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Euro Plus: Old wine in old bottles

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Erik Jones examines the Euro Plus pact and says the European Council is offering 'old wine in old bottles'

The European Council met on March 24 and 25 to put the final touches on a multi-faceted reform of macroeconomic policy coordination. At the heart of the package, the governments of the eurozone have agreed to a new Euro Plus pact calling for renewed efforts to foster competitiveness.

The ostensible goal of the pact is to monitor wage and productivity developments, giving particular attention to unit labour costs. Where large increases in unit labour costs are combined with a widening current account deficit and declining market shares for exports, member states will be encouraged to make their wage bargaining more flexible and to put downward pressure on wages in the public sector.

The question is whether action like this would have solved the problem that Europe currently faces or instead made matters worse. The evidence is not straightforward.

Consider the contrast between Greece and Germany. From 2002 to 2008, Greece chalked up a cumulative current account deficit worth more than 91 per cent of the country's gross domestic product. Over the same period it managed to hold onto its world export market share – which is just 0.16 per cent – even as manufacturing employment increased from 517,000 to 519,000.

By contrast Germany succeeded in running a cumulative current account surplus equal to more than 35 per cent of GDP, even as it saw its export market share fall from 9.6 per cent in 2002 to 9.0 per cent in 2008 and its manufacturing employment fall from 8.14 million to 7.66 million. If we look only at current account balances, Germany is clearly more competitive. If we focus on export market share and manufacturing employment, Greece held its ground while Germany lost the equivalent of a whole Greece.

The comparison of unit labour costs does not make matters much clearer. Setting the index for real unit labor costs so that 2002 equals 100, then Germany's costs fall to 94 in 2008 while Greece's costs remain at 100. This seems like a straightforward advantage for Germany. But that really depends upon how you interpret what is being measured.

When economists talk about real unit labour costs, what they measure is the ratio of employee compensation per worker to GDP per worker. So if real unit labour costs are falling, then nominal GDP per worker is increasing faster than employee compensation. That is what happened in Germany. Nominal GDP per worker grew by 11.7 per cent cumulatively over the 2002-2008 period and nominal compensation per work grew by just under half that amount, or 5.8 per cent. The difference between these two numbers makes up the six point drop in the German index. In Greece, by contrast, both nominal GDP per worker and nominal compensation per worker grew by around 31 percent.

Now imagine what happens in a downturn. GDP per worker will surely fall as output falls more generally – compensation will come down only more slowly as wages are slow to adapt to the fall in output. This is what happened in both Germany and Greece after 2008. By 2009, real unit labour costs had increased by three-to-four points in both countries as a result – from 94 to 98 in Germany and from 100 to 103 in Greece.

This is where the attention given to real unit labour costs in the Euro Plus pact becomes problematic. Although there is no clear link between current account performance, export market shares, and manufacturing employment, there is a clear connection between sudden economic downturns and rising unit labour costs. The message from the council is that economic downturns should be accompanied by lower employee compensation. If demand for exports has fallen, then domestic consumption should be compressed as well.

There is nothing new in this formula. It is the same recipe for national competitiveness that John Maynard Keynes set out to combat in his general theory on employment, interest and money. Keynes showed that downward pressure on employee compensation would hurt rather than help the national economy as a whole. The council seems to have forgotten that message. Instead, they offer old wine in old bottles. This is hardly surprising. As Keynes anticipated, these practical men and women are the inadvertent slaves of some defunct economist. Let's hope they realise their folly before we all suffer the consequences.

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