Growth with jobs: what can economic policy do to revive the global and the European economy?

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The global economic engine is blocked. After the financial crisis of 2008 the world economy has not been able to find its way back to the global growth conditions of the past decade, which had been largely supportive to economic and social progress in the developing world. Many developed countries continue to suffer from deep self-inflicted scars of the financial crisis, while developing countries, having stoked the engine of the world economy since the crisis, are also losing momentum. However, the crucial problem at this juncture is the inability of the developed countries to return to a normal growth pattern. Amidst a very fragile recovery and macroeconomic policies in major industrialized countries that could prove to be ineffective, if not counter-productive, it is questionable whether the internal growth dynamics in the developing world are strong enough, and whether their governments manage to find the right economic policy mix, to sustain growth.

The downside risks for the global economy remain alarmingly high by mid 2012. In the United States, a sluggish recovery remains vulnerable to events in Europe given the deeply intertwined financial systems. Europe as a whole is on the brink of a deep recession with some major members stuck in an unprecedented depression for several years now. In both cases attempts to overcome the present crisis are dominated by fiscal austerity combined with attempts to "flexibilize" the labor markets, which means wage restraint and in some cases even massive wage reductions.

However, these policies are more likely to further weaken growth dynamics and to increase unemployment instead of stimulating investment and the creation of jobs. At the same time, they serve to reinforce the trend towards greater inequality, as similar structural reform policies did over the past 30 years without leading to the promised land of full employment and vigorous investment in fixed capital. Indeed, alternative economic theories and experience suggests that growth cannot be spurred and unemployment reduced by fiscal and wage policies that lead to greater inequality in income distribution. This holds for developed and developing countries alike, even in a financialized global economy.

There is, as argued forcefully in UNCTAD's TDR 2012, a need for a fundamental policy reorientation, recognizing that healthy growth dynamics require a stable expansion of consumption and investment in productive capacity, based on favourable income expectations of the mass of the population and positive demand expectations of entrepreneurs. This

requires a rethinking of the principles underlying the design of national economic policy and supportive international institutional arrangements.

In particular, an efficient outcome of market processes in an increasingly globalized economy does not require greater inequality between capital and wage incomes and a greater dispersion of personal income distribution. While globalization and technological change, and their interplay, have exerted certain pressures on income distribution, the apparent impact of these forces on inequality in many countries must be understood in the context of macroeconomic and labour market policies which have caused unemployment to rise and remain high. Neither globalization nor technological improvements inevitably require a shift in the distribution of income that favours the rich and deprives the poor of the means to improve their living standards. On the contrary, with more appropriate national and international policies that take into account the crucial importance of mass incomes for aggregate demand and investment-growth dynamics, the creation of employment can be accelerated and inequality can be reduced.

Considerable downside risks

The main risks to global recovery and benign rebalancing are concentrated in developed countries. Still the country with the largest current account deficit by far, the United States has seen its external deficit decline due to a marked acceleration in export growth relative to import growth while domestic demand growth remains sluggish. Going forward, an important risk is that premature and excessive fiscal austerity in the United States scheduled for the turn of the year, the so-called “fiscal cliff”, could choke growth dramatically. An even greater risk for global recovery is the increasing export dependence of Europe. Germany’s external surplus is similar in absolute size to China’s but, in contrast to China’s, only slightly smaller today than prior to the crisis. So far, much of the German surplus has found its counterpart deficits mainly in the rest of Europe. But the current crisis is compressing incomes and European imports in general. Given attempts in most countries to improve their competitiveness the European Union’s external position may be shifting towards a sizeable surplus position. The whole region is, in effect, trying to export its way out of the crisis. This risks exerting an enormous drag on global growth.

