

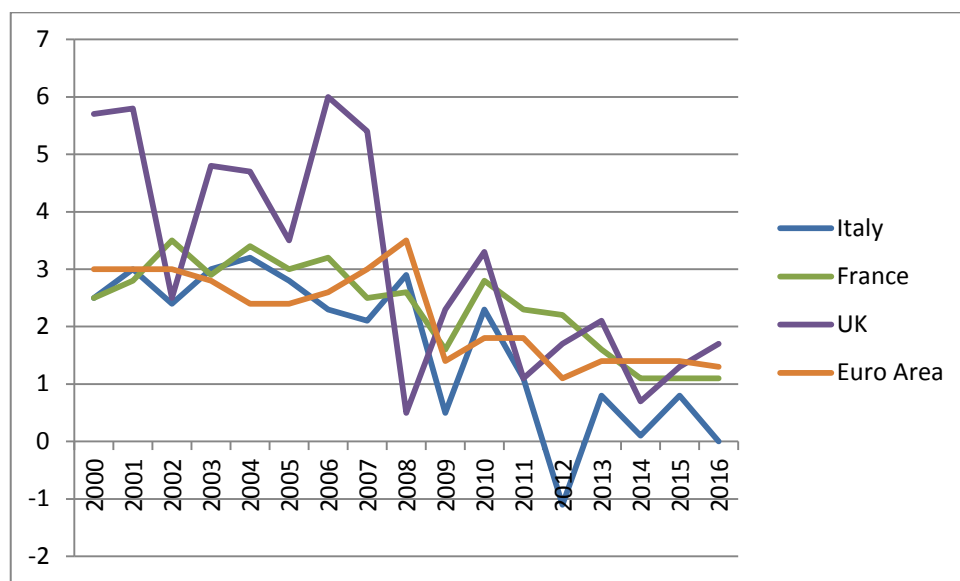
## PAY RISES ARE A PLUS FOR THE ECONOMY

### Introduction

Wages across Europe have been suffering much in the aftermath of the Great Financial Crisis. Before the crisis, nominal wages were increasing at a rate of 3 to 3.5%. Since then wage dynamics have substantially come down (see graph). For the euro area, the most recent numbers are that average wages went up by a mere 1.3% in 2016. And while pay rises in France and Spain are even slightly below this number (around 1%), workers in Italy and Belgium are not having any wage increase as they are confronting nominal wage freezes.

Outside the euro area, the story is similar: In the UK, pay is stumbling along at a pace of just 1.3 – 1.7%, much down from the wage dynamics experienced during earlier recoveries. Even countries from Central and Eastern Europe are not bucking this trend, with wages in Poland or Hungary for example down at 1.7% in 2015 and this despite much more robust increases in worker productivity in these countries when compared to Western Europe.

### Compensation per employee



Source: OECD Economic Outlook November 2016, statistical annex

What explains this weakness in wages? One factor is of course the crisis itself and the high and persistent unemployment that was caused by it, thus weakening the bargaining position of trade unions and workers. Another key factor however is policy. Key policy makers such as ministers of finance and central bankers decided to react to the crisis by giving ‘cost competitiveness’ central stage. Even if the crisis was caused by a fundamental market failure in finance, the consensus view amongst policy makers quickly became that in order for the economy to get out of the crisis it needed to become more “competitive”. A ‘competitive’ economy would draw in new demand and additional jobs from the outside by

increasing flows of export. To do so, there was but one quick fix: Squeeze wages. Thus, policy embarked on structural reform of wage formation systems with the aim of weakening or even dismantling all sorts of institutions and mechanisms that work to back up wages and collective bargaining. In the euro area, this came to be known under the name of ‘wage devaluation’, the latter term reflecting the idea that since euro area members could no longer devalue their national currency, they needed to devalue wages instead. The process first took off in those economies that were literally with their backs against the wall as financial markets were refusing to fund them. To get access to financial bail outs from Europe and the IMF, Greece, Portugal, Spain, Latvia and Romania took the most aggressive measures. Wage freezes were imposed, minimum wages and public sector wages were cut and individual firms obtained the power to undercut wages that were agreed at sector level. As the pressure to keep up with the wage race to the bottom that was unfolding in Southern Europe continued to build up, other countries such as France, Italy and Belgium were contaminated with the same virus of wage squeezes.

