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The missing link. Labour unions, central banks and monetary integration in Europe[1]

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Summary

This article examines the problems of the single currency in light of the organization of labour relations in the Member States and their interaction with monetary policies. Continental (western) Europe consists of two very different systems of employment and labour relations, roughly coinciding with 'coordinated market economies' in the north-west of the continent, and 'Mixed Market Economies' in the south. These differences in employment relations and wage-setting systems implied that, against the background of a relatively restrictive one-size-fits-all monetary policy in place since 1999, the north-west of the continent systematically improved its competitiveness, while the south lost competitiveness in parallel. Small differences between the two groups of countries at the start of EMU thus were accentuated and, against the background of low growth and an almost closed E(M)U economy, the northern coordinated market economies accumulated current account surpluses while the GIIPS (Greece, Italy, Ireland, Portugal and Spain) ran into severe balance of payments problems in 2010 and 2011.

Résumé

Cet article examine les problèmes de la monnaie unique dans le contexte de l'organisation des relations professionnelles dans les États membres et de leur interaction avec les politiques monétaires. L'Europe continentale (occidentale) se compose de deux systèmes très différents de relations d'emploi et de travail, coïncidant grosso modo avec les «économies de marché coordonnées» dans le nord-ouest du continent, et les «économies de marché mixte » du sud. Ces différences dans les relations d'emploi et les systèmes de fixation des salaires ont mis en évidence que, dans le contexte d'une politique monétaire unique qui ne peut convenir à tous les pays en

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même temps dans leur diversité (« one-size-fits-none »), en place depuis 1999, le nord-ouest du continent a amélioré systématiquement sa compétitivité, tandis que dans le même temps, le sud a perdu la sienne. De petites différences entre ces deux groupes de pays au début de l'UEM se sont donc accentuées et, dans le contexte d'une faible croissance et d'une économie UE(M) presque fermée, les économies de marché coordonnées du nord de l'Europe ont accumulé des excédents de balances courantes, alors que les pays GIIPE (Grèce, Italie, Irlande, Portugal et Espagne) se heurtaient à de sérieux problèmes de balance des paiements en 2010 et 2011.

Zusammenfassung

Dieser Beitrag untersucht die Probleme der Einheitswährung unter dem Gesichtspunkt der Organisation der Arbeitsbeziehungen in den Mitgliedstaaten und ihrer Interaktion mit Geldpolitiken. Im kontinentalen Westeuropa bestehen zwei sehr unterschiedliche Systeme der Beschäftigungs- und Arbeitsbeziehungen, die grob als „koordinierte Marktwirtschaften" (im Nordwesten des Kontinents) und als „gemischte Marktwirtschaften" (im Süden) bezeichnet werden können. Angesichts der relativ restriktiven einheitlichen Geldpolitik, die seit 1999 geführt wird, haben diese Unterschiede zwischen den Beschäftigungs- und Lohnbildungssystemen bewirkt, dass die Wettbewerbsfähigkeit der Länder im Nordwesten des Kontinents systematisch zugenommen hat, während die der südlichen Länder parallel dazu gesunken ist. Die zu Beginn der Wirtschafts- und Währungsunion (WWU) bestehenden kleinen Unterschiede zwischen diesen beiden Ländergruppen haben sich somit verstärkt. Vor dem Hintergrund eines geringen Wachstums und einer nahezu geschlossenen W(W)U-Ökonomie haben die nördlichen koordinierten Marktwirtschaften Überschüsse akkumuliert, die „GIIPS"-Länder (Griechenland, Italien, Irland, Portugal und Spanien) hingegen sind 2010 und 2011 in erhebliche Zahlungsbilanzschwierigkeiten geraten.

