question has two legs. The first one is that strong trade unions invite strong pre-emptive constraints by conservative central banks. Since labour unions might exploit their power to raise wages above productivity, the central bank monitors wage outcomes because of their potentially inflationary effects. Trade unions, well aware of this, thus set wages at a level commensurate with low wage inflation, and that leads to falling (not rising) unit labour costs, which safeguards profits. The second leg is that the constraints that strong labour unions and wage coordination impose on employers are of the 'beneficial' kind (Dore 1986; Streeck 1992). A wage floor set by highly coordinated wage-setting systems forces employers to organize production so that they can afford to pay those wages: it imposes a permanent search for higher labour productivity, through training, and by developing products for markets that are relatively protected from price (and therefore wage) competition. The aggregate effect is that companies are forced to increase their productivity, expressed in value added per hour, and that economic growth rates rise.

The balance of this chapter develops this counterintuitive interpretation of economic performance under EMU, building more explicitly on labour market institutions, and particularly the institutional arrangements that govern wage setting. I will start with linking the discussion back to the macro-economic regimes in different EMU member states, by examining the economic performance effects of different labour-central bank interactions. The crucial message there is that countries with strong labour unions and coordinated wage-bargaining systems also face conservative central banks and, thus, a fundamentally restrictive macro-economic regime. The forced disinflation that results from this set-up, however, feeds into a more competitive export profile, underpinned by the micro-organizational adjustment discussed earlier. Low domestic demand is compensated by strong performance in export markets, as a result of the depreciation in the real exchange rate that such domestic disinflation produces. The second section explores the links between shifts in the macro-economic regime and supply-side adjustment. The basic point is that coordinated wage bargaining has led to increased export performance through a productivity whip mechanism. A compressed, industry-wide target

wage in effect rewards well-performing firms and punishes poorly performing firms by forcing them 'up' or 'out'. The third section, in turn, relates these insights on the performance effects of macro-economics to the crisis of EMU in 2010. The different evolutions of competitiveness in the northern (CME) and the peripheral parts of EMU (including Ireland) found their expressions in growing current account imbalances that are probably not sustainable for long in the absence of high growth and/or political union.

5.2 Aggregate Demand Regimes and Different Economic Growth Models

The place to start this enquiry about economic organization and economic performance is with the remarkable stylized fact that most economies that have combined strong labour unions, centrally coordinated wage-setting systems, and organized labour markets with a large component of formalized training also have strong, conservative, independent central banks and, on the whole, relatively tight fiscal regimes. This was certainly true for north-western Europe (DE) before the introduction of the euro, but it also seemed to have survived the introduction of the euro.

The macro-economic policy-making framework of an economy consists, in principle, of four broad elements: the exchange rate, monetary policy, fiscal policy, and wages. In theory, countries (governments) can choose any mix to meet their goals; in practice, some combinations are more (less) desirable, since they reinforce (contradict) each other. A relatively tight fiscal policy accompanied by low interest rates is, for instance, a self-reinforcing growth-oriented mix, as US president Clinton's two terms of growth showed. An expansive fiscal policy and a restrictive monetary policy, on the other hand, is a combination that is, all other things equal, self-defeating, since the high interest rates not only counteract the fiscal expansion, but add to the debt burden. Similarly, wage moderation takes the pressure off the central bank, since fears of inflation are subdued, which implies that the central bank can relax its policy or, at the very least, not tighten it.

However, a comparison of OECD economies since the second oil shock reveals a paradox regarding the relation between wages and the wider macro-economic policy framework. In countries where wage coordination has been high, fiscal policy and (particularly) monetary policy have been relatively restrictive, and governments have endeavoured to keep a high external value of the currency. The key case is Germany, of course, where Keynesian fiscal policy never really took hold (Allen 1989), and where the hawkish Bundesbank never missed an opportunity to alert other economic actors to the inflationary dangers of, well, almost anything they did. But much of the

rest of north-western Europe slowly adopted the same path after the second oil shock, when they introduced an exchange rate peg against the Deutschmark and thus aligned the rest of the macro-economic policy framework with the German one (while occasionally exploiting the degrees of freedom that their size and follower status offered them). Somewhat surprisingly, central banks and governments thus did not compensate, and implicitly reward, wage moderation in a coordinated wage-setting framework with more expansive policies—quite the contrary, in fact. The entire macro-economic framework was geared toward what we would now call permanent austerity (Pierson 2001). Wages were kept under control, fiscal policy was restrictive, and monetary policy was asymmetric, in the sense that the central banks punished inflation but did not reward wage moderation.

In countries where wage coordination has been low, however, the opposite is the case. Think, for paradigmatic cases, of the Anglo-Saxon economies, where the macro-economic policy framework has been considerably more permissive. Not only has monetary policy explicitly (UK) or implicitly (Fed) followed a Taylor-rule for the better part of the last two decades, thus targeting deviations from inflation as well as potential output, fiscal policy has been broadly New Keynesian in orientation, consolidating the budget in good times and using deficits as countercyclical tools in bad times, while exchange-rate policy has benefited from 'benign neglect' as in the US or has even been used as a tool for active adjustment, as was the case after Britain's exit from the ERM in 1992.

What explains this somewhat surprising constellation of a restrictive macro-economic policy framework when wage moderation is high (and where, therefore, fiscal and monetary conservatism both have additional countercyclical effects), and a more permissive regime in countries where the beneficial macro-economic effects of wage discipline are absent? Why do countries with the most developed ability for wage moderation, and therefore also for keeping wage inflation under control, face the most conservative monetary and the tightest fiscal policies, rather than be rewarded for wage moderation with looser macro-economic policies and vice versa?

The answer to these questions is related to the political economy of the *aggregate demand management regime* (ADMR) that prevails in these different economies (Soskice 2007). Start, again, from the helpful Calmfors–Driffill (1988) model, first introduced in Chapter 3. Economies with highly decentralized or with highly centralized wage-setting systems do extremely well in terms of economic performance (think of highly centralized wage setting as a very high level of central coordination). In the first case, individual workers or small groups of workers in companies are forced to internalize the inflationary and employment effects of their wage-setting behaviour. If they set wages above labour productivity, prices rise, employment falls, or both, and wages

adjust back to the level commensurate with productivity. In the second case, the single labour union acts in effect as a single collective worker, and thus also internalizes the employment and inflation effects of wage setting. The problem lies in the in-between case, where a small number of strong trade unions can extract high wages from their employers but are able to off-load a large part of the costs, under the guise of inflation, onto the economy as a whole.

The highly decentralized arrangement is the one mainly found in Anglo-Saxon economies today: after the Reagan–Thatcher revolutions, labour unions have, perhaps with the exception of a few sectors such as traditional large-scale manufacturing and the public sector, been very weak, both in terms of organization and in terms of their wider impact on the political economy. Under those conditions, labour markets approximate the textbook neo-classical version, in which they will clear, and the wage reflects the marginal productivity of labour. This is a world, therefore, that cannot be improved in Pareto-efficiency terms. Since the labour market clears, macro-economic policy has no reason to intervene, and can concentrate on getting aggregates right through New Keynesian countercyclical policies.

Highly centralized systems in which the inter-industry union confederation sets an economy-wide wage, found in the Scandinavian countries until quite recently, have a parallel effect. Because of the self-correcting mechanism associated with a single encompassing labour union, monetary and fiscal authorities generally did not need to be too concerned about inflationary pressures either: rational wage setters would understand the broader self-inflicted negative effects of their actions, and thus avoid those—and as the last mover in this set-up, the central bank always had the tools to enforce wage moderation. Central banks and governments can therefore, as in the highly decentralized systems, bracket out wage-push inflation and get on with keeping aggregate demand at a sufficiently high (but not higher) level to guarantee full employment.

Many of the north-western economies are of the third type, however, in which a small number of strong unions can make wage claims without the discipline imposed by the market or by the central union leadership. Austria, Belgium, Denmark, Germany, and the Netherlands all have a wage-setting and employment relations system in which strong industry unions are the key actors in collective wage bargaining, and where central confederations are relatively weak vis-à-vis their industry affiliates. After the collapse of central wage bargaining in Sweden and Denmark in the 1990s, most of the Scandinavian countries have also moved away from a world of highly centralized wage setting into this world of a few strong labour unions. And even in countries such as France and Italy, where the confederations are stronger—largely as a result of the ideological fragmentation of the labour movement (Eyraud and Tchobanian 1995)—much of the industrial (as opposed to

political) action is organized by the industry-level unions. Most countries in EMU therefore have a wage-setting system that is organized around a very small number of industry-level associations on the labour and employers' side—but the number of unions is large enough to invite the inflationary free-riding problems that Calmfors and Driffill (1988; Driffill 2006) identified more than two decades ago. Note that it is not really that important for the argument here if unions actually exploit these externalities and will always do so (they almost certainly do not): what is important is that the situation is conceptualized as one in which unions might exercise this freedom, because that triggers reactions from the other actors in the set-up.

In this world of strong industry-level labour unions, the central bank acts as a backstop, first for the unions, and then for governments (see Soskice 2007: 96–102, on which this discussion is based, for more details). By signalling to the labour unions that it will retaliate against wage settlements that end up above the target range it deems commensurate with inflation, the central bank assures that the strategy of individual unions shifts from one where they end up bargaining a higher nominal wage, and thus fuelling inflation (a prisoners' dilemma in which defection from a going rate always pays off), to one where they take the inflationary preferences of the central bank into account, and thus not set wages above the implied target rate of the central bank (i.e. a cooperative game). Conservative fiscal policy, in turn, is necessary to support the central bank's credibility. After failing to obtain monetary accommodation, the labour unions might want to have a second chance through fiscal expansion, thus nullifying the constraint imposed by the central bank. This is even more likely in a system of proportional representation, which will have strong social-democratic parties in government or in opposition. By signalling that fiscal profligacy through discretion is also punished, the central bank effectively pre-empts this possibility, thus constraining the labour unions' strategies to cooperation around the inflation target.