The result is where we are now. Wage dynamics, as described above, are extremely weak to the point that they are almost stagnating and close to zero. Moreover, and much to the delight of business, the idea that the lid needs to be kept on wages for the economy to become competitive has become widespread, both in the mind set of policy makers as in the public discourse.

So if we want to turn the tide and if we want to give workers in Europe a pay rise, then we need to get the message across that squeezing wages is bad policy and that the opposite is true: More robust wage increases assist the economy to perform better. This paper describes the reasons why pay rises are a plus for the economy.

## **I. “My wage is my spending and my spending is your job”**

Employers tend to see wages as just a cost. Wages however are also the main source of income for workers and their households. And spending that income provides business with the demand for the goods and services they are supposed to produce. In this way, wages and wage increases function as an engine for economic activity, growth and jobs. In other words, one person’s wage is his or her spending and that spending equals another workers’ job and wage. And in return, the latter’s wage and spending secures the job of the former worker.

Individual employers usually have a hard time in understanding this logic of mutual dependency between wages, demand and jobs. As stated, from the point of view of the individual company, wages are just a cost factor. This makes individual employers quick to think that cutting their workers’ wages will make their business more competitive and will make them sell more. In doing so, individual employers base themselves on the assumption that “all else is equal”, in other words that the level of aggregate demand in the economy is fixed and that the company can take a larger chip of this total demand by offering cheaper products and services.

In reality however, not ‘all else is equal’. Especially in times of crisis, many other companies are likely to react in the same way by squeezing their own workers’ wages. However, if that happens, if wage depression becomes generalised across the economy, then the level and intensity of aggregate demand can no longer be taken for granted but will instead go down. Nor can an individual company hope to gain a larger part of falling total demand as relative wage competitive positions between companies do not change much if

the wage squeeze is general. Leaner company wage bills will thus result in fewer jobs as total demand for goods and services goes down and a larger part of staff remains idle. Wage cuts thus end up in more, not less job cuts.

In economic theory, this is known as ‘the fallacy of composition’ or the false idea that simply summing up of all individual behaviour (“each single company cuts wages to save jobs”) equals the total outcome for the entire economy (“all jobs are saved”). Another way to understand this is to compare with the behaviour of an audience in a (football) stadium. If one member of the audience gets up, he or she has a better view. If all stand up, no one has a better view, nor does anyone have a seat anymore. A policy of squeezing wages comes down to the same thing. Uncoordinated behaviour in the form of all of us cutting wages to secure our jobs does not help but makes things worse.

It’s important to underline that this logic also works the other way around. If workers at one individual company push wages higher, this will not have much of an effect on the level of total demand in the economy. However, if such wage increases are coordinated across the economy, for example because of an interconnected series of collective bargaining agreements, then aggregate demand does go up and companies are likely to react by increasing production and jobs to service higher demand. **By strengthening purchasing power, wage increases are an engine of demand, growth and jobs.**

## **II. “One country’s wages are that country’s spending and part of that spending is another country’s exports’**

What about the competitiveness argument of an entire economy trying to export itself out of trouble? Can export demand take over from domestic demand when wages are being squeezed? Can the positive effect that would be coming from improved external competitiveness be expected to more than offset the negative effect of reduced wages compressing domestic demand?

The answer is that it depends. First of all, it depends on the structure of the economy. If you are a small open economy where export demand represents the lion share of overall demand and where the importance of domestic demand for overall production is relatively limited, the positive effect of such an export led growth strategy may outweigh the negative effect. However, if you are a relatively closed economy where exports only account for 10 or 20% of total demand and where domestic demand takes the lion share, then the revival of exports will be insufficient and the net impact of wage squeezes will still be negative.

More importantly however, the same mechanism of inter dependency that was described above for a single economy is also at work in a region such as the European Union where the different economies mainly import from and export to each other.