Keywords

EMU, wage setting, current accounts, labour unions

In 2009, the euro celebrated its 10th anniversary. Champagne corks popped in Brussels and Frankfurt at self-congratulatory birthday parties, with the added bonus of the euro as a safe umbrella against the turmoil in financial markets. Less than two years later, when the financial crisis of 2007–08 rapidly spilled over into a sovereign debt crisis on the continent and beyond, the single currency was facing an existential crisis. The combination of massive bank bailouts, low growth, increased expenditure when the automatic stabilizers kicked in, and discretionary fiscal stimulus measures implied that the public purse would be heavily taxed in any case. In addition, some Member States, from the always fiscally fragile Greece to the considerably more robust Italy and Spain (which had been running primary surpluses for most of the last decade), were threatened with exorbitant interest rates on government debt. Greece, Portugal, and Ireland called in the IMF and were forced to borrow from other EU governments in order to remain functioning states. The diagnosis, both in the press, among politicians, and in academic circles, was unequivocal: a toothless Stability and Growth Pact invited fiscal profligacy, while labour market rigidities prevented adjustment. Less than two years after the world's tempestuous flirt with Keynesianism in response to the financial meltdown, it seemed, orthodox economic recipes had made a strong come-back.

This article looks elsewhere for explanations: the problems of the single currency are directly related to an important but ignored element in EMU's political economy, namely, the organization of labour relations in the Member States and their interaction with monetary policies – the 'missing link' of this essay's title. Somewhat schematically, continental western Europe, EMU's heartland, consists of two very different systems of employment and labour relations, roughly coinciding with what Hall and Soskice (2001) call 'coordinated market economies' (CME) in the north-west, and, for want of a better term, 'Mixed Market Economies' (MME) in the south, in the form of the now infamous GI(I)PS, Greece, Italy, (Ireland), Portugal, and Spain (Hall and Soskice, 2001; Hancké et al., 2007). The main difference between the two lies in the nature of the actors and the configuration of institutions and rules that they face. In CME, strong labour unions encounter strong employers' associations, particularly in the export sector; as a result, they negotiate wage settlements which simultaneously safeguard real wages and profitability; and that is done through negotiating wage rates between a floor set by inflation and a wage ceiling set by labour productivity. Strong systems of wage coordination then transmit these wage rates to the rest of the economy. In MME, the situation is different. First of all, the state regularly has to step in to compensate for the lack of autonomous bargaining capacity among the key actors. Secondly, cross-industry wage coordination is considerably weaker than in the north of Europe, and as a result inter-sectoral wage drift is endemic. These differences in employment relations and wage-setting systems implied that, against the background of a relatively restrictive one-size-fits-all monetary policy in place since 1999, the north-west of the continent systematically improved its competitiveness, while the south lost competitiveness in parallel. Small differences between the two groups of countries at the start of EMU thus were accentuated and, against the background of low growth and an almost closed economy (the virtual economy known as EMU trades less than 10 per cent outside the EU), the northern coordinated market economies accumulated current account surpluses while the GI(I)PS ran into severe balance of payments problems in 2010 and 2011 (Scharpf, 2011). The sovereign debt crises of 2010–12, which have threatened the survival of the euro area itself after the summer of 2011, simply reflected these structural imbalances: current account deficits are financed through debt, private and public. The problem with EMU, in other words, is one of current accounts, not fiscal deficits.

This article starts with a short review of the debate on the political economy of EMU and the crisis that the single currency has faced in the last few years, and develops the argument above in contrast to the prevailing explanations. It then continues to its empirical point of gravity, by reconstructing the development of wage-setting systems against the background of monetary integration in Europe since the second oil shock in the early 1980s – the emergence of the Deutschmark-bloc and its effects on wage setting and labour relations, the Maastricht process, and the introduction of the euro. The final section concludes by putting this analysis in the wider context of the debates on EMU.

Understanding the crisis of EMU

The crisis of EMU is an excellent place to take stock and analyse what makes EMU fragile: the tensions provoked by a major crisis have the potential to bring out the problems with an institutional architecture that may be obfuscated by its operation under 'normal' circumstances. Four types of explanations have been offered for why EMU faces the problems it does. The first is an old stalwart of orthodox economics: labour market regulation. The basic idea harks back to theories of optimal currency areas. If all other macroeconomic adjustment mechanisms – monetary and fiscal policies as well as exchange rates – are more or less fixed, 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,

Table 1. Average budget deficit in selected euro area 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.

however, should give pause for thought: the at least equally inflexible labour markets in countries such as Germany, Austria and the Netherlands 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.