The outcomes of such a set-up are quite intriguing. Over the decades following the second oil shock, when disinflation became the norm, the share of national income that went to wages (the wage share) has fallen more (although from a higher initial level) in economies with strong labour unions than in those with weak labour unions (for technical details of the analysis, see Hancké 2012). While the wage share fell in all advanced capitalist countries over that period, on average by almost 11 per cent, the drop was, somewhat surprisingly, by far the lowest in the Anglo-Saxon economies with weak unions, highest in the southern European countries (and Ireland), immediately followed by the north-western economies that have coordinated bargaining systems organized around strong labour unions. Individual country data tell an even starker story of diverging fates than averages: in the UK and the US, both countries with very weak trade unions and decentralized wage-

Table 5.1. Evolution of the wage share in selected OECD economies 1970–99

Country	Wage share as % of GDP				Evolution in percentage points			Difference between maximum and minimum value				
	1970	1980	1992	1999	1970–80	1980–99	1992–99	Max	Year Max	Min	Year min	Max-Min
CME	Strong and embedded wage coordination											
AT	74.82	88.51	82.74	74.03	13.69	–14.47	–8.71	91.79	1978	74.03	1999	–17.76
BE	64.14	74.33	70.26	70.02	10.19	–4.31	–0.24	75.07	1978	64.14	1970	–10.94
DE	72.60	75.28	70.86	69.08	2.68	–6.19	–1.77	75.70	1974	68.59	1998	–7.11
DK	70.09	73.68	68.94	69.24	3.59	–4.44	0.30	73.68	1980	66.55	1994	–7.13
NL	72.59	76.29	70.68	69.21	3.70	–7.08	–1.48	77.14	1975	68.42	1997	–8.72
SE	71.66	75.85	72.32	65.31	4.19	–10.54	–7.00	77.94	1978	65.31	1999	–12.63
Avg.	70.98	77.32	72.63	69.48	6.34	–7.84	–3.15	78.55		67.84		–10.71
MME1	Strong, not embedded wage coordination											
FR	75.86	79.38	69.92	67.74	3.51	–11.64	–2.19	79.89	1981	67.32	1998	–12.57
IE	74.74	79.34	68.76	58.38	4.60	–20.96	–10.38	79.34	1980	58.38	1999	–20.96
Avg.	75.30	79.36	69.34	63.06	4.06	–16.30	–6.28	79.62		62.85		–16.77
MME2	Weak wage coordination											
ES	68.47	74.29	70.73	67.17	5.82	–7.12	–3.56	76.40	1976	66.18	1989	–10.22
IT	80.37	79.49	77.07	67.80	–0.88	–11.69	–9.26	83.36	1971	67.80	1999	–15.56
PT	63.94	70.26	71.62	67.34	6.32	–2.92	–4.27	84.03	1975	63.07	1973	–20.96
Avg.	70.93	74.68	73.14	67.44	3.75	–7.24	–5.70	81.26		65.68		–15.58
LME	Decentralized wage bargaining											
CA	68.99	63.70	67.27	62.57	–5.29	–1.13	–4.70	69.10	1971	62.57	1999	–6.54
UK	71.63	71.18	72.15	68.91	–0.45	–2.27	–3.24	75.65	1975	67.13	1997	–8.52
US	69.48	69.60	68.67	66.77	0.12	–2.83	–1.90	69.60	1980	66.33	1997	–3.27
Avg.	70.04	68.16	69.36	66.08	–1.88	–2.07	–3.28	71.45		65.34		–6.11

Source: OECD

bargaining systems for most of the period since the second oil shock, the fall in the wage share over the period is almost negligible. In Germany and Austria, in contrast, both countries with strong trade unions and highly coordinated wage bargaining between 1970 and 2000, the fall in the wage share is quite dramatic. From the highest to the lowest point, it is seven percentage points for Germany and almost 18 percentage points for Austria. Table 5.1 gives the most pertinent descriptive data in this regard.

Interestingly, this fall in the wage share in those countries is not the result of a decline in the power of labour as a result of financial globalization, economic integration, or deregulation, all of which increase the exit options of capital over labour (see Jayadev 2007 and Kristal 2010 for representative arguments). Instead, it appears related to the macro-economic framework that revolved around central banks, which constrain the excessive wage claims of strong labour unions. Table 5.2 regresses the annual change ('first difference' in the table) in the wage share against the annual variation in

Table 5.2. Regression results for wage share, wage-bargaining regime, and monetary policy, OECD 1973–99

Dependent variable: First difference in wage share					
Column	I	II	III	IV	V
Lagged dependent variable	0.0284	0.0303	0.0274	0.0253	0.0799
Non-accommodation index (first difference)	–4.4372***	–1.1043	–0.9521	–0.9516	–0.9444
Index of Coordination (lagged)	–1.8086***	–1.7197***	–1.7224***	–1.7393***	–1.4214***
Non-accommodation index (first difference) *Index of Coordination (lagged)		–5.7374*	–6.0821*	–6.0299*	–6.9541**
Unemployment rate (first difference)	–0.4105***	–0.4049***	–0.4045***	–0.4026***	–0.3517***
GDP growth	–0.8833***	–0.8795***	–0.8769***	–0.8739***	–0.7381***
Left Cabinet share (first difference)			–0.002	–0.002	–0.0024
Union density (first difference)				0.0083	–0.0007
Openness (first difference)					–0.1015***
trend	0.0457	0.0489	0.049	0.0486	0.1111*
Constant	2.3284***	2.2533***	2.2481***	2.2632***	1.5676***
Observations	132	132	132	132	132
R-squared	0.3911	0.3942	0.3952	0.3953	0.4457

Legend:* p < 0.1; ** p < 0.05; *** p < 0.01

wage coordination, in central bank conservatism, and the interaction term between these two (i.e. a regime in which both high wage coordination and central bank conservatism are present). Not only does this analysis suggest quite strongly that the simultaneous presence of both high wage coordination and high central bank conservatism had a significantly higher effect than their individual presence, the explanation appears robust when controlling for most explanations that prevail in the literature and that invoke the rise in the power of capital or the inverse for labour, such as unemployment (which lowers the bargaining power of organized labour), Left cabinet seats and union density (which ought to have the opposite effect), and economic openness (an indicator of economic integration, which increases exit options of capital).

The fall in the wage shares in the OECD economies with strong unions and coordinated wage-setting systems is, from the perspective of the framework that has underpinned this book on EMU, relatively easy to understand. It is an expression of the low or even negative growth of unit labour costs, imposed by strong conservative central banks in economies with coordinated wage-bargaining arrangements, and the lack of that in more liberal market economies with decentralized wage-setting systems. Since real wages grew in the former, and less so in the latter, the conclusion is that labour productivity more than compensated for high wage growth.

While low unit labour cost growth (i.e. wage growth adjusted for labour productivity growth) may be beneficial in terms of inflation, there is an obvious downside to this: the entire aggregate demand management regime, which also includes a strong currency and tight monetary and fiscal policies aimed at stability rather than growth, is fundamentally restrictive. All other things equal, domestic aggregate demand is, therefore, in a quasi-permanent deficient state in economies where strong, conservative central banks contain strong unions.

That is not the case in other types of capitalist economies. In liberal market economies such as the UK and the US both monetary and fiscal policy have, since the great deflation of the 1980s, been symmetric and responded much faster to falls in output. Simply compare the Bundesbank's (BuBa) or the ECB's response to inflationary and demand shocks with the Bank of England's and the Fed's. The BuBa and the ECB respond faster to inflationary threats (the ECB actually raised interest rates in the summers of 2007 and 2010 because of a perceived risk of rising inflation!), and have also kept interest rates high, even when inflation was falling. When the economy slows down and output falls, however, the BuBa and the ECB did not respond rapidly with a more accommodating policy. The reactions by the Bank of England and the Federal Reserve, on the other hand, were the same when inflation was rising but they almost invariably also lowered interest rates faster than the BuBa or the ECB.

A systematic comparison of the legal documents underpinning central bank policies in the main Anglo-Saxon liberal market economies and the north-west European economies with wage-setting systems that include a small number of strong trade unions (Soskice 2007: 104–5) buttresses this point. There is a remarkable variation between these two groups of countries and an equally remarkable convergence within each. In liberal market economies, central bank charters typically incorporate two elements. One is that finance ministers and parliament retain a measure of control over the central bank: the inflation target is set by politicians, and the executive or the legislative branch is involved in *ex post* monitoring—think of the letter that the BoE governor has to write to the Chancellor when inflation varies beyond 1 per cent from the target, or the six-monthly appearances by the Fed chair before Congress. Second, the objectives of the central bank beyond price stability invariably include that it should support the general objectives of other economic policies. The north-west European economies, in contrast, do not include either. Governments generally play no role in setting targets, political actors exercise little oversight, and the central bank's objectives are limited to price and currency stability. Both in theory and in practice, therefore, monetary policies in economies with a small number of strong trade unions are considerably less permissive than in others.

With domestic demand constrained from all sides, growth necessarily depends on exports in such systems—yet even that is difficult because of the hard currency policies that follow from the restrictive macro-economic policies, which result in a stable but high exchange rate. Somewhat surprisingly, however, these economies have, despite the generally high wages in these economies, managed to retain a relatively large export sector based on manufacturing. To a large extent, this was the result of wage moderation: as long as productivity outgrew wage costs in those countries faster than in their main trading partners, especially those within the eurozone, their export sectors became more competitive. Not only did the others see their real exchange rate rise, they were unable to adjust through currency devaluations.

The contrast with economies that cannot rely on such an embedded system of wage coordination, and which have adopted very different growth strategies, is stark. The Anglo-Saxon liberal market economies, we discovered after 2007, essentially relied on an extension of private debt, not only in rather madly growing housing markets, but also in consumer credit (Trumbull 2006). This strategy replaced, as Colin Crouch (2009) suggests, government-led Keynesianism, which secured rising incomes for all. Once labour markets became flexible, and government abdicated its role as arbiter through deregulation, wages stagnated (see Krugman 2009 for the US). Income growth thus shifted from wages to non-wage income: remortgaging a house often earned a higher annual income for a middle-income family in

the UK and the US during the late 1990s and 2000s than a standard day job. And credit card debt grew fast during the same period. That increased spending power underpinned private consumption, which became the backbone of economic growth—until the bubble burst. The southern European economies, in turn, have relied on public debt to keep the economy going (with the exception of Spain, which grew on a private debt bubble as well). The story is familiar enough not to have to be repeated here.

