GLU

Global Labour Column
http://column.global-labour-university.org/
Number 101, June 2012

CSID
CORPORATE STRATEGY AND INDUSTRIAL DEVELOPMENT

Europe's lost Decade – Paths out of Stagnation

by Hansjörg Herr

The Great Recession of 2008-2010 reflects an economic instability that had built up over the previous decades. Within the European Monetary Union (EMU), the crisis of the financial market-driven development model is overlaid by a largely homemade state debt crisis and an undefined integration goal. The western world, and more particularly Europe, is facing a lost decade.

The market radical globalisation project

The 1950s-60s may be counted among the best years of the young capitalist social order. This was because everyone could have a slice of progress. The dynamic consumer demand was based on a relatively well-balanced income distribution. Investment activity was high and stable, given the low level of economic uncertainty and the stable development of demand. Precarious employment relationships were just as rare as complicated financial market products or obscenely high managerial pay. The 1970s saw the start of a crisis that reflected an inability to adapt the prevailing economic model. The crisis led, notably in the UK and the US, to the election of conservative governments who embarked on a radical reshaping of the policy framework.

Unstable financial markets

A shadow banking system developed, with new financial products and institutions based on high risks, short-termism and massive leveraging. The central banks lost control over the money they were creating. The experience of recent decades has shown that far too great a share of the credits went into speculative activity. The Internet Bubble of the 1990s was followed by an almost worldwide Property Bubble in the 2000s, together with other stock market or commodity bubbles.

The deregulation of international capital movements left exchange rates to the whim of unstable international capital flows. Trade balances and international debt positions exploded, as did the number of currency crises and international financial market woes.

Over the past few decades, high indebtedness has built up a credit bubble that is now impairing development. Government debt has also increased dramatically. The rise in debt ratios has made the economic system more fragile, at a time when it is considerably less regulated than it was in the 1970s. If attempts to bring about a sustained growth process do not succeed, debt ratios will continue to rise even if hard consolidation efforts are made, and will further destabilise the system as a whole.

Market radical European integration

European integration also followed the logic of a market radical project. The institutionally insufficient integration led to low and partly negative real interest rates in some of the EMU countries, and stimulated real estate bubbles. There was no strong fiscal centre in the EMU. The Euro is a project, which could also benefit workers by reducing interest rates, increasing potential GDP growth, support regions with development problems, and strengthen solidarity among countries, guaranteeing freedom. However, these potentials were not sufficiently used and turned the European project into a nightmare for workers in many countries.

Deflationary risks

Precarious employment relationships and low-pay sectors have expanded, while trade union power has been eroded. Widening pay gaps and rising profit ratios have led to the greater inequalities. From a macroeconomic point of view, uncontrolled market mechanisms within labour markets are highly dangerous. A wage development is functional if nominal wages rise in line with medium-term productivity trends in the overall economy plus the central bank's target inflation rate. In this case, nominal unit wage costs will rise at the same pace as the central bank's target inflation rate. This takes the pressure off monetary policy, as it will not be pushed into contractionary mode because of undesired inflationary wage increases, nor will it have to struggle against deflation due to falling nominal unit wage rates – a deflation that monetary policy would have difficulty in tackling.

Deflation increases the real debt burden and the financial system comes under pressure. Since the Great Depression, it has been clear that nominal wage reductions are one of those medicines that make the patient worse. All the more so given the high debt positions also to be found in the private sector.

To seek a currency union without a political union is illusory. Without coordination of wage development, a currency area cannot be stable. Institutions are needed to guarantee coherent wage development within a currency union. In the EMU, wage coordination has failed. Nominal unit wage costs for the overall German economy stayed unchanged from 2000 to 2008, the last boom year, whereas in the southern European countries over the same period they rose by 20% or even 30%. Together with Germany's relatively low growth rate and hence

Corporate Strategy and Industrial Development (CSID)
University of the Witwatersrand

Nicolas Pons-Vignon
E-mail: Nicolas.Pons-Vignon@wits.ac.za

relatively low imports, this led to large trade and current account disparities.