The other orthodox interpretation 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 – was fiscal mismanagement, possibly supported by aloof capital markets. 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-bailout 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 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 Table 1 shows, 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 Stability and Growth Pact – hardly a persuasive indication of widespread fiscal irresponsibility.

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 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 bailout 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, at best, only pieces. One problem that they share is that they consider the problem 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, helped 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 do 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 macroeconomics (Carlin and Soskice, 2006) – suggests a more systemic explanation of the crisis.

One key stylized fact that helps us understand the more structural dimension of the crisis of EMU is that since its inception in 1999, EMU has witnessed an increased divergence of inflation and wages, as well as of economic performance more generally in the single currency area. In part this has been a relatively standard, more or less anticipated process of inter-country adjustment, especially since some countries, most notably Germany, entered EMU with an overvalued exchange rate. But it is equally a consequence of Germany's reliance on exports for growth, which imposes a tight wage moderation strategy on its key industrial sectors, diligently followed by unions, both in the export and in the sheltered sectors, including the public sector (note that the 'wage moderation' referred to in this article is, unless explicitly stated otherwise, expressed in unit labour costs – abbreviated as ULC henceforth – which measure the ratio of wage rates over labour productivity rates). This neo-mercantilist adjustment argument, again, helps us understand part of the problem: it explains why competitiveness rose in the north and fell in the south. But it probably attributes too much to a prevailing consensus among the key political-economic actors in Germany and particularly to their capacity to set relative wage rates. Leading trade unions in Germany, among them the IG Metall and ver.di have, in fact, campaigned for higher wages for most of the euro's existence, but failed to gain these. Explaining why these strong labour unions have been unable to set wages in their favour requires a more structural approach: in the EMU set-up. As I will show with a simple model below, there are strong systemic pressures that force a divergence of inflation and wage rates across the euro area (see Hancké and Soskice, 2003 for a more formal elaboration of the basic idea).

Imagine, for ease of exposition, that EMU consists of two economies of equal size, called DE (i.e. Germany with its north-west European neighbours, including Austria) and RE (for Rest of Europe). At the start of EMU, DE's inflation rate is, because of its more strongly coordinated wage-setting system, slightly below RE's; they average 2 per cent, which is the ECB's inflation target. Since the ECB sets its interest rate for all members to reflect the difference between the target and the actual (i.e. the aggregate/average) inflation rate of DE and RE, the real interest rate (the nominal interest rate that the ECB sets for all minus the country-specific inflation rate) is therefore lower in the country with high inflation (RE) and higher in the low-inflation country

(DE) (Scharpf, 2011: 13). These differences between real interest rates and domestic institutions have several consequences that are poorly understood.

First of all, monetary policy is pro-cyclical. The country with higher inflation in effect has a more accommodating monetary policy than it should, because the bank's target is lower than its actual inflation rate. The country with a lower inflation rate, on the other hand, will have an unnecessarily restrictive monetary policy, which will not have a significant effect on price dynamics (since inflation is low already), but only on growth. Note that the opposite would happen if monetary policy were decided for each country individually (Allsopp, 2002: 23 ff): if inflation in DE were to fall, DE's central bank would almost certainly lower the nominal, and therefore in effect the real, interest rate; if inflation rises in RE, its monetary policy would tighten. None of that happens in EMU, where rising inflation is implicitly rewarded through a falling real interest rate. In part, of course, this pro-cyclical dynamic is compensated by a lower real exchange rate (RER) in the low-inflation countries, which improves competitiveness and therefore exports. However, this compensation effect is limited to the export sector, which makes up at most half of the GDP of small economies in EMU and not more than a quarter of output in large economies. More importantly, perhaps, a RER depreciation in the low-inflation countries is at the root of their stellar competitiveness performance, and thus indirectly at the basis of massive current account deficits in countries with a higher RER. A depreciation of the RER in the low-inflation countries is part of the problem, in other words.