Leaving aside the non-EMU liberal market economies, the north and the south in EMU are caught in a deadly embrace, however: being an exporting economy—as the northern EMU member states are—is on the whole beneficial. But exports require imports, and those markets are primarily in the south of the continent. The profits made in the north thus found their way, via the banking system and the organized system of private and public debt, back to the south, where they were used to purchase more goods exported by the north, which started the capital transfer cycle again (see Scharpf 2011 for an exceptionally clear exposition of this north–south trap).

Summing up, the restrictive macro-economic regimes that accompanied strong trade unions and coordinated wage-bargaining systems thus imposed caps on the growth potential of domestic consumers in the north (while doing the opposite in the peripheral EMU economies). This restrictive domestic regime, in turn, was compensated by a steadily growing export competitiveness: since the central banks punished excessive wages, and since everyone was aware of this, labour unions systematically claimed wages in line with or below productivity, making, all other things equal, their economies more competitive. This half-imposed export propensity of economies with highly coordinated wage-setting systems is the subject of the next section, which examines the typical (i.e. average) competitive strategies of companies in different types of wage-determination systems. It asks the questions if and how these macro-economic shifts found a reflection in supply-side adjustment. How did companies respond to the institution of the more restrictive monetary regime under Maastricht, which involved hard currencies, fiscal consolidation and, as we saw in Chapter 2, incomes policies to keep wage inflation under control?

5.3 Wage-Setting and Comparative Advantage

Imagine that wages in a particular sector grow at a rate exactly reflecting average labour productivity in that sector, and that wage setting is coordinated through strong labour unions so that all companies more or less pay the same wage. The aggregate effect of such a system of wage setting is, perhaps somewhat surprisingly, that this sector becomes ever more competitive.

Companies in which labour productivity is above the average are rewarded: they pay wage rates below their actual labour productivity growth rate; companies below that rate are punished for the inverse reason. This one-size-fits-all wage-determination system produces a mechanism that is reasonably well known in countries such as Sweden and, backed up by more institutional safeguards, in many northern continental economies, including Germany. It is called a productivity whip: it imposes higher productivity growth in the low-productivity companies and allows well-performing companies to invest more on the back of higher profits and thus raise their productivity. Average productivity thus permanently rises. The key is provided by the wage-setting system, which sets a hard floor on wages through wage coordination. The again somewhat surprising effect is that the economy is made in the image of the wage determination system, which forces up wages for all against the background of better-performing firms. Constraining company strategies through such strong labour market institutions thus produces beneficial outcomes for the economy as a whole (Martin 1984).

Many prospective EMU members dealt with the pressures emanating from the Maastricht process through incomes policies—either stand-alone or embedded in social pact and similar arrangements. These incomes policies took, in effect, two forms. One was the method of strong coordination approximating a centralized wage-setting arrangement. Labour unions, employers, and governments adopted a wage-rate target commensurate with the inflation target that the central bank or government had set, and then used the institutional arrangements at their disposal to impose that wage inflation target. Beside the early, usually short, periods of rapid disinflation, when wage rates often fell significantly below labour productivity growth rates, wages normally tracked the sum of inflation and labour productivity, and strong unions and employers' associations guaranteed the adoption of this target by their affiliates. In such a system, labour productivity growth is the driver, and wages adjust to that rate.

There was another method of disinflation, however, which was primarily adopted in countries where employers, labour unions, or both, were much weaker and often unable to organize the top-down coordination necessary for such a labour productivity-oriented wage moderation regime. (Think of Spain and Portugal for this second instance.) The reasons for the weakness could be many: ideological fragmentation among unions, conservative organizing strategies, adverse labour law, competition regimes, or an industrial structure that hindered collective organization, for example. Whatever the reason, however, the outcome is that central wage guidelines may or may not be adopted. Since no one ever is fully certain that they will be followed throughout the economy, a standard collective action problem ensues, and central coordination collapses.

The Maastricht criteria were there, however, and not meeting them constituted a hard sanction: EMU entry was delayed at best, and never going to happen at worst. Faced with that predicament, governments and social partners in these countries adopted a disinflation method that led to the same aggregate outcome as the central coordination systems, but by adopting decentralized modes of coordination. Rather than the inflation plus productivity target being set at the level of entire industries or even the economy as a whole, these regimes allowed for variation at the level of companies by setting a wage ceiling that reflected company-level (and not aggregate) productivity. Such a strategy allowed a minimal extent of central control over wages, but did not tax the system as a whole by requiring unions or employers to take on central tasks that they could not meet. Compared to a system of central coordination, however, it also changed the basic incentive structure for companies away from the choice between ever-increasing rationalization and exit. The strong productivity whip that emerged in a system of central coordination has all but disappeared if companies are allowed to use their own performance as a wage benchmark. Instead of labour productivity driving the adjustment, this process was driven through downward adjustment of wages, since labour productivity was much lower.

The system of wage coordination that was adopted to meet the Maastricht criteria in the 1990s, should, according to this argument, have had very important effects on the competitive strategy of firms. Central wage coordination led to higher labour productivity than decentralized wage setting through two mechanisms. The first was the hard constraint imposed by an industry-wide wage floor (through pattern bargaining or government-sanctioned *erga omnes* extensions), defended and policed by strong unions. The second was a cooperative workplace, where workers' representatives were engaged in productivity coalitions, which raised the ceiling for wage bargaining. In effect, in such a set-up with a hard wage floor, companies are forced to move up-market, in niches where value-added permanently rises and cost competitiveness is less important.[1]

That is also exactly what happened in the 1990s in the run-up to EMU: those economies preparing for EMU which relied on centralized forms of wage coordination—where, in other words, one wage prevailed in the sector where they were negotiated—were also the ones where average company strategies moved up-market. In economies that worked towards meeting the Maastricht criteria by means of decentralized forms of coordination, in contrast, firms did not, on the whole, change their aggregate strategies or, if they did, moved down-market into more cost-sensitive segments. And a closer

[1] This section builds on previous joint work with Andrea Herrmann (Hancké and Herrmann 2007), which also has more technical details on the data related here.

look at the mechanisms underlying this reveals that it was driven by increases in labour productivity, through training and other 'soft' mechanisms that have been part of the new local agendas that labour unions developed since the early 1990s.

How was this link between wage coordination and firm-level strategy established? The level of wage coordination is relatively easy to measure: there are a series of indicators, such as those developed by Traxler et al. (2001) or Kenworthy (2001 and 2003), which have been updated and can be used almost exactly as they are. Measuring the average competitive strategies of companies in an economy is somewhat more difficult. Start from the assumption that differences in prices (unit values) reflect quality differences (see European Commission 1997: 70–83; Porter 1985: 62–4). The competitive strategy of firms within one country is measured in terms of the *Weighted Relative Unit Value* (henceforth WRUV) of a country's relatively most important export sectors, which is calculated as follows. For each production sector, the *Revealed Comparative Advantage* (RCA) is obtained by comparing the relative export performance of a country to the relative export performance of a group of countries, in this case the EU (see Balassa 1965). These calculations reveal the sectors in which this country exports comparatively more than the EU average. For each E(M)U member state, I identify the five most highly ranked export sectors.

$$\text{RCA} = \frac{(\text{Exports of Country A in Sector p} / \text{ Total Exports of Country A})}{(\text{EU Exports in Sector p} / \text{ Total EU Exports})}$$

The second step is to calculate the WRUV for these five sectors. I start with calculating the Relative Unit Value (henceforth RUV) by comparing unit prices in a country's sector to EU unit prices in this sector.

$$\text{RUV} = \frac{(\text{Value of Exports in Sector p of Country A} \ / \ \text{Quantity of Exports in Sector p of Country A})}{(\text{Value of EU} - \text{Exports in Sector p} \ / \ \text{Quantity of EU} - \text{Exports in Sector p})}$$

The WRUV, in turn, is the weighted average, expressed in value added, of the five export sectors. It measures the difference between average prices of these domestically produced goods and average prices in the EU. In countries with a positive WRUV in Table 5.3 firms pursue a high quality production strategy, whilst in countries with a negative WRUV firms pursue a low cost production strategy. These data suggest two dominant patterns: aggregate competitive strategies either changed entirely (from positive to negative or vice versa), or existing strategies became more pronounced over the 1990s.