Europe is in the midst of a double-dip recession, concentrated in the Euro zone. The state of affairs is widely referred to as a “sovereign debt crisis” as public finances have deteriorated markedly since the global financial crisis and interest rates have soared in a number of countries. However, public finances have deteriorated less dramatically in the Euro zone as a whole than in other developed economies, like the US or the UK where bond rates fell to historical lows. The deterioration of public finances is undoubtedly due to the working of automatic stabilizers and the bailouts of financial institutions after the shock of autumn 2008, wholly justified in the light of the gravity of the moment. But calls for an “early exit” from fiscal stimulus and a push for quick fiscal consolidation have gained the upper hand since 2010. As a consequence, fiscal austerity is the golden rule throughout the Euro zone, entailing especially draconian fiscal retrenchment in the Southern European member States. Such medicine may prove not only counter-productive, but even lethal for the euro and dire for the rest of the world as well.

A currency union in its core is about harmonization of inflation rates as all countries give up national monetary policies and explicitly agree on a common inflation target (close under two percent in EMU). From here the argument is absolutely straightforward: First, there

is strong evidence that inflation rates are highly correlated with unit labour costs (ULC, for the overall economy, of course, not for industry). Second, the development of ULC is much more the result of exogenous factors than the development of price changes, which allows concluding that ULC growth determines inflation to a very large extent. Third, it should be known that the biggest country in Europe, Germany, even before the official start of EMU, had decided to dramatically change the course of its wage policy.

The new German labour market approach coincided with the beginning of the currency union and brought about a huge divergence in unit labour cost growth among the members of the currency union. After the start of the European Monetary Union (EMU) German unit labour costs, the most important determinant of prices and competitiveness, did hardly rise any more. On the other side, in most of the countries in Southern Europe nominal wage growth exceeded national productivity growth and the commonly agreed European inflation target of two percent by a low but rather stable margin. France was the only country to exactly meet the agreed path for nominal wage growth perfectly; it was all the time in line with the national productivity performance and the inflation target of two percent.

The “small” annual divergence in price and wage growth yielded a huge gap over time. At the end of the first decade of EMU the cost and price gap between Germany and Southern Europe amounted to some 25 percent, and between Germany and France to fifteen percent. In other words, Germany’s real exchange rate depreciated quite significantly despite the absence of national currencies. The emerging huge gap in unit labour costs and prices had an enormous impact on trade flows. Germany’s exports flourished and its imports slowed down. Southern Europe and France ran into widening trade and current account deficits. While trade at the beginning of the currency union and in many years before was rather balanced, the first decade of EMU marks a period of dramatically rising imbalances. Even after the shock of the financial crisis and its devastating effects on global trade that hit German exports 2010 and 2011 the global German surplus quickly returned to some 150 billion Euros per year and some 80 billion against the other EMU countries.

On the other side, the deep recession and the austerity programs in the deficit countries tend to reduce the visible deficits but without a fundamental turnaround in competitiveness the countries lack the stimuli to revive growth. The lesson is simple: Absolute and accumulating advantages of one country against a similar country group are unsustainable. A huge gap in competitiveness has to be closed sooner or later. Failure to do so will create uncertainty on the side of lenders and tend to increase interest rates. As the final repayment of any debt has to be a payment in kind it requires the perspective that a debtor has a chance to generate current account surpluses. If the creditors defend their surplus positions by all means default of debtors in unavoidable.

The model used in Germany was taken by analogy from the competition of companies. However, the conditions for competition of companies are different from those of countries and in particular of countries with independent currencies. Companies able to generate higher productivity through innovation and new products produce at lower unit labour costs than their competitors. At the level of countries this mechanism doesn’t apply because wages are normally set at the level of countries. In a world of national currencies and national monetary policy, a country supplying its goods at much lower prices would gain market shares and accumulate huge trade and current account surpluses. Political

pressure to adjust wages and prices in international currency would mount and sooner or later the country would be forced to adjust its wages, measured in international currency, through a revaluation of its currency.

In a currency union the member countries explicitly or implicitly agree not to go the deflationary or inflationary way (nominal wage growth below (above) national productivity plus the commonly agreed inflation target). With an inflation target of close to two percent (in EMU established by a decision of the ECB) the implicit contract was that nominal wages would not rise more than national productivity growth plus two percent. This implies that each country was asked to enjoy its productivity increase, be it 1 percent like in Germany or 2 like in Greece, in terms of real wage growth or shorter working hours or both. If one member deviates upward or downward it creates an externally unsustainable situation.