The second ill-understood effect is that the lower real interest rate that RE has faced during the first 10 years of EMU feeds into a path of higher growth in RE, fuelling (wage) inflation. At the same time, the tighter than necessary monetary policy imposes further disinflation through wage moderation on DE. The very small differences in inflation that existed at the start of EMU thus have become more pronounced in the second round (rising asset prices fuelled inflation in RE, externally imposed disinflation further reduced export prices in DE) and the perverse procyclical effects gain in strength, pushing inflation rates and competitiveness of DE and RE on sharply diverging paths.

Finally, the differences in wage setting between DE and RE play a crucial role in this process. Not only did different wage-setting systems put DE and RE on different tracks from the start; in addition the ability of DE to counter inflationary pressures through wage coordination around more slowly growing unit labour costs is almost perfectly mirrored by the inability of RE to do so. Since inflation is more of a problem in RE (though hidden under the beneficial effects of very low real interest rates), the lack of capacity to disinflate implies that RE slowly but steadily loses competitiveness relative to DE. In itself that does not have to be deeply problematic: if RE can grow through trade outside EMU, it can compensate its falling competitiveness within EMU through rising competitiveness outside EMU. But only about 10 per cent of EMU-wide GDP leaves the single currency zone, and most of that goes to other EU Member States. Within such an almost closed trade bloc with relatively low economic growth since its inception, DE's rising competitiveness *must imply* RE's falling competitiveness. Trade in EMU has, in effect, become a zero-sum game in which one's gains are another one's losses, and DE's improving competitiveness and current account surplus are mirrored in current account deficits in RE.

What follows traces the design and the emergence of this system back to the start of monetary integration in Europe, the construction of the Deutschmark-bloc within the European Monetary System. It then continues with the generalization of the model to the rest of Europe through the Maastricht process in the 1990s. At the start of EMU, the political economy of the prospective euro area Member States was, in effect, a robust disinflationary system, calibrated

Table 2. Correlations of national and German nominal wage restraint; 3-yr moving averages, 1991–1998 and 1999–2006.

	1991–1998	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.

by the interaction between strong wage setters and central banks. The introduction of the euro changed all that by transferring monetary policy to a single central bank without a parallel centralization of wage setting and fiscal policy, an idea that had been floated among trade unions since the 1970s. The outcome was a dramatic divergence of inflation rates and competitiveness.

The primordial period: DM-bloc and Maastricht

EMU's ancestry consists essentially of two periods, the construction of the DM-bloc in the 1980s and the Maastricht period in the 1990s, with the first as the critical formative period. The political economy of the construction of the DM-bloc, including the economic philosophy underlying the construction of an integrated monetary bloc, and the struggles between and within countries about economic policy were very similar in both periods. There is, however, one important difference in the trajectories that different blocs of countries, over the two decades, took to get there: northern Europe in the 1980s followed a period of protracted social conflict when governments decided to peg their currency to the DM. The 1990s, in contrast, saw attempts at social pacts among the prospective EMU Member States, with very few large-scale social conflicts. The outcomes were the same, however: in both instances countries that wanted to do so entered EMU, and in both cases, the wage-setting systems were crucial ingredients of the policy mix to meet the informal DM-bloc criteria (which were imposed by markets, sanctioning countries that failed to stick to the currency peg) and the formal Maastricht criteria. France, the Netherlands, Belgium and Denmark all witnessed sharp increases in strikes (including working days lost) in the critical period right before they gave up monetary sovereignty. The public sector in particular was militant in its refusal to accept the austerity that appeared to accompany pegged exchange rates.

The outcome of this period of social conflict 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 (Scharpf, 1991). 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 (see Ramskogler, 2012). 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 as German wages; the other was provided by credible conservative monetary policies as the back stop in case of excessive wage settlements. Table 2 presents the simple correlation coefficients between nominal wage restraint in Germany (the difference between nominal wages and labour productivity, measured in 3-year moving averages) and in other EMU economies during the 1990s. All are above 0.80, usually above 0.90, implying close to perfect shadowing of German wages, adjusted for labour productivity.