Armed with these statistics we can now more systematically explore the links between institutional frameworks for wage-setting and competitive strategies

Table 5.3. Competitive strategy of firms in E(M)U member states in 1992 and 2001

E(M)U Member States	Firms' Aggregate Competitive Strategy (WRUV in 1992)	Firms' Aggregate Competitive Strategy (WRUV in 2001)
Ireland	1498	1813
France	122.5	27.7
Denmark	47.9	65.3
Sweden	43.9	29.8
Germany	24.0	80.4
Italy	17.2	27.1
Belgium	15.9	52.0
Luxembourg	15.9	–32.6
UK	10.2	479.8
Finland	2.1	61.2
Austria	–6.7	4.4
Spain	–11.7	–14.2
Portugal	–12.4	106.2
Netherlands	–23.5	71.9
Greece	–26.2	–60.1

Source: Hancké and Herrmann 2007

adopted by firms in these economies through correlation analysis. However, one issue needs to be addressed first. By the early 1990s, several EMU member states had relatively highly centrally coordinated wage-bargaining systems, often as a result of their earlier membership of the DM-bloc. A measure that takes into account changes in wage-setting systems will not reflect the fact that these countries either cannot increase the degree of central coordination of their wage-bargaining systems, or that top-level centralization is not necessary for a coordinated outcome. I therefore calculated three separate correlations, which capture different dimensions of our argument. The first of these reflects the 'tightness of fit' between the centralization score and WRUV for 1992 and for 2001. If the difference between the correlation coefficients for 2001 and 1992 is large and positive, the fit between competitive strategy and the institutional framework of wage bargaining has improved during that period. The second addresses one aspect of the causality in this argument and answers the question: have firms adapted their competitive strategy (expressed in WRUV) to the institutional framework or the other way around? The extent to which the competitive strategy fits the institutional framework better in 2001 than in 1992 is measured by holding constant the institutional framework of wage setting at 2001 scores. The basic idea is that if the value is higher for the 2001–2001 correlation, companies adjusted their product market strategies anticipating (as it were) shifts in the institutional framework or, at the very least, reinforcing those when no changes in wage bargaining occurred. The third analysis, finally, correlates the shifts in WRUV with the centralization scores for 2001. Again, the hypothesis is that positive

Table 5.4. Correlation analysis, wage coordination, and competitive strategy

H1	$R_{WRUV\ 1992}$ * Centralization 1992	$R_{WRUV\ 2001}$ * Centralization 2001	Δ (Difference)
EMU-11 (without Eire)	–0.424	0.348	+0.772
H2	$R_{WRUV\ 1992}$ * Centralization 2001	$R_{WRUV\ 2001}$ * Centralization 2001	Δ (Difference)
EMU-11 (without Eire)	–0.261	0.348	+0.609
H3	$R_{WRUV\ (2001–1992)}$ * Centralization 2001		Strong Corr.
EMU-11 (without Eire)	0.547		> 50 %

shifts in comparative advantage reflected the type and level of centralized wage bargaining at the end of the period. In other words, if the correlation between $\Delta WRUV_{1992–2001}$ and the scores on wage centralization is positive and high, the competitive advantage of companies moves in line with the position in terms of wage bargaining that these countries were choosing in the 1990s. Table 5.4 recapitulates the hypotheses and the results in condensed form; all three coefficients take the form that I predicted. In fact, in the case of the first two, the correlation not only jumps quite significantly, the sign of the coefficients actually changes from negative (meaning that institutions and strategies are entirely misaligned) to positive (in which they are entirely aligned). Companies in prospective EMU member states did, indeed, change their competitive strategies to bring them more in line with the institutional framework of wage setting.

The upward shift in productivity where wage coordination rises is, as I suggested earlier, best understood as a by-product of the parallel shift toward more central wage coordination in some of the EMU candidate member states, in which central wage coordination acts as a productivity whip, forcing weak companies to improve their performance rapidly. If this explanation is correct, then the underlying 'soft' mechanisms with regards to skills and work organization should also differ systematically between centralized and decentralized modes of wage coordination. Table 5.5 presents the key basic data, and suggests that different modes of wage coordination do produce different adjustment profiles. The rate of unit labour cost (ULC) growth in the 1990s is much higher in the economies that adopted decentralized modes of wage coordination, with annual labour productivity growth almost twenty percentage points lower and wage growth almost

Table 5.5. Competitiveness, productivity, and wages in the manufacturing sector

	Average score 1990–99 ULC growth	Average score 1990–2000 L productivity growth	Average score 1990–99 real wage growth
Central wage coordination			
Average score	1.3	2.7	1.1
Decentral wage coordination			
Average score	5.4	2.3	1.9

Source: OECD STAN Indicators

Table 5.6. Continuous vocational training programmes in economies with centrally and decentrally coordinated wage-setting systems, 1993 and 1999

5.6.1 Percentage of all companies reporting CVT

	1993	1999
Central wage coordination		
Average score	53.2	69.6
Decentral wage coordination		
Average score	33.3	25.3

5.6.2.Employees covered as a percentage of all companies

	1993	1999
Central wage coordination		
Average score	77	87
Decentral wage coordination		
Average score	50	57

Source: 1993 data, *First Continuous vocational training survey, Statistics in Focus*, 1996; 1999 data: *Second Continuous vocational training survey,* Office for official publications of the European Communities, 2002

seventy-five percentage points higher than in the centrally coordinated economies.

Now, is this difference in ULC growth due to higher skills in centrally coordinated systems, as the productivity whip mechanism suggests? Slow growth of ULC can, after all, be accomplished through moderate wage growth as well as higher productivity. We know that the latter holds for the centrally coordinated economies when compared to the economies with decentralized coordination. However, is this difference reflected in other statistics as well? Table 5.6 offers two sets of data that point in that direction. The upper half of the table reports for 1993 and 1999 (appropriate proxy years for the start of the Maastricht period and the introduction of the euro) how training fared when measured in terms of *the number of companies* reporting continuous vocational training for their workforce, while the lower half of Table 5.6 presents data for the *number of employees involved* in such training systems. In

both instances, the economies with central wage coordination have higher levels for both observations, and higher growth rates throughout the 1990s. In economies with a decentralized mode of wage coordination, the number of companies reporting continuous vocational training programmes fell, in fact, during the 1990s (while it rose quite steeply in the others). The relative stability of unit labour costs in the centrally coordinated economies is, therefore, directly linked to changes in workforce skills and job organization that led to rising labour productivity, and not just to wage moderation against a background of stagnating productivity.

When the economies of the prospective EMU member states ratified the Maastricht Treaty, they also implicitly adopted a series of shifts in their wage-setting systems that installed a disinflationary regime. These shifts, in turn, had effects on the way labour markets operated and therefore also how firms deployed their workforce. If countries adopted a centralized form of incomes policies, the competitive strategy of companies shifted upward; the opposite was true for countries that adopted a decentralized form of wage coordination. The explanation is simple—and far from new in political economy, although it had been forgotten since the demise of the centralized Swedish model. A centrally coordinated wage-setting system effectively sets a floor on wages, and thus punishes companies that have below average labour productivity, while rewarding the others. The mechanism is known as a productivity whip, and has served the northern European economies well during the turbulent Maastricht years, and even more so during the first years of the big crisis of EMU. But this system has a dark side: the more competitive the economies in the core (in the northern part of the continent) became, the less the others did. And eventually these trade asymmetries translated into significant current account imbalances. The next section explores how that happened.

5.4 Wages, Real Exchange Rates, and Current Accounts

How did different arrangements for wage determination, considering their effect on economic performance, contribute to the crisis of EMU in 2010 and after? In essence, the mechanism goes through the real exchange rate, the single most important inter-country adjustment mechanism after the fixing of nominal exchange rates in EMU. Real exchange rates express the price of the same good in the same currency in different countries: a lower real exchange rate means that goods are cheaper in one country as opposed to another. While many factors go into the determination of the real exchange rate, in the tightly integrated advanced capitalist economies that make up EMU one of the main determinants is the variable input factor labour cost—wages. In the northern, coordinated, economies the domestic institutions of

wage-setting, and the way these can turn complex information into tangible wage-setting targets, allow some countries to depreciate their real exchange rate and thus become more competitive (while others in the south, appear unable to do so). If the growth of ULC in country A is lower than in country B, A gains competitiveness vis-à-vis country B.

We can now pull together the different threads developed in this chapter for a coherent picture. Exhibit A: economies with strong trade unions and coordinated wage-bargaining systems also have adopted a restrictive macro-economic regime. Aggregate demand in the domestic economy is kept artificially low: the central bank punishes, as the last mover, any excessive wage push inflation and imposes a similarly restrictive stance on government expenditure. Even the possibility of 'imported inflation' as a result of a depreciating exchange rate is eyed hawkishly. All other things equal, the outcome is slow growth as a result of low domestic aggregate demand and a massive orientation of the economy toward exports—in effect the only remaining stable source of economic growth. The strong currency, however, works against a reliance on exports, and labour unions and employers are locked in a search for slowly rising or even falling ULC. Coordinated wage-bargaining systems offer the solution: they guarantee a competitive real exchange rate through wage moderation and pattern bargaining. Economies with weaker trade unions face a considerably more permissive macro-economic regime, in which the central bank adopts a symmetric inflation target, fiscal policy is used as a countercyclical tool, and the exchange rate benefits from benign neglect by government and central bank. Growth, not surprisingly, is high in the second model and, most importantly, perhaps, does not depend on exports. But that growth also has important toxic elements: unstable (and unsustainable) financial exposure, low labour productivity, high inflation, and a gradual erosion of competitiveness.

Exhibit B shifts the attention to the supply side. Central wage coordination forces firms to search for productivity as a way of compensating for a relatively high wage floor. The same constraint also forces labour unions to search for productivity, but this time because the wage ceiling is given by the labour productivity growth rate—rising labour productivity thus allows for higher wages. Again, labour unions and employers find themselves locked in a search for a common solution—this time increased labour productivity. They do so through a permanent rationalization of production, relying on skill upgrading and work reorganization. The new division of labour within the labour unions between the central unions who negotiate wages, and local unions who negotiate the production of skills and the reorganization of workplaces is a major help in this instance.

In countries where labour unions have been weaker, however, none of these constraints and opportunities existed, none of these virtuous cycles

ensued, and competitiveness slowly fell. This process can take three basic forms. The first is the simple collapse of exports as a result of rising export prices because of domestic wage inflation. This is often associated with a wage-bargaining system where the sheltered sector is either a wage leader or decoupled from wage setting in the exposed sector. Aggregate inflation rises, the exposed sector is unable to compensate for a rising domestic price level, and export goods are priced out of the market. Think of Greece, Portugal, and possibly Spain, as cases in this regard. The second scenario is the sabotage of a reasonably well-performing system. Italy under Berlusconi offers a vibrant example of this. The country accomplished a feat hitherto unknown among advanced capitalist economies: it managed to build up coordination in an economy that had suffered from a lack of organized strategic interaction among firms and between firms and organized labour, by building on the wide array of existing but weakly articulated non-market institutions in regions, local industrial systems, and municipalities. After the introduction of the euro, however, these institutional arrangements, embodied in the 1993 Social Pact and its subsequent generations, were abandoned by the Berlusconi governments, and Italy moved rapidly from a more to a less coherent mode of coordination and entered a decade of decline (Simoni 2012). Finally, there are the countries that have stayed the course, such as France, but that simply suffered from being caught up in a whirlwind around adjustment in the northern EMU economies. Real labour productivity in France has followed almost exactly the same upward pattern as Germany's since the early 2000s, and real ULC growth was very subdued between 1999 and 2008. Exports have roughly followed the same trajectory as Germany since the late 1990s: whilst Germany has performed slightly better, France has been very close on its heels throughout the 2000s. Yet France's current account has moved from a surplus between 1994 and 2004 to a deficit since then. The explanation: France is caught in a monetary union, with a restrictive macro-economic regime, in which Germany is clawing back competitiveness (data can be found in Krumbmüller 2011). For every move toward a current account surplus in Germany, France's main trading partner, France inches closer to a deficit—even when the country's underlying performance does not deteriorate (see Europp 2012 for more details).