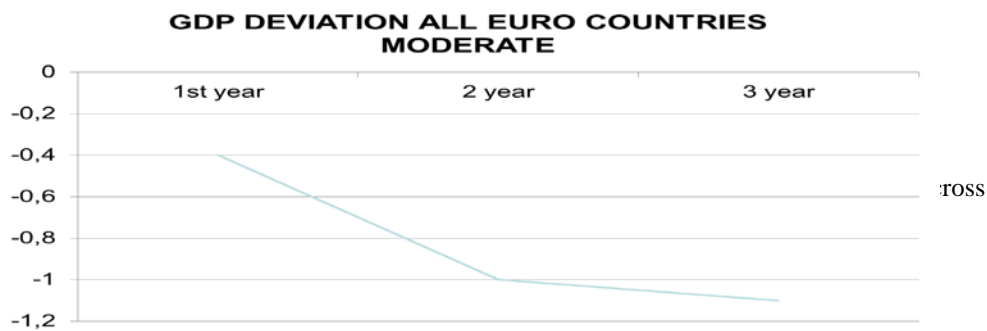
In that case, the wages of country A are the basis of that country’s total demand and part of that demand will be serviced by imports from neighbouring countries, thus supporting economic activity and jobs in these countries. Vice versa, wages of the neighbouring economies support activity and jobs in country A because their wages are being partly spent on goods and services that are produced in country A.

Hence, an identical ‘negative sum game’ may come to realise itself. If one single economy pursues a strategy of wage devaluation, then that particular economy will still be able to benefit from the ongoing wage and demand dynamics in neighbouring economies by

exporting to these economies.

If however, the entire or a large part of the group of economies attempts to poach activity and jobs from each other, then the squeeze in wages that is operated throughout the region does not just weaken each country's domestic demand but also weakens export perspectives for all other economies. Hence, the economic region as a whole suffers both from weak domestic demand inside the single countries as well as from weak import demand from the other trade partners.

This zero sum game was actually illustrated by a simulation the IMF produced at the end of 2015 in one of its research papers. In this paper, the IMF calculated what would be the effect on the crisis economies (Greece, Italy, Spain, Ireland, Portugal) if all economies who are member of the euro area would decide to squeeze wages by 2%. The result, as can be seen from the graph below, is that the economy goes sinks deeper into depression.



**To summarize, and using a similar expression as before, “my wage is my spending and part of my spending are your exports”. Or, to put it the other way around, if we want the European internal market to flourish and to keep export and trade flows up, then pay of European workers needs to flourish as well.**

### **III. “If we can’t increase workers’ wages, let’s increase their debt”**

Central bankers and finance ministers are certainly aware that robust wages are a key ingredient for the economy to work and that squeezing wages creates gaps in aggregate demand that will drag growth down. That is why central bankers have also been looking for substitute policies to fill in the demand gap that is created by their own efforts to discipline wages. Central bankers thought they had found such a substitute in financial policy. As Alan Greenspan, former chairman of the US Federal Reserve once said: ‘If we can’t increase workers’ wages, let’s increase their debt’.

This policy has effectively been pursued in many economies. Every time aggregate demand and wage dynamics went down, economic policy reacted by deregulating the world of finance so that credit would become cheaper and easily accessible and households would continue to spend by indebting themselves more. Remember the famous ‘Ninja’ phrase (No Income, no Job, and no Assets) from the US boom in subprime loans? Where less creditworthy households were provided with mortgage loans higher than the value of the house at extremely low or even zero interest rates in the first years of the mortgage? And when the loan matured and higher interest rates needed to be paid which low income households could not afford, they simply refinanced their mortgage by taking out another ‘ninja’ loan on the basis of the increase in the value of the home. And while this sort of practice tends to be less extreme in Europe, several European economies such as Ireland and

Spain shared rather similar experiences with central banks and financial regulators ‘sleeping on the job’ while housing booms were swinging out of control and huge household debt loads were building up.

Obviously, this policy of replacing wages with risky debt and asset price bubbles is not sustainable. Workers and households cannot continue to indebt themselves indefinitely. When they stop indebting themselves, the “music stops”. Spending comes to a standstill, asset prices stop rising, banks and financial markets finally start doubting the quality of their lending portfolio and become much more careful in extending new or rolling over credit. With the speed of lightning, what was once a virtuous cycle of easy and cheap credit, high spending, rising asset prices and hence even more easy credit becomes the opposite: A vicious circle where everything (demand, asset prices, the banking system the economy and jobs) comes crashing down.