This set-up became the template for future monetary integration. When the Maastricht Treaty, mapping the road to EMU, was negotiated in 1991, average inflation differentials between the DM-bloc and the other economies in the EMS (Italy, Spain, Portugal and Greece) were about 9 per cent (all inflation data are taken from the OECD Employment Outlook, 2002). By the late 1990s, a few months before the introduction of the euro, inflation rates across the prospective euro area had converged on an average slightly above 1 per cent, with a differential between the DM and non-DM countries of just 1 per cent and, per Maastricht criteria, none more than one and a half per cent above the best performers.

The importance of inflation in this process is that it is the key variable for meeting the convergence criteria: stable domestic prices not only were a target in themselves, but they also stabilized both the currency peg and the interest rate against the key target rates embodied in the Treaty. Long-term interest rates thus fell, both as a result of the exchange rate peg and through imported credibility, which alleviated budgetary pressures in turn. Whatever other conditions may have been necessary, keeping domestic inflation under control was vital for a country's entry into EMU.

Governments, assisted by central banks, played a crucial role in this process. In essence, an implicit deal was proposed everywhere along the following terms: if the social partners agreed to keep wage growth under control and refrained from raising prices, governments would support those disinflationary moves by co-opting labour market parties in major welfare, labour market and budgetary reforms, while central banks would keep interest rates as low as possible; if social partners failed, however, determined governments and central banks would reduce inflation nonetheless, almost certainly with higher social costs (and possibly higher political costs for governments, but these would have to be weighed against the political costs of non-EMU membership). In a subtler, and definitely more cooperative, form, therefore, these post-Maastricht arrangements thus replicated the government policies and institutions of the prospective DM-bloc countries almost a decade earlier (Fajertag and Pochet, 1997).

The effects of these reorganizations of the macroeconomic policy framework everywhere, but especially in the south, have been nothing short of spectacular. All the major Maastricht convergence criteria were easily reached, and all applicant EU Member States 'irrevocably' fixed their exchange rate to the new single currency in 1999. EMU was born.

Labour unions, wages and the ECB

The introduction of the single currency dramatically changed the institutional framework of macroeconomic policy, both within and between countries. First of all, the single nominal interest rate for the euro area, reflecting the ECB's 2 per cent inflation rate target, translated into excessively loose real interest rates (the nominal interest rate minus the actual inflation rate) in countries with inflation above 2 per cent, and excessively tight monetary policy in countries with a low inflation rate. That fed into higher growth and higher inflation in the first group and lower growth in the second group, thus pushing both groups of countries in opposite directions: inflation rose in the high-inflation group in the first period and fell in the low-inflation group

These perverse effects could easily be off-set through fiscal policy. But two considerations make that a less appetizing choice than it would seem. Governments are on the whole reluctant to impose taxes, especially in times of fiscal surplus. The Stability and Growth Pact (SGP), in addition, makes annual deficits above 3 per cent of GDP problematic: that raises the bar for countercyclical fiscal policy in a tight monetary regime. (The SGP, in fact, operates in a moderately pro-cyclical fashion as well, by rewarding countries with a surplus and punishing countries with a deficit, thus exacerbating the problems that pro-cyclical monetary policy produces.)

Against the background of this shift in the international regime toward a pro-cyclical monetary policy, domestic wage-setting regimes witnessed an important but underappreciated structural shift. EMU transferred stewardship of the economy from national central banks, with all the power they held over wage setters and governments, to a single ECB, with the implicit perverse effect that the domestic pressure by the central bank on wage setters in EMU Member States effectively disappeared. Many observers in the late 1990s predicted a massive inflationary scramble as a result: since the ECB is unable to retaliate against one union in one country – in contrast to how national central banks had increasingly threatened tightening during the previous two decades – excessive wage rates could no longer easily be punished (Iversen and Soskice, 2001; Hall and Franzese, 1998).

The first decade of EMU since 1999 demonstrates rather convincingly that this is not what happened. While wage inflation rates diverged between Member States, EMU's aggregate inflation rate remained low throughout the first decade, usually hovering between 2 and 3 per cent. Wage growth in EMU was, on the whole, moderate, and there were very few signs of the inflationary scramble that many observers feared.