The findings in exhibits A and B reinforce each other and they all push in the same direction within each country or group of countries, but also drive the divergence between groups of countries. The restrictive macro-regime is supplemented by a very well-oiled, well-performing organization of the supply side of the economy in places where unions are strong. This may sound counterintuitive, though it should be more commonplace by this stage in the analysis: labour unions *do* care about employment and wages of their members and if improving relative competitiveness is the (only) way to get there, they

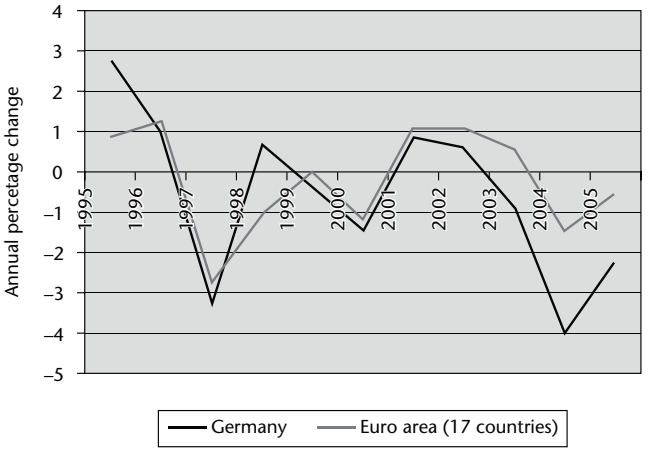

Figure 5.1. Evolution of unit labour costs, Germany v. rest of Europe, 1995–2005
Source: OECD

will embark on that route—often, it should be added, with little regard for the consequences of their actions on workers elsewhere. Where labour unions are weak, however, as in the southern peripheral countries, none of these elements were in place, and the result has been a steady deterioration of competitiveness. Unit labour costs rose faster than in the north, and economic growth was the result of an unsustainable consumption boom based on debt, mainly in the private sector in the Anglo-Saxon liberal market economies, and mainly in the public sector in the others. Figure 5.1, which maps the evolution of ULC in Germany and in the rest of Europe, leaves little doubt as to what happened. While the competitiveness of Germany, and in its wake many of the economies in the northern EMU member states slowly improved after the introduction of the euro, ULC grew at a faster rate elsewhere, especially in the periphery.

This divergence of ULC has to be seen against the background of two other elements: the relatively restrictive macro-regime that imposed low aggregate growth in EMU, resulting from the ECB's tight stance, and the restrictions placed on public spending through the Stability and Growth Pact, and the fact that EMU is almost a closed economy, exporting very little of its combined GDP outside the EMU-EU zone. Under those conditions, the shifts in the real exchange rate implied by this divergence in ULC necessarily implies that the gains in competitiveness in the northern group find their counterpart in falling competitiveness in the south. What DE (i.e. NW-Europe) gains, RE (in this case southern Europe, including, sadly, the good pupil France) loses.

This brings us to the political-economic processes at the basis of the devilish structural dynamic that has haunted EMU for the better part of the last decade. The differences in the wage-setting systems forced central banks and governments to keep a lid on domestic sources of growth, in countries where strong, large labour unions might exploit such expansionary policies (i.e. DE). The economy in highly coordinated wage-setting systems thus turned to exports as a source of economic growth, with the supply side of the economy supporting this export-orientation: highly coordinated wage-setting systems with strong labour unions forced companies to engage in a permanent rationalization through labour productivity increases. The rest of Europe (RE), and especially the southern EMU members, faced a different regime, in which export competitiveness fell, in large measure as a result of the rise in competitiveness in the north. This, in turn, implied that DE accumulated an ever-growing trade surplus, while RE accumulated a massive trade deficit—which eventually turned into an EMU-internal balance of payments crisis, expressed in diverging current accounts. Figure 5.2 presents the current account evolution of these two groups of economies within EMU since the Maastricht period. What is immediately apparent is how the convergence that governed most of the 1990s, was abruptly reversed in the years 2000–1, with Germany's current account surplus rising fast and the others' deficit rising fast.

Under any other arrangement, a combination of exchange rate adjustment and domestic price controls would have been forced upon the countries with a deteriorating current account. Yet, with the intra-EMU exchange rate fixed, and growth constrained by restrictive monetary and fiscal policy stances, weakly performing countries are unable to adjust precisely where it matters most—in trade with their main trading partners in EMU. Transfers from the (currently) faster-growing DE in the north to the slower-growing economies

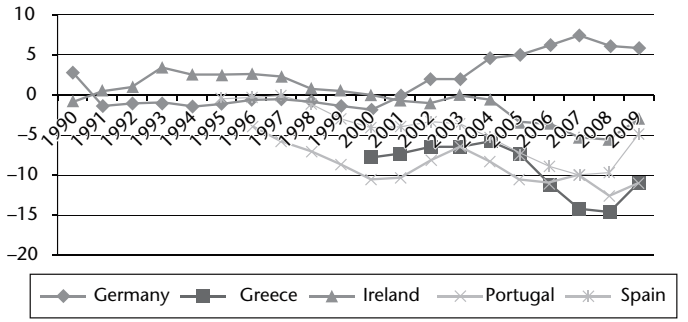

Figure 5.2. Evolution of current accounts Germany v. GIPS 1990–2009
Source: OECD

of RE are another, almost opposite, adjustment mechanism: in a fiscal union, poor member states would, in part, be financed by their wealthier brothers and sisters elsewhere through a fiscal transfer mechanism. But the absence of political union makes that very difficult (although, as we saw with the Greek bail-outs, not completely impossible).

The upshot is that with current account imbalances increasing between the northern European economies and the peripheral southern economies and Ireland, the divergence between private debt and public deficits in the two types of EMU member states increased in lockstep. Current account deficits may result from trade imbalances and asymmetric capital flows, but they find their expression in national accounting in deficits: a current account deficit is, by definition, equal to the sum of private debt and public deficits, and a current account surplus, by definition, to the net sum of private and public savings. Put simply, no current account deficit, no fiscal crisis and/or no banking crisis, and vice versa.

Conclusion

Labour market institutions, such as those that govern wage setting, employment protection, training, and workers' participation in decision-making have often been seen as key obstacles to adjustment in modern capitalist economies. Growth, thus the argument, would follow structural reforms—especially in the labour market. EMU almost institutionalized this dictum: freezing the nominal exchange rate, and imposing relatively restrictive monetary and fiscal policies implied that the burden of adjustment unilaterally fell on labour markets. Yet the first decade of EMU has shown that the key ingredients for economic success were not reformed—that is, deregulated, decentralized—labour markets, but a combination of tighter central coordination of wage-setting and high-productivity adjustment patterns in companies based on training and social peace. Strong trade unions were kept in check by strong central banks, the growth of ULC was very slow as a result—much slower than in countries where this constellation involving labour unions and central banks was absent—and local productivity coalitions ensured that the pressure on companies was resolved in a search for productivity.

This virtuous set-up in the northern EMU member states was, almost perfectly, mirrored in the southern periphery: not only were strong labour unions absent (or sidelined, as in Italy), the search for productivity-led ULC adjustment proved futile, and low wage growth became the mechanism for disinflation under the Maastricht process. Once membership of EMU was secured, however, relative ULC rose fast as a result of wage catch-up, especially in the public sector, and low labour productivity in the southern economies, on the

one hand, and the disciplined competitiveness-oriented wage-setting systems in the north on the other. If 1990–9, under the Maastricht regime, was the decade of convergence, the first years of EMU heralded a dramatic divergence in almost every relevant indicator. Relative ULC diverged, current accounts followed, and a balance of payment crisis ensued. The financial crisis of 2007 no doubt exacerbated the problem, but the divergence of ULC and current accounts was built into the system from the start.

As it was conceived in the late 1980s and early 1990s, EMU was doomed to fail, therefore. It imposed a one-size-fits-all interest rate on economies that were very different in their political-economic make-up, and displayed important variation in their levels of socio-economic development. The unitary monetary policies were very poorly digested domestically (*pace* Enderlein 2006) and bubbles ensued in the high-inflation countries, stoking further inflationary growth there, and forcing deflation (i.e. negative ULC growth) upon the northern countries—who then became more competitive, helped by the organization of their supply side. Eventually this divergence led to the current account and fiscal adjustment problems that we have witnessed since 2010. A crisis was born.

6

The Missing Link

Labour, Inflation, and EMU

High politics and high-level politics have been the main perspectives through which economic and monetary union in Europe, EMU, has been analysed. The desire to stabilize the basic macro-economic framework in the EU informed the plan to build and adopt a common currency. And a single currency would be the harbinger of further, deeper political integration, ultimately leading to a political and fiscal union. Those goals were pursued by a small group of statesmen (very few women indeed) since the late 1970s, when the costs of floating exchange rates and uncoordinated economic policies on the continent were obvious to all. Thus the conventional narrative of the design, emergence, and evolution of EMU. Neo-realists added a complementary point, by emphasizing the benefits to individual countries of joining EMU, but did not challenge the underlying script.