Occasionally, the fact that wage depression and financial instability are closely related is openly recognised. Consider for example an interview with William White, chair of the OECD’s Economic and Development Review Committee, expressing concern about the continuing built-up of debt across the world economy and explicitly calling for more attention to wage growth (<http://www.bloomberg.com/news/videos/2016-02-09/oecd-s-white-says-more-wage-growth-attention-needed>). Coming from the OECD, such statement is rather remarkable as this OECD committee often tends to give member states the advice to bring wage growth down in order to become, yes, more competitive.

**The key lesson that urgently needs to be drawn from the Great Financial Crisis (GFC) and from many other periods of financial turmoil that preceded the GFC is that debt and finance are a dangerous substitute for wage growth. Greenspan’s slogan should be turned upside down. The correct thing is to say that:**

**‘If finance and debt loads are not to become out of control and if demand and the economy is to grow, then let’s make sure wages go up’.**

#### **IV. Wage increases anchor price stability**

Central bankers cherish price stability. The European Treaty on Monetary Union even defines price stability as the overriding priority that the ECB should be pursuing. Price stability however is not limited to inflation rates overshooting the ECB’s inflation target of ‘close to 2% inflation’. Price stability also implies preventing inflation from turning into its opposite, into a process of deflation with a falling general level of prices.

Central banks have good reasons to worry about deflation. One is that households and firms systematically postpone spending because they know the product or the machinery they intend to buy will become cheaper in future, thereby deepening the process of crisis and deflation.

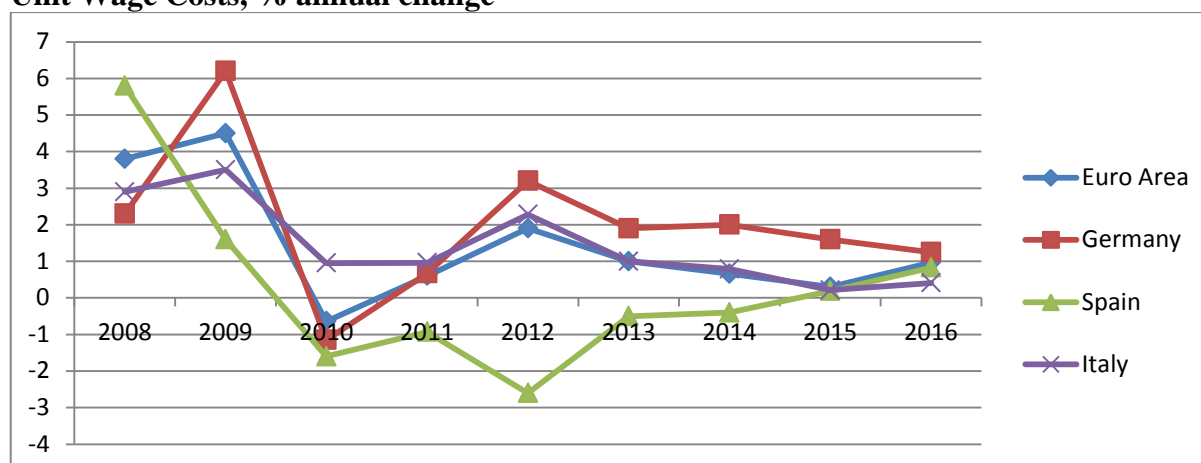
A second reason is that deflation increases the real burden of debt. With deflation, prices and incomes are falling but the amount of nominal debt that needs to be repaid remains the same. As wages and household income are falling, a higher share of their income goes to service nominal debt, thereby crowding out household spending for goods and services. Thus, the economy stagnates, idle capacity is created and is followed by even more downwards pressure on prices. If, sooner or later, interest rates hit the zero bound (it is difficult for a central bank to go below zero and impose negative interest rates as savers

would react by hoarding cash instead of putting their money in a bank where they themselves have to pay interest on it), the economy becomes trapped in depression and deflation.

Deflation, in other words, is something smart policy makers want to avoid. This is also why central banks do not define price stability as zero inflation but as a positively higher inflation rate. This gives them a buffer or safety margin. In case the economy does get hit by an unexpected negative shock, then inflation goes down but still stays above the deflation threshold (from 3% inflation to 1% for example). The economy does not sink into deflation.