However, the German approach to create a favourable competitive position by very low wage growth in relation to the progress of has not been successful. Inside Germany it destroyed the dynamics of the domestic markets and provoked vulnerability of trading partners that will surely backfire on Germany. While German exports exploded some time after the beginning of EMU, domestic demand remained as flat as real wages. This fact clearly shows that the neoclassical nexus based on substitution of capital by labour and rising employment with given growth never came to the fore. This nexus to work would have asked for the number of hours worked to rise to an extent that the wage sum of workers would have grown in real terms in line with productivity growth. Real wages and incomes of workers being more or less constant since the beginning of the experiment clearly proves that the domestic nexus never worked but that the apparent success of the experiment was only due to the historically unique situation of the currency union and the false tolerance of the partners in the first decade of EMU.

The result of the German experiment was disastrous for Southern Europe and France as they lost international market shares without having a chance to successfully retaliate the German attack. With German politics refusing to move in terms of higher wages they would need a number of years with falling wages to come back into the markets. However, the time to do that is not available as falling wages mean falling domestic demand and recession in the first place in countries, like Italy or Spain, with rather small export shares of some 25 percent of GDP. The resulting depression is, as Greece has amply shown, politically not feasible.

Structural reforms cannot replace a growth strategy

Adding to the dark prospects for global recovery is the problem that policymakers now appear to be placing their hopes again on the alchemy of "structural reforms", mainly focusing labor market liberalization including wage cuts, weakened collective bargaining and greater wage differentiation across sectors and firms. Policy-making fixation on such reforms can be dangerous in the current situation of unemployment and a vacuum of private demand.

The supposed wisdom behind the structural reform agenda is flawed because the purely *microeconomic* reasoning which inspires it ignores the macroeconomic dimension of labor markets and wage determination in any situation. For example, by placing the burden of adjustment solely on the shoulders of current account deficit countries in the European periphery, "structural reform fundamentalism" ignores that asymmetric rebalancing that

places the burden on crisis-stricken members is bound to further undermine integrated regional growth.

Global governance reforms have to be reinvigorated

The G-20 process, established in 2008 to enhance global macroeconomic and financial coordination, has lost momentum. No progress has been registered towards reforming the international monetary system or even studying the issue, although exchange rate misalignments driven by currency speculation remain vital. International financial reform is another unresolved matter. While the crisis-prompted an agenda for placing the international financial system on a safer footing, policy-makers' attention to it remains fragmentary and hesitant.

It now seems that the moment of opportunity has passed, the advice to never let "a serious crisis go to waste" unheeded. Emerging from the crisis and the bail-outs even more concentrated than before the financial industry has meanwhile largely re-mustered its political clout. Overall, national and global initiatives for financial reform have been timid rather than courageous, falling well short of any fundamental overhaul. Short-term rewards rather than long-term productivity of the financial industry remain the guiding principle for collective behavior in this sector. The threat that financial institutions and shadow banking activities may once again succeed in submerging below regulators' radar screens cannot be dismissed.

The most important lesson: Rising income inequality is an economic danger

Fiscal austerity combined with wage restraint and further flexibilization of labor markets does not only generate contraction of the economy but also greater inequality in the distribution of income. The ensuing risk of undermining social cohesion has already become visible in several countries. However, rising inequality is by no means a recent phenomenon; it has been a feature in the world economy over the past thirty years, even if in some developing countries this trend appears to have come to a halt since the beginning of the new Millennium.

After a long period of relatively stable distribution of income between profits and wages, the share of wages in total income has fallen since the around 1980 in most developed and many developing countries. In several of the larger developed economies much of this decline already occurred between 1980 and 1995, when increasing unemployment started to put pressure on workers and unions and average wages began to fall behind overall productivity growth. In some cases this trend continued for two decades. With wage compression pursued in many developed countries to overcome the current crisis, in light of new records in unemployment this trend is likely to be even reinforced. In several developed counties this has been accompanied by a dramatic divergence between the top-income groups and those at the bottom of the scale.