The introduction of the single currency did reveal, however, that wage setting in the Member States were aggregations of two increasingly divergent trajectories: the exposed sector's path, on the one hand, where markets had sufficient power to contain excessive wage demands, and the sheltered sector's on the other, where international competition (and in the case of the public sector any competition whatsoever) restraining wage growth was absent. All other things being equal, wage inflation was unlikely in the former, lest the export sector began to price itself out of the market and therefore workers out of a job, while it was, for the mirror reasons, almost certain to emerge in the latter. The institution of EMU thus, somewhat perversely, reopened a cleavage within the labour unions that had been closed in the previous decades (Johnston, 2012).

Yet, things were not wholly equal across EMU's Member States: in north-western Europe, wage coordination across different sectors constrained the public sector in its wage setting – mostly because shadowing wage rates in the leading manufacturing sector possibly secured the best medium-term wage deal for the public sector, but often also because of coercion, as in Austria and Belgium, where institutional and legal constraints, such as labour law, budget rules (Hodson, 2011: Ch. 5) or organizational power within the union confederation, imposed a hard ceiling on public sector wages (Johnston and Hancké, 2009; Johnston, 2012). In countries where the exporting manufacturing sector was not the leading trade union, however, and/or where public sector unions were capable of extricating themselves from the wage-setting system that revolved around the leading export-sector unions, wages (expressed in ULC) in the public and in the manufacturing export sector diverged rapidly. This was the case in Ireland, Portugal, Spain, Italy and Greece for much of the first decade of EMU up until the crisis of 2008. Since domestic wage inflation is, in effect, the weighted average of sheltered (including, and possibly dominated by, public) sector wage inflation and exposed (manufacturing and other export) sector wage inflation, inflationary

Table 3. Wage restraint in the manufacturing and public sectors, 1991–2005.

	Manufacturing and non-market services 1991–1998	Manufacturing and non-market services 1999–2005
Austria	0.91***	–0.84**
	(0.002)	(0.017)
Belgium	0.85***	0.06
	(0.008)	(0.904)
Finland	0.91***	–0.42
	(0.002)	(0.352)
France	0.53	0.49
	(0.172)	(0.263)
Germany	0.95***	0.15
	(0.000)	(0.750)
Ireland	0.15	–0.03
	(0.720)	(0.952)
Italy	0.93***	0.88***
	(0.001)	(0.009)
Netherlands	0.86***	0.40
	(0.006)	(0.375)
Portugal	0.99***	0.90***
	(0.000)	(0.006)
Spain	0.97***	0.63
	(0.000)	(0.126)
EMU average	0.81	0.22
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

P-values in parenthesis. *, **, and *** indicate significance on a 90%, 95% and 99% confidence interval.
Note: Table 3 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-yr 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.
Source: Compiled from Johnston and Hancké, 2009: 609–610.

pressures thus started to rise in these countries. Table 3 shows correlation coefficients between 'wage restraint' (operationalized as 3-year moving averages of the difference between nominal wage growth and labour productivity) in manufacturing (the sector exposed to trade) and the sheltered public sector. These data demonstrate convincingly that in the majority of the prospective EMU Member States these correlations were very high under the Maastricht regime and then weakened considerably everywhere after the introduction of the euro: expressed in these terms, the public sector stopped following the export sector in many Member States. It is important to note here that the same correlations calculated for wage growth, which is what unions traditionally target – 'wage restraint' is a variable that I constructed for the purposes of this article, but which does not figure in trade union strategies as such – show that they remained equally strong in the 2000s as they were in the 1990s (Johnston and Hancké, 2009: 611). In other words, the collapse of the coefficients in Table 3 is not the result of a fall in wage coordination across the export and the sheltered sectors in the EMU economies, but of the public sector paying higher wages than warranted by its implied productivity rate (see also Giordano et al., 2011).