What is the link with wages? If we want the economy to experience positive inflation rates of say, between 2 to 3%, then wages are an important tool to help achieving this. If wage dynamics are very weak, as is the case right now, then weak wage growth combined with some growth in labour productivity, results in almost zero wage cost pressures (see graph on unit wage costs). There is no pressure at all on business to raise prices (or at least not by 2%) as wage costs are stagnating. Inflation thus comes out far below the inflation target of the central bank and the economy remains vulnerable to the possibility of a negative demand shock.

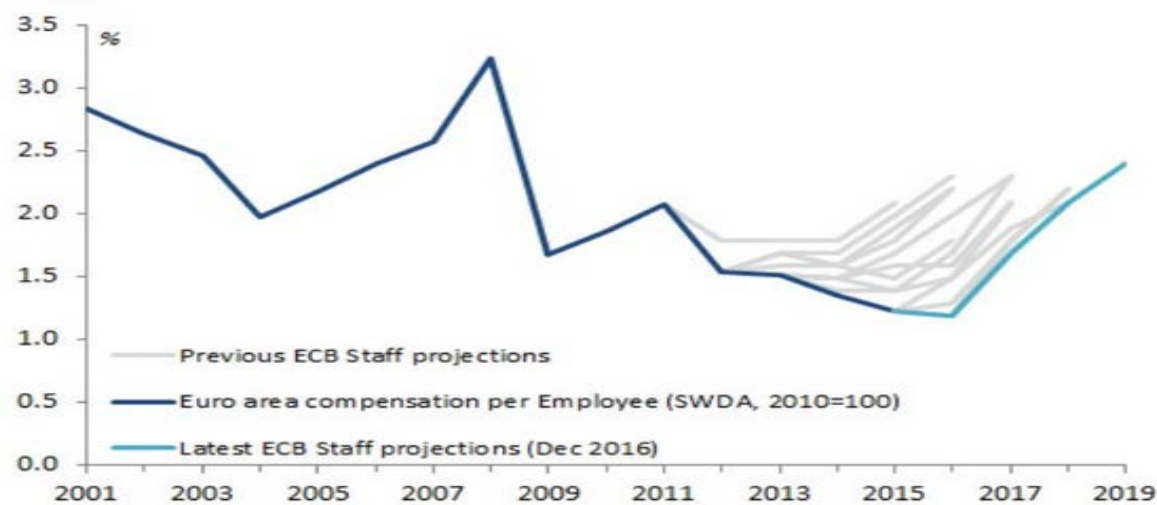
### Unit Wage Costs, % annual change



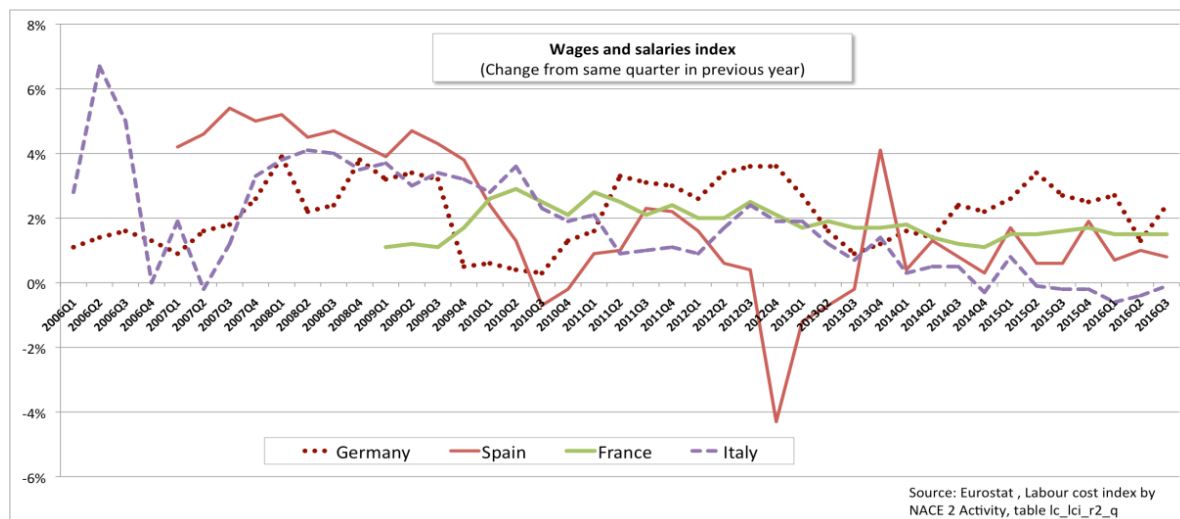
Source: Commission, AMECO

The ECB does indeed realise that higher wage increases are necessary to get the euro area economy back to substantially higher (core) inflation rates. In fact, stronger wage increases is exactly what their research department has been hoping for to happen over the past few years. This can be seen from the next graph which shows the estimated wage increases the ECB has been using in its growth and inflation forecasting over the past years. Starting already from 2010, the ECB was projecting, first stable then accelerating wage growth in the next years. However, instead of accelerating, wage dynamics actually weakened further. In September 2016 the ECB is again projecting wage dynamics to double from 1.2% to 2.5% in 2018-2019. However, as can be seen in the second graph below, wage dynamics in several economies are still at rock bottom rates with not much of a recovery to be seen, not even in close to full employment Germany.