Rising inequality is not a precondition for effective adjustment and overall success of the economy. It is just the other way round: participation and the sharing of success is a precondition for success. A participative society is not just the model many people prefer for reasons of social justice and cohesion; a participative society is a precondition for economic success as otherwise the economy cannot use the rising income it is generating in the process of an intensifying division of labour. The increasing division of labour and the increasing

dependence of every participant in its success make it absolutely indispensible that the result is shared in a manner that allows increasing demand for the goods and services produced in line with the productivity growth. In this way only an economy can avoid the danger of ever-rising unemployment or the need to beggar her neighbours time and again to find the demand for their supply surplus. There is no automatism that would guarantee such an outcome if there are no regulatory institutional arrangements in place to systematically balance the negotiating power between labour and capital independent of the cyclical position.

The international framework

There can be no doubt; to be efficient, the adjustment process in developed and developing countries alike has to be entrenched into a rational global or regional monetary system. This is crucial, as otherwise external macro shocks threaten the smooth adjustment described above. For macroeconomic shocks to be buffered nominal exchange rates have to follow strictly the fundamentals of the countries involved, i.e., the inflation or unit labour cost differentials. In this way only, unit labour cost determined at the level of the nation state can be equalized if measured in international currency. This is the most effective instrument to avoid huge macroeconomic shocks like overvaluation and their potential to bring about downward pressure on wages and more inequality.

At the same time, a system of exchange rates following nominal unit labour cost differentials is a necessary condition for the creation of a level playing field for international trade. The level playing field, despite many doubts, is the core idea underlying the rules that govern international trade since the end of the Second World War. If global monetary cooperation or rules to create the level playing field are not achievable developing countries have to consider monetary cooperation at the regional level (UNCTAD TDR 2007). In any case, with rather open capital markets exchange rates following inflation or unit labour cost differentials are the only feasible way to create the policy space for national monetary policies to foster growth through incentives for investment in fixed capital.

The macroeconomic framework

For economic policy at the national level the analysis of internal and external shocks and its implications for inequality suggests a number of institutional arrangements to allow for the recommended rigidity of nominal wages. Most important is government support for the creation and strengthening of unions with a nationwide mandate. The indispensible law of one price in the different segments of the labour market can – at least in economies with a rather low mobility of labour - only be installed and enforced by strong unions with a very broad mandate.

Additionally, protection of workers against the need to quickly "price themselves back into the market" (OECD) is crucial for successful adjustment. Sure, the much-quoted social aspects of protecting workers against prolonged phases of unemployment should not be diluted, but the economic aspects are even more important. To prevent the "pass through" of high unemployment following shocks on the goods or financial markets to wages, a tight safety net is needed that would allow the temporarily unemployed workers to search for those jobs that are coming up elsewhere in the economy without major cuts in their standard of living.

Governments that are quickly and aggressively tackling rising unemployment also minimize the period of uncertainty and threat for workers and the danger of falling into a second dip due to the effects of original unemployment on wages and domestic demand. Indeed, the more aggressive stance of economic policy in the United States has long been seen as a substitute to the more advanced social safety net in Europe and its more sophisticated unemployment insurance.

In general, with cuts in wages and rising inequality not at hand as an efficient instrument to deal with rising unemployment, the role of governments in stabilizing the overall economy turns into a utility (or externality). Governments can prevent huge additional costs, which would arise if the pressure on wages stemming from high unemployment would be allowed to permeate the whole economy. The negative second round effects of falling wages or the wage share on domestic demand can and should be avoided by all means.

This result must sound perplexing to those who have grown up with the traditional approach based on normal supply and demand curves on the labour market. But even for the believers in the logic of such a market the fact that recently unemployment has risen throughout the developed world without any increase in the wage share, actually with falling wage shares should be reason to reflect their position. If the labour market can get easily out of "equilibrium" without involvement of the prices on the market, there is no argument to conclude that the way to equilibrium back would be possible through a further fall in the prices. The most striking cases are to be found in the euro area. In Southern Europe unemployment exploded despite enormous cuts in wages. The conclusion frequently drawn that the countries need more labour flexibility is a mere reflection of the old static view that has to be conquered to find cogent solutions for a world of change and development.