Rising wage inflation in the public sector is, in principle, relatively easy to compensate in the exposed (export) sector, as long as the productivity rate of the latter is high enough – which it is in many of the key manufacturing sectors – and wages grow at a moderate enough rate. But in some cases the export sector may have only a low potential to compensate, because it consists primarily of relatively low value-added sub-sectors, it is too small compared to the sheltered sector, or it might simply set its own wages above productivity regardless of the consequences, thus exacerbating the inflationary pressures emanating from the sheltered private and public sectors. Under those circumstances, the ability to compensate for high wage inflation in the sheltered (public) sector is drastically limited, aggregate domestic wage inflation rises faster and higher, and the competitiveness of the export sector falls rapidly as a result of what is, in effect, an appreciation of the real exchange rate. That was also exactly what we witnessed in the EMU economies that faced important public debt problems in 2010–2011. Before the introduction of the euro in 1999, manufacturing wages and public sector wages roughly followed the same pattern in all prospective Member States. From 1999 onwards, however, the evolution of the two diverged sharply: manufacturing wages across the euro area remained tightly controlled (expressed in unit labour cost terms, they were negative, in fact, as Johnston 2012 demonstrates), while public sector wages were on an upward trajectory until 2007.

This potentially explosive reconfiguration of relations between the sheltered and the exposed sectors took place against the background of the newly instituted centralized monetary policy in EMU. The ECB's single interest rate, which reflects the distance from the central bank's asymmetric inflation target of 2 per cent, has had very different consequences for different regions within EMU – which is what the Member States in the single currency area effectively have become. Somewhat ironically, therefore, by implicitly rewarding high-inflation countries with a lower real interest rate, the ECB ended up de facto also rewarding excessive wage claims by the public sector.

Conclusion

The crisis of the euro, which erupted in 2010 and has engulfed practically every country in the single currency area, has spawned a vast number of proposals to save EMU. Most address 'discipline' in some form or other to avoid emerging macroeconomic imbalances, and enlist the European Commission and the ECB to police the rules. The key plans discussed at several EMU summits call for an intrusive 'fiscal union', in which governments that run sustained fiscal deficits will be held to account, and other macroeconomic imbalances will be punished (although asymmetrically, since current account deficits are and surpluses are not – a logically inconsistent position since all cannot have a current account surplus; see De Grauwe, 2011).

While these arrangements may help EMU overcome its immediate crisis, although possibly only after a large-scale restructuring which sees the euro area break up, they are unlikely to produce a sustainable long-term outcome. If the analysis in this article has any traction, the new governance arrangements of EMU will not address the underlying structural problems of EMU, which are related to the sharp divergence of competitiveness between the two blocs of economies against the background of a one-size-fits-all monetary policy. Because of the demise of the nested arrangements that preceded EMU, in which central banks held wages in both the exposed and sheltered sectors in check, EMU has become a monetary union that invites these imbalances. And it is hard to see how these can be addressed. The southern GIPS and Ireland would have to increase their exports in absolute and relative terms significantly by producing and exporting more high value-added goods and services, while Germany and its neighbours would have to reorient their domestic economies away from exports into private and public consumption. Easy to imagine on paper but nigh impossible in practice – and the new EMU governance arrangements are not helping.

The upshot of this analysis is therefore clear: EMU is doomed unless it develops two mechanisms that alleviate the imbalances that have grown in the past decade. The first is a mechanism that counteracts excessive inflation divergence when it emerges: a proper fiscal union, with transfer mechanisms through which fast-growing countries contribute more to a central pool than slow-growing ones – Greece, Ireland and Spain in the past; Germany and north-west Europe today – would produce that. This would moderate growth and inflation somewhat in the fast-growing countries and compensate for the ECB-imposed deflation in the slow-growing countries and thus mitigate the growing current account divergences when they emerge. But, as things stand now, this would also entail a dramatic shift of fiscal sovereignty from elected governments – possibly the key defining characteristic of democracies in the advanced capitalist world today – to non-majoritarian political actors (Scharpf, 2011). The second is that Germany and its northern neighbours would have to rethink their domestic economies away from the massive reliance on exports to the rest of EMU, and adopt more classical Keynesian policies geared toward managing domestic demand – possibly at the risk of higher inflation, which both the ECB and Germany will therefore have to live with. In short, EMU needs a bottom-up redesign if it is to survive. The rest, including the political acrobatics that we have seen in Brussels since 2010, is tinkering in the margins.

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