This elite-centred view has been very helpful for understanding EMU and other projects of economic integration, in Europe and beyond. During the crisis of the late 2000s, however, it has also revealed its limitations. As long as economic integration in Europe in general, and EMU in particular, was steadily chugging along on what appeared to be a predetermined path, the top-down perspective of high politics and high-level politics served us well. When things turned sour, however, as they did in the latter years of the 2000s, the limits became clear. Domestic politics re-emerged with a vengeance during the euro crisis, as Greece and Spain's street protests and German obstinacy informed by growing eurosceptic sentiments at home testified.

With our attention redirected to the domestic scene, we discovered that much deeper processes, rooted in the adjustment of national frameworks for economic policy-making to growing monetary integration, were unfolding. Since the introduction of the euro in 1999, one group of member states, consisting of Germany and its satellites (which I have called DE in this book), gained in national competitiveness, while another group, primarily those in

southern Europe (RE, for Rest of Europe), lost competitiveness in parallel. The first group relied systematically on their domestic wage-setting institutions to do so; the lack of those in the second meant the opposite. It matters little, in fact, if DE did so on purpose or was forced by rising inflation in RE to compensate (both are almost certainly true to some extent). Once each of them found themselves on that trajectory, there was little to stop this slow-moving, diabolical scenario to play out. Trade flowed, by and large, in one direction, from north to south, while capital flowed in the other: DE's current accounts went structurally in surplus, while RE's remained stuck in deficit, without the domestic adjustment mechanisms to correct these divergences.

The reinterpretation of the origins of EMU and its effects through the perspective of differences in wage-bargaining systems and underlying models of capitalism more generally that I have adopted in this essay on EMU raises several questions. One set of these deals with the academic literature on EMU as it exists in the economics, politics, and industrial relations literatures, and goes beyond the high/high-level politics distinction to challenge some of the central ideas about labour markets in political economy. The other collection of question marks deals with the policy frameworks associated with the design of EMU and the constellation of central banks and wage-setters at its heart. These two form the backbone of this final chapter. I will conclude by looking back at the wider problems of economic integration in Europe, in particular the politics of further economic and monetary integration.

6.1 Monetary Integration in Europe: New and Unanswered Questions

As I have argued in this book, understanding EMU, both its origins and its crisis (and possible demise?), is impossible without understanding the co-evolution of monetary integration and wage-bargaining systems. Early monetary integration in Europe—the emergence of the Deutschmark (DM)-bloc—required a deep and fundamental shift in the domestic institutions of wage setting in the countries aspiring to a peg with the German currency. A stable exchange rate vis-à-vis the DM implied a convergence of domestic inflation rates on the German one. In the case of a divergence of inflation rates, the national central bank would raise interest rates to keep the peg. That, in turn, imposed wage moderation on the leading labour unions in the exposed/export sectors (i.e. those that produce tradable goods and services) and an institutionalization of wage leadership of these unions over those in the sheltered sector, mainly in the public sector with strong trade unions and employees that enjoyed lifetime employment. In the nascent DM-bloc, this led to social conflict, wage moderation in the export sector, and the subordination of public-sector

wage claims to those in the exposed sectors of the economy. In the remaining future EMU member states, during the Maastricht process, social pacts and wage restraint through coordinated incomes policies led the way. By the time of the introduction of the euro in 1999, the political economy of EMU-Europe consisted of a series of nested arrangements, with German wages at the helm, kept in check by an aggressive Bundesbank, followed by parallel interactions between the leading union and the domestic central bank in the rest of EMU. Within each of the member states, export sector unions, assisted by credible central bank and government policy stances, kept tight control over wages in the sheltered sector.

The advent of EMU fundamentally altered this set-up. Transferring authority for monetary policy to the ECB eliminated the capacity of the national central bank to punish excessive wage inflation: the weight of individual sectors fell significantly, proportional to their weight in the EMU-wide (and no longer the domestic) economy, and a collective action situation emerged in which individual unions would be strong enough to extract wage concessions but no longer paid the full price in terms of real wage erosion or unemployment. Since the export sector was, by definition, exposed to competition, economic integration imposed wage moderation through a hard competitiveness constraint. But the sheltered sector—especially the public sector—was, in effect, cut loose from the constraining authority of the central bank. If wage leadership remained with the export sector because of other institutional safeguards, as in DE, inflation was subdued. Elsewhere, in RE, aggregate inflation rose, competitiveness fell, the trade position deteriorated, and current accounts diverged. The crisis of EMU was born.

There is more to the problems that EMU has faced since 2010, of course, than a misalignment of wage-setting systems. However, it is highly likely that, even without the combination of a banking crisis, asset inflation in overheating economies, and the sudden fiscal crisis, the devilish dynamic of current account divergences, with its roots in different wage-setting institutions, would have manifested itself—perhaps a little later, or less violently, but ultimately no less urgently. Because of the ECB's effectively pro-cyclical policy, resulting from a single nominal interest rate set against different inflation rates, divergence in economic performance was built into the system. And lacking domestic wage-setting arrangements that kept wage inflation in check and furthered productivity growth, one group of countries lost competitiveness while another gained. Add to this that the domestic macro-economic make-up of DE in the north, including above all its capacity for wage moderation, was such that it relied almost solely on exports for growth, while the others relied on (public or private) debt, and it becomes simply impossible to underestimate the role of labour market institutions in the build-up of the crisis.

Giving credit where it is due, looking at the crisis of EMU today, the vast literature in political economy known as the theory of optimal currency areas (OCA theory) seemed to have had a point—at least in this EMU, with its endemic low-growth regime and decentralized fiscal policy. The differences in domestic institutions led to differences in the wider economic organization, which in turn implied divergent economic performance, and those fed into the problems that we have seen since 2009. But OCA theory was almost certainly looking in the wrong direction when analysing the problems of EMU: the more (not less) organized labour markets and the more (not less) coordinated wage-bargaining systems in the north were key to the successful adjustment to the challenges of monetary integration—in the DM-bloc, during the Maastricht period, after the introduction of the euro, and in the crisis of 2010–12. The social conflict in the emergent DM-bloc in the early 1980s led to a more nationally and internationally organized wage-setting system; social pacts and other incomes policies inevitably led to changes in labour market institutions that built on wage coordination; and the collapse of the tight links between export and sheltered sectors in some member states was at the basis of the competitiveness problems they faced. The reason is simply that tighter coordination of wage setting makes unions respond as a single collective worker and thus forces them to internalize any inflation and employment effects, while more organized labour markets with a strong training component and peaceful workplace arrangements allow unions and employers to raise the feasible (i.e. non-inflationary) wage because of the positive productivity effects they generate.

At the very least, therefore, this conclusion suggests the need for a more careful and more sustained inquiry into the role of these labour market institutions, and especially how they produce such beneficial outcomes—often against the prevailing orthodoxies in political economy that advocate their deregulation. While this benign view of labour market institutions has existed since the early 1980s, if not before (Schmitter 1981; Cameron 1984; Flanagan et al. 1983), these insights were largely forgotten when the New Classical orthodoxy took hold. Baker et al. (2004) were among the first to go against the grain: they suggested that labour market deregulation may, at best, have very weak effects on standard economic performance indicators and, at worst, none at all. Bassanini and Duval (2006) suggested there might well be many roads to full employment, ranging from the Anglo-Saxon deregulated labour markets over the Danish-inspired flexicurity system to more traditional corporatist arrangements. And according to Hall and Gingerich (2009), building on Hall and Soskice (2001), economic performance, when averaged over relatively long periods, was high in systems with high levels of either strategic or market coordination among political-economic actors and low when coordination was a mix of market and non-market coordination. Deregulating and

liberalizing labour markets—or 'structural reforms' as these are often euphemistically known today—is, in other words, useless at worst, and a set of policies with only a marginal impact on economic performance at best.

Adding these arguments to the points I made earlier in this book, suggests three sets of research questions in particular that require more attention. The first builds directly on these insights about structural reforms: to what extent is labour market deregulation a necessary and/or sufficient condition for improved economic performance in general and adjustment to EMU in particular? Baker et al. (2004), Hall (2007), Schettkat (2003), and Theodoropoulou (2008) are all very sceptical about the need for labour market deregulation to improve economic performance. While carefully leaving open the possibility that deregulation may have beneficial effects, they suggest that it is probably not a necessary condition. The most careful conclusion to draw from this debate is that there are many possible adjustment paths, some of which require deregulation, while others do not.

The conclusions reached by Hall and Gingerich (2009) help us understand the conditions under which deregulation might have beneficial effects. Their analysis suggests that deregulation of labour markets has negative repercussions on economic performance unless the rest of the institutional framework governing capital and product markets is also highly deregulated: in the limiting case, the institutional complementarities that they put forward only seem to operate when all elements of an institutional framework are calibrated in the same direction—coordination either via markets or through strategic interaction.

Labour market deregulation may, therefore, only work in systems in which most other economic relations are also governed mainly through markets, as is the case in the UK and the US, but definitely not to the same extent in continental Europe. On the continent, and therefore in EMU, labour markets are either of the highly strategically coordinated type, as in the north of Europe, or more or less shielded through state regulation, as in the south. And, while capital and product markets have been integrated through liberalization in the EU, they remain a hybrid with a strong non-market component. Deregulation of labour markets in either of the two continental families of capitalism may, under these conditions, not have the benign medium-term effects usually associated with them and make an already bad situation worse. What we need here, therefore, is systematic, critical research that examines if, how, and when labour market deregulation has had positive effects on unemployment in the first place, and on life chances more generally—and when the opposite has been the case. Baker et al. (2004) have demonstrated that the across-the-board claim of the beneficial effects of labour market deregulation rests on very shaky empirical foundations. A careful examination of these claims and others would help us disentangle myth from reality.