Growth in the later crisis countries was primarily generated by property bubbles. When they burst, domestic demand collapsed. Current account deficits further reduced demand. The fiscal policies required to stabilise plummeting demand and save the financial system led to rising public debt ratios. From 2010, doubts developed about the solvency of public households in the crisis countries. The crisis countries are now in a jam: investment demand has hit rock bottom, current account deficits are reducing domestic growth, public budgets are under pressure to make savings and, given the constellation described, consumer demand is also weak.

The strategy for resolving the crisis of confidence in the solvency of southern European public households holds out little prospect of success. Public spending cuts and tax increases for the broad majority are further reducing demand and employment. One factor that is radically worsening the crisis is the forced reduction of nominal wages. This is leading to deflation and putting a heavy burden on the domestic financial system. The motivation for wage cuts in the crisis states is understandable, as it is aimed at reversing the previous overly steep rise in unit wage costs. But a policy in the tradition of Reichskanzler Heinrich Brüning at the beginning of the 1930s cannot work.

Policies needed to overcome the crisis

An immediate resolution of the public debt crisis in the EMU is feasible if the European Central Bank (ECB) guarantees the refinancing of public budgets within the EMU and, if necessary, purchases unlimited quantities of state bonds. It would then take on the role of lender of last resort also in regard to public debt, as do the central banks in the US, the UK and Japan. In addition, the rescue package aimed at stabilising the crisis countries needs to be expanded.

Interventions by the ECB or through the rescue package could be interpreted as an invitation to run irresponsibly high budget deficits. Institutional precautions must be taken to avoid such a moral hazard problem. Decisions to that effect were made at the latest EU crisis summits. So there are no longer any obstacles to ECB interventions and expanded rescue packages.

In addition, a symmetrical stabilisation mechanism is needed in order to increase the surplus countries' imports. Surplus countries such as Germany must stimulate their domestic economies. This can be achieved through expansionary fiscal policies, as Germany does have some medium-term legroom, including for increased budget deficits. Advisable measures include taxing higher incomes and spending the revenue this would bring in. Thus, expansionary stimuli could be provided without running up debts.

Nominal wages must rise faster in the surplus countries than in the crisis countries. As nominal wage reductions should be avoided in the crisis countries because of their deflationary effects, wages in the surplus countries should be increased more strongly for several years. In this way, the imbalances within the EMU could be reduced in the medium term without courting the risks of deflation and inflation. Policymakers, especially in surplus countries like Germany, can and must back this goal by strengthening wage bargaining systems, introducing legal minimum wages and reducing precarious employment. Steps towards wage coordination within the EMU are also essential. Overall, the EMU's external trade is in balance. The ECB should pursue an exchange rate policy such that the trend is for the EMU's external trade to remain balanced.

As well as fiscal coordination of public budgets within the EMU, a stronger fiscal centre is also needed. This should receive part of the national tax revenues. It should be able to pursue an active anti-cyclical fiscal policy and to issue Eurobonds with guarantees from all EMU countries. A stronger fiscal centre, up to and including an economic government, would increase the democracy deficit at the European level. To compensate for this, the role of the European Parliament must be strengthened.

Integration within the EMU must go hand in hand with a completely overhauled model of capitalism. Following the Great Recession, the market radical globalisation project seems to have had its day. What is needed is strict regulation of the financial markets, which should have a service function; a shift away from shareholder value as the guiding principle of enterprise management; a new regulation of labour markets; the achievement of balanced income distribution; a reform of global governance; and an ecological reorientation. In the current crisis, Europe is not an active partner for the development of the world economy in the direction mapped out here. Rather, it is a danger to the world economy. Things need not be that way.

A longer version of this column appeared in German as *Europa vor einem verlorenen Jahrzehnt: Wege aus der Stagnation* in Friedrich-Ebert-Stiftung, Internationale Politikanalyse, Berlin 2012.

Hansjörg Herr is professor for Supranational Integration at the Berlin School of Economics and Law and at his university the economic director for the MA Labour Policies and Globalisation of the Global Labour University.

Selected references:

Dullien, S., Herr, H. and C. Kellermann (2011) *Decent Capitalism*, London: Pluto Press;

Herr, H., Kazandziska, M. (2011) *Macroeconomic Policy Regimes in Western Industrial Countries,* London: Routledge