### Exhibit 3: Area-wide wage growth has consistently disappointed %yoy



Source: ECB, Goldman Sachs Global Investment Research



Source: Eurostat, Labour cost index by NACE 2 Activity, table lc\_lci\_r2\_q

**To reach price stability targets of, for example 2% inflation, wages play a key role. By increasing nominal wages by about 3%, business is pressed to increase prices by 2% in order to keep profit margins (taking into account productivity increasing by 1% so that unit wage costs increase by 2%). Wage increases thus work to anchor price stability. The euro area, which has been missing the ECB's price stability target for several years, urgently needs to set in motion an acceleration of wage increases. If not, troubles will only get worse when the next crisis strikes and the economy is pushed into outright deflation.**

### VII. Fair wages make a society whole

Political turmoil (Brexit, election of Donald Trump....) shows how important it is to ensure that economic progress is widely shared. If not, people will no longer feel part of society and be tempted to turn to radicalism.

Here, wages have a double role to play. Wages on average need to keep up with productivity. If they do not, then the remaining part of productivity will go to capital and

increase income (dividends) and wealth (higher equity value) of shareholders. At the same time, to keep a lid on inequality within the group of workers themselves, wages need to increase across the board. If entire groups of workers are left behind while a selective minority of CEO's or professionals (traders, bankers) are cashing in on spectacular wage increases, this will again split society.

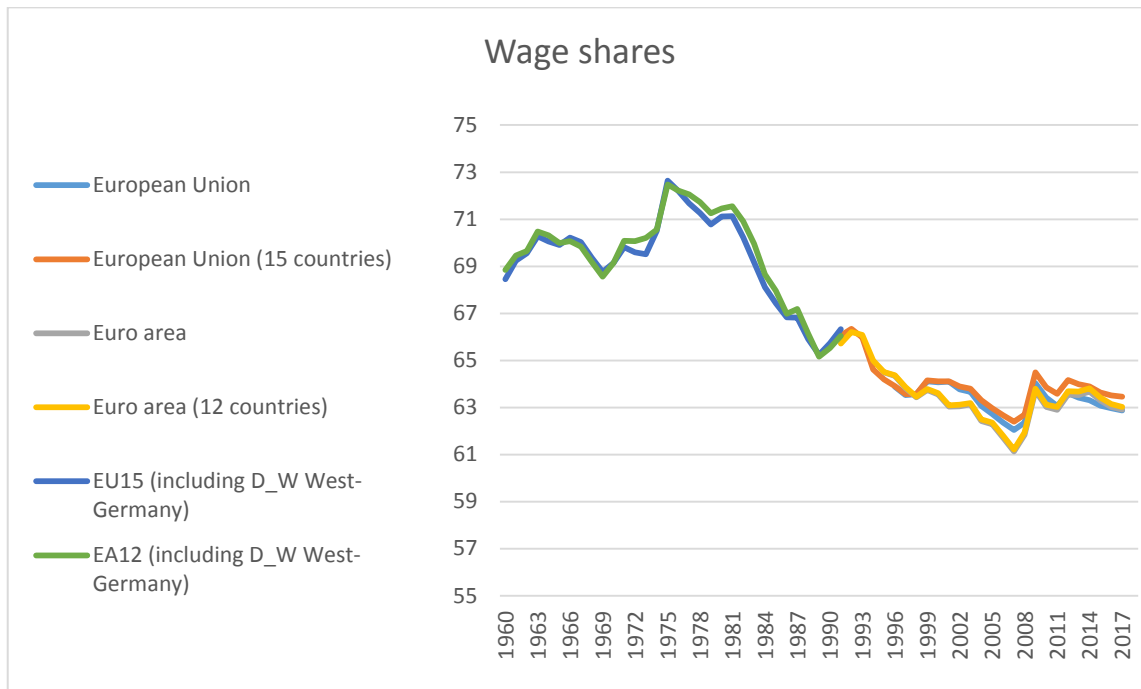
On both accounts, wage dynamics in and across Europe are a ground for serious concern.