The second question engages one of the key variables for the analysis of EMU here: wage coordination. If wage coordination, and by extension strategic coordination of other economic activities, has the beneficial effects that I (and others) have identified, that begs the question if and how it can be built. Is it possible to design policies that produce an institutional framework in which strong autonomous actors engage in forms of cooperation and political exchange that further stable, longer-term relations based on cooperation? The main position, almost by default, in the debate thinks not: coordination among political-economic actors of any sort is given by history. If at some point in time a national economy took a route that did not involve coordination—for whatever historical reason, early decentralized laissez-faire capitalism as in the UK, or centralized state-led capitalism as in France, for example—it is impossible to (re-) discover and construct it afterwards. The analysis of international wage coordination among trade unions in Chapter 3 earlier supported this: the lure of the gains from defections is always strong enough for individual parties to undermine the arrangement.

Yet there are two types of counterarguments to this, which warrant closer inspection. The first is that sometimes building coordination from very flimsy foundations does work. In response to the hard constraints imposed by the Maastricht process, Italian wage setting went, almost overnight, from a chaotic system that excluded trade unions, to one that targeted a nominal wage encompassing productivity and inflation, and relied on union discipline to transmit that target throughout the economy. The effect was that Italian wages in different sectors grew in tandem, that inter-regional wage differentials within industries diminished, and that Italian firms adopted more high-end product market strategies (Herrmann 2005). This remarkable institutional shift was possible because Italian employers and labour unions were often able to rely on a set of highly informal, but also highly effective, local arrangements, sometimes semi-codified in territorial pacts, which governed local labour markets. When the labour unions and employers, under the aegis of the central bank, negotiated the 1993 Social Pact, this patchwork of local deals provided flexible institutional support for the reorganized national system. Those who point out that this was simply a specific form of the hypothesis that 'history matters' should bear in mind that Italy had experimented for decades with policies to instil some form of neo-corporatist wage discipline (Salvati 1981), went through a period of protracted social conflict after that failed, developed a political economy that sidelined the labour unions, and entered the 1990s with only a marginal chance to meet the Maastricht criteria. Then, miraculously, it rediscovered this positive historical heritage. History may matter, but this is the analytical equivalent of tumbling dice: something more than chance should explain this.

The argument that coordination and cooperation are intrinsically difficult because of collective action problems has intuitively more appeal: if even the European labour unions, who all desire more cooperation and would benefit from its existence, face significant difficulties developing it, we may well be presented with a critical case. This is possibly one of the most likely worlds for coordination to emerge; if it does not do so here, it is very unlikely it will under other, less conducive circumstances. But as Hayek (1967) and Sabel (1993 and 1995), the first with a Right-liberal and the second with a Left-constructivist version, argue, endogenous forms of cooperation can exist. Hayek's argument is elegant in its simplicity: any dyad constructs the institutions necessary to govern its exchange—A and B agree on rules to follow, just as C and D do. Competition between different forms of institutional governance will weed out the inefficient ones, and what we are left with is an endogenous institutional order fitted exactly to the needs of contracting parties. Sabel offers a socially denser version of such an endogenous argument: any interaction between two parties is built on a minimum of trust—else we would, in the limiting case, be unable to understand each other. Trust as a commodity grows in value with use (Arrow 1974), and the second-round interaction is therefore socially richer than the first. The same happens for the third round of exchanges, and so forth, until cooperation ensues, governed by a dense, mutually agreed, institutional framework. Sabel and Zeitlin (2008) use this model to understand the emergence of coordination between sovereign states in the context of the EU. Governments agree on targets, are free to choose the means to reach them, and learn from each other by monitoring other parties in this exchange.

These examples of the Italian pact and the arguments on endogenous cooperation suggest that coordination may be difficult to build, but it is not necessarily impossible. That brings us back to the central issue: can coordination be constructed under historically adverse situations, and if so, how? A research design that carefully examines cases of attempts and non-attempts at strategic coordination under similar circumstances in several critical dimensions, and success and failure in the case of the former, may help shed light on the different possible pathways to cooperation and coordination, and may help us understand better when it fails and succeeds. By isolating factors that contribute to failure, we may also develop a better sense of the conditions under which it can emerge (or not) in international settings such as EMU, when the common ground is narrower and the lack of trust higher.

Finally, there is the question of different viable macro-economic policy mixes associated with EMU. The orthodox one is simple: a restrictive and narrow monetary policy, combined with fiscal discipline, will impose structural reforms on labour market actors, which will lead to better economic performance in terms of growth and employment. After only twelve years of

its application in EMU it is quite clear that this recipe is not working all that well (but, as with leeches many centuries ago, the doctors might scream for more of them to cure the patient). The orthodox policy mix of EMU, as laid out most clearly in Issing's (2002) Maastricht assignment, has been nothing less than an abject failure.

Yet the alternative to the orthodox view, the New-Keynesian model of section 5.2, in which the central bank addressed wage setters, has its own problems. Not only does the financial sector only play a cameo role in this model (Schelkle and Hassel 2011), but most problematic, from the perspective of the analysis here, is its conclusion that wage moderation is a crucial component of a sustainable political-economic model, since it (a) keeps the central bank happy and (b) allows countries to target a competitive real exchange rate—precisely what was at the basis of the problems with EMU as I analysed them here. If DE's real exchange rate had not systematically worked in its favour, the current account divergence between DE and RE would have been much smaller as well, and the problem of financing imports with debt much smaller. Put differently, as an analytical device to describe what happened, as I have used it in this book, the New-Keynesian model seems remarkably pertinent. As a prescriptive device, however, it produces serious problems.

Both of these views fail, I suspect, because they ignore the contribution that labour market actors can make to macro-economic policy-making. The orthodox model does so by relegating it to the residual adjustment point: fix all other policy areas, and labour markets become the buffers. The New-Keynesian view does so by handing, somewhat arbitrarily, the gun to the central bank: if wage-setters do not understand the need for wage moderation as part of the policy mix, the (independent, conservative) central bank will, as the last mover, retaliate. The underlying assumption is that labour unions will always put a sectional interest before the general one and thus generate inflation externalities. Unless kept in check, the world will slide into the worst medium-coordinated world for which Calmfors and Driffill (1988) and Hall and Gingerich (2009) have warned us.

Ascribing such rationality to labour unions in the pursuit of their self-interest is remarkably short-sighted, however. If unions are that rational, there is no reason to assume that they cannot explore longer-term strategies that benefit all parties. Imagine for a moment that governments offer a deal to unions, benignly watched over by a central bank along the following lines: 'if you agree to coordinate wage setting to keep wage inflation under control, we will adopt a more expansive fiscal policy that disproportionately benefits wage earners and their families'. Governments could increase training expenditure, for example, or R&D expenditure, which have a short-term Keynesian stimulating effect alongside a long-term effect of raising the feasible growth rate by increasing productivity. The central bank does not lose its

centrality—it remains the last mover in the set-up and can therefore punish the potential time-inconsistency of wage setters or governments—but it does coordinate its actions with other political-economic actors as long as its preferred outcome of low inflation is reached. It does engage in dialogue with governments and wage setters, to convey its preferred outcomes, and instead of imposing a single solution, accepts that there may be more than one route to get there. Central bank independence, as Willem Buiter points out, 'does not mean that you don't answer the telephone: coordination and cooperation with the fiscal authorities [and, by extension with wage setters—BH] is entirely consistent with central bank independence' (Buiter 2006: 42).

This brings us to the policy implications of this analysis. The dramatic crisis that EMU entered in 2010–11, and which shows no signs of abating at the time of writing, has been the subject of numerous summits by EU and EMU governments. If the analysis in this book, which suggests that deeper processes of divergence and fragmentation were playing out than simple fiscal problems, is correct, the future of EMU is far from certain. While European leaders may come up with short-term solutions to shore up the single currency—and assuming that the political will to do so is there—the underlying problems may turn out to be intractable for the eurozone in its current form.

6.2 The Future of EMU: Dark Linings in Dark Clouds

Lest we forget, the crisis of EMU was an outcome of the global financial crisis. The recapitalization of the banks, and the sustained collapse in growth following the financial crisis, fed into unsustainable fiscal imbalances. Greece was the first domino to fall, while the crisis engulfed Ireland, Portugal, Spain, and possibly Italy. As financial markets took an increasingly dim view of the fiscal capacity of member states, the latter encountered problems refinancing public debt, thus reducing their fiscal capacity even more. The vicious spiral was such that by mid-2012, the GIPS had asked for and received bail-outs from pooled funds through the EU, the IMF, and the ECB, and both Malta and Slovenia were among the next countries in line for a bail-out organized by the EU. Meanwhile, the northern member states grew stronger, without much sympathy for the fate of the southerners.

None of this was a foretold outcome, however. A system of fiscal federalism through political union could have helped. Consider how this works in Germany, the poster child of EMU. A small part of value added tax is pooled and redistributed to poorer Bundesländer; something similar could easily be organized in EMU. Imagine that countries with an inflation rate above the ECB's 2 per cent target were forced to transfer a small proportion of their

taxes to a central pool to reflect the difference between the actual and the ECB's target rate. Economies on the verge of deflation would receive funds from that pool proportionate to their negative distance from the inflation target. The effects of even a small transfer would be significant: inflation in the first group, riding a debt and asset-inflation fuelled boom, would be forced down; deflationary dangers in the second group would be alleviated. Each time inflation rates started to diverge and current accounts had a tendency to diverge as well, there would be a structural push to converge again. It is not hard to recognize the GIPS in the first and Germany and its satellites (DE) in the second characterization. In the first half of the 2000s, Germany, France, and a handful of other countries, trapped in a low-growth regime, would have benefitted from this fiscal federalism. Today, the reverse would happen and redistribution would take place from the northern EMU member states to the 'peripheral' eurozone economies and thus reduce the pressures on the latter. In addition, a more accommodating stance by the ECB (a higher inflation target which accompanied higher growth) might have avoided the zero-sum situation that the eurozone found itself in—the one in which my increase in competitiveness automatically translated into your big loss.

Neither of these two options are very likely to emerge soon: not only is the appetite for deeper political-economic integration at a low in Europe today, it would also be very difficult to see how fiscal federalism and political union would work, given the many different tax regimes in the eurozone. The ECB, in turn, has certainly become more accommodating given the magnitude of the crisis, yet it is almost certain to impose curbs on inflation once the euro economy is stabilized or if inflation starts to rise. The imbalances between the north-west European economies and the rest are, therefore, likely to persist.

The main problem is that the countries with coordinated wage bargaining systematically produce lower inflation rates than the economies that lack such a set-up. Because of the ECB's single interest rate, this divergence produces a perverse pro-cyclical effect: countries with a high inflation rate face low real interest rates and vice versa. Since the latter are no longer able to devalue, their only reply (in part also as a result of the fiscal crisis) is a combination of austerity and 'internal devaluations'. That may bring down inflation in the peripheral economies—but it also reduces growth, and therefore creates further fiscal problems. Meanwhile, the opposite dynamic is playing out in the northern EMU economies, which grow through exports, at least as long as the periphery imports—which may not be long any more if growth continues to fall. Austerity and internal devaluations (low growth of relative ULC) depress domestic demand, after all. If northern exports fall, as they seemed to be doing in mid-2012, the economic locomotive of the exporting northerners will run out of steam, and growth everywhere in EMU will collapse.

The solutions to the eurozone crisis are, therefore, not simple. The short-term restructuring of debt is a necessary condition for immediate survival. But debt may not be the problem per se: debt, public and private, is the outcome of the process of (mis-) adjustment to the new macro-economic framework of EMU. The key issue is the combination of systemically different (wage) inflation regimes across two groups of countries in EMU, and diverging real interest rates that produce unsustainable public and private debt situations. Resolving that imbalance requires domestic institutions well beyond what austerity can deliver (assuming austerity can deliver anything at all). These seem to include strong, legitimate employers' associations and trade unions that can compromise, a product market strategy of firms oriented towards high value added market segments, and a disciplined wage-bargaining system that acts as a productivity whip but also assures that wages grow at a moderate pace.

Such a reorganization of the domestic institutions is not easy to accomplish, because of an important in-built asymmetry. Since all elements in the new framework have to be simultaneously present for beneficial effects to ensue, they have to move in tandem—and that is a hard task. To illustrate this, consider what happened in France in the 1980s. The newly elected Left government passed several important laws with regard to labour relations, banking, and regional policy, in an attempt to emulate the virtuous German system with peaceful labour relations, banks with a strong interest in industry, and regional networks of technologically sophisticated firms. But the policy-makers ignored, to their peril, that employers' associations and labour unions were not strong and autonomous; that banks had no experience in close monitoring because the Treasury had always underwritten their loan decisions; and that local chambers of commerce and technology transfer systems in the regions were underdeveloped (Levy 1999). The effect was that the well-intentioned reforms died a silent death, while the residues of the reforms were hijacked by the large firms in France to build up their operations without much regard for the negative externalities of such a private appropriation of public policies on the ground (Hancké 2002).

While constructing such an integrated framework of coordination might be very difficult, destroying it appears considerably easier. After many years of attempts to build a framework for neo-corporatist income policies in the UK, Margaret Thatcher was able to dismantle the existing (admittedly dysfunctional) labour relations system in the UK with a handful of new labour laws and set the UK on the track towards a deregulated liberal market economy. And the tragic story of Italy alluded to earlier, in which the country managed to build a well-functioning new system on the basis of existing local proto-institutions, is equally instructive: when Prime Minister Berlusconi came to power in 2001, he abandoned the social pact, opportunistic employers

seized the chance to redesign their relations with unions, and the economy slid back into its old ways (Simoni 2012).

These different stories all tell the same important tale: building complex systems of coordination is very difficult; destroying them relatively easy. And that is what makes the outlook for the peripheral economies so dire. They have, on the whole, very few institutional and political foundations on which to build coordination. Remember that even during the highly urgent Maastricht process, at a moment when a political consensus on EMU reigned, Portugal, Spain, and Greece failed to build economy-wide systems of (wage) coordination because of the fragmented structures of their political economies. While the situation today is arguably even more urgent, the institutional foundations for adjustment are no less absent, and the political systems of these countries considerably more fractured than they were in the 1990s. It is highly unlikely, therefore, that the peripheral economies will find themselves on a surer institutional footing soon.

The EU and international organizations involved in the EMU crisis have, in fact, not helped. Of all the proposals on the table since the crisis erupted in 2010, the 'Macro-Economic Imbalances Procedure' (European Commission 2012) is perhaps the most developed. Under this framework, countries can receive bail-out aid in exchange for fiscal discipline and improved competitiveness. There are many problems with this and similar packages. The first is that the proposed policies are asymmetric (De Grauwe 2012) and incoherent. In the current version of the macroeconomic imbalances procedure (MIP), the burden of adjustment rests solely on the weaker debtor countries (the peripheral economies) and none of it on the wealthier creditor countries in the north. Funding is contingent upon the adoption of highly restrictive policies in the periphery, yet without the concomitant, necessary, economic expansion in the north. Not only is this unfair; it is also logically impossible and very unlikely. If, say, Spain were to improve its competitiveness vis-à-vis Germany, wages in the latter would have to start growing faster than productivity. Given how dependent the German economy is on exports, however, it is far from certain that this will happen in the export sector, and the probability that such wage increases in the public sector will be welcomed outside the sector is very small at best. Finally, trying to balance adjustment between the creditor and debtor nations also creates its own demons, since it ignores the likely reaction of the ECB, which is well aware of the leading role of German wages. If wage inflation in Germany increased significantly, the ECB would be forced to raise interest rates in response, since wage inflation would rapidly spread to all other economies in the north through the informal wage-shadowing system that exists in this group of DE economies. The MIP is, even in a more benign, symmetric form, therefore, not the solution to the economic problems that EMU faces today.

This brings me to two concluding thoughts on more narrowly political issues in the margin of the analysis in this book, but which are both strongly affected by the crisis of EMU. The EU's democratic credentials have never been high. To many it has been a distant institution, producing policies over which citizens of the member states have little control. There have been two types of replies to this critique of a democratic deficit. The first has been that the EU (and EMU, in the guise of the ECB) delivers the goods: the European system may be weak on input legitimacy—the participatory dimension of a political system—but it does produce stability and prosperity. Its output legitimacy is high, and that is what matters. The second has been that the non-majoritarian institutions of the E(M)U are, even in its member states, often the subject of non-majoritarian decision-making through independent administrative agencies. Central banks are independent everywhere in the EU, for example, as are competition authorities, and technical commissions are involved in workplace health and safety and food safety (Moravscik 2002).

The crisis of EMU sharply questions both these positions. A system that is almost solely built on output legitimacy suffers disproportionately when a crisis hits that produces the ominous consequences we witness today. Instead of stability and prosperity, the crisis of EMU, misgoverned as it has been by the European Commission, the European Council, and the ECB, has produced political instability, social dislocation, and falling living standards in many member states (and the period 2010–12 may only be the beginning of the troubles for the continent). If the implicit compact between the EU and the citizens of EU member states resembles something along the lines of 'as long as we get richer, you have a free hand', then the opposite is likely to be true as well. That does not bode well for the future legitimacy of the EU.

The reply to the crisis has also thrown into sharp relief the second line of defence in favour of the EU and EMU. The euro can be saved, it is claimed, but requires taking bankrupt economies into receivership and steering them with the help of the EU, IMF, and ECB troika. Ignore for a moment that countries cannot go bankrupt the way a company can—that is merely imprecise language (although not entirely devoid of ideology). Far more important is that by going down this route, the EU and the ECB are moving into areas that have never been isolated from the democratic process in Western capitalism (Scharpf 2011). There have been some recent attempts by technocratically minded economists to install independent fiscal policy committees to oversee the budget process (Wyplosz 2002), but the idea was dead on arrival, for the simple and correct reason that the essence of a modern state is its fiscal capacity—and that fiscal policy in a democracy therefore requires majoritarian decision-making. While the IMF has often played the bad cop role in adjustment programmes, the EU and ECB are blazing an entirely new trail with the MIP and similar top-down programmes.

There are two types of dangers here. The first is simply that the EU in the guise of the Commission and the ECB takes on responsibilities for which it is not particularly well equipped and by which it may be haunted if things turn sour. Getting involved in rescue packages that combine austerity and non-majoritarian governance, means that the EU and ECB engage in activities beyond their job description according to the treaties, and which will backfire badly if the crisis of EMU gets worse rather than better. Demanding widespread austerity and reductions in wages and income of the vast majority of the population in response to a crisis produced by a skewed financial system and incomplete monetary union was never going to be very popular. Without positive results, being unpopular may well be the best the EU and the ECB can wish for.

Second, these are areas in which the EU has, with the exception of the now as good as forgotten *Open Method of Coordination*, never really played a role (Hodson 2011), not even in the transition economies that joined the EU in 2004. The transfer of sovereignty since the 1957 Treaty of Rome, in fact, carefully side-stepped fiscal policy—remarkably enough, even when the construction of EMU, with its massive transfer of monetary sovereignty, cried out for more integration in that area. Being seen as the harbinger of austerity without a democratic mandate oversteps that line. While it is understandable for member states to point to Brussels as a way of avoiding blame for unpopular policies, it verges on suicidal folly for the European institutions to attract blame with aggressive, largely ineffective, but very painful policies.

The activity emanating from the European institutions may, to put it in stark terms, therefore undermine what is left of the legitimacy of the EU, feed into Euro-scepticism everywhere, and undermine the political foundations upon which the EU was built. It would be a rich irony indeed if the instrument to build a more integrated Europe turned out to be Lenin's proverbial rope for the EU. It is probably too soon to call in the undertakers and declare the death of EMU. The single currency is likely to survive the current crisis, a Greek exit, and even a Spanish bail-out. But by then the institutions of EMU will be very stretched, possibly up to the point that they are incapable of dealing with a second or third wave of adjustment. A few years of low growth may by then give way to a long and deep depression. That will be the moment when dissatisfaction with the EU will skyrocket and the party systems of both rich member states in the north and poor ones in the periphery will have been transformed with 'Europe' as a key political cleavage. And that is when we Europeans will have to be truly worried.

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