To start with, wages in Europe have been lagging behind productivity for decades. For example, starting from 1997, real wages in Europe went up by less than 20% while productivity shot up by close to 30% (see graph). A closer look at the graph also reveals that real wages barely budged since the European economy exited the 2009 recession despite the fact that productivity started to move upwards back again.



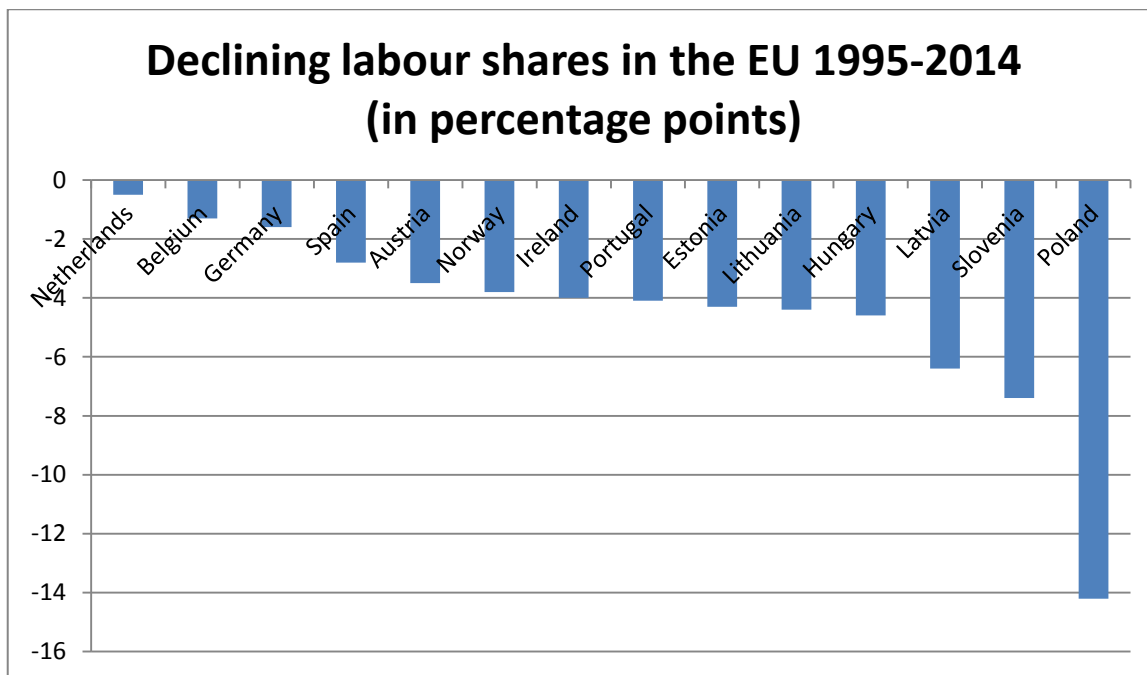
If, year after year, real wages are unable to keep up with productivity, much of the benefits of economic growth will go to the side of capital while the labour share (share of wages in total income or GDP of the economy) goes down. The long term trend for Europe is a labour share that is in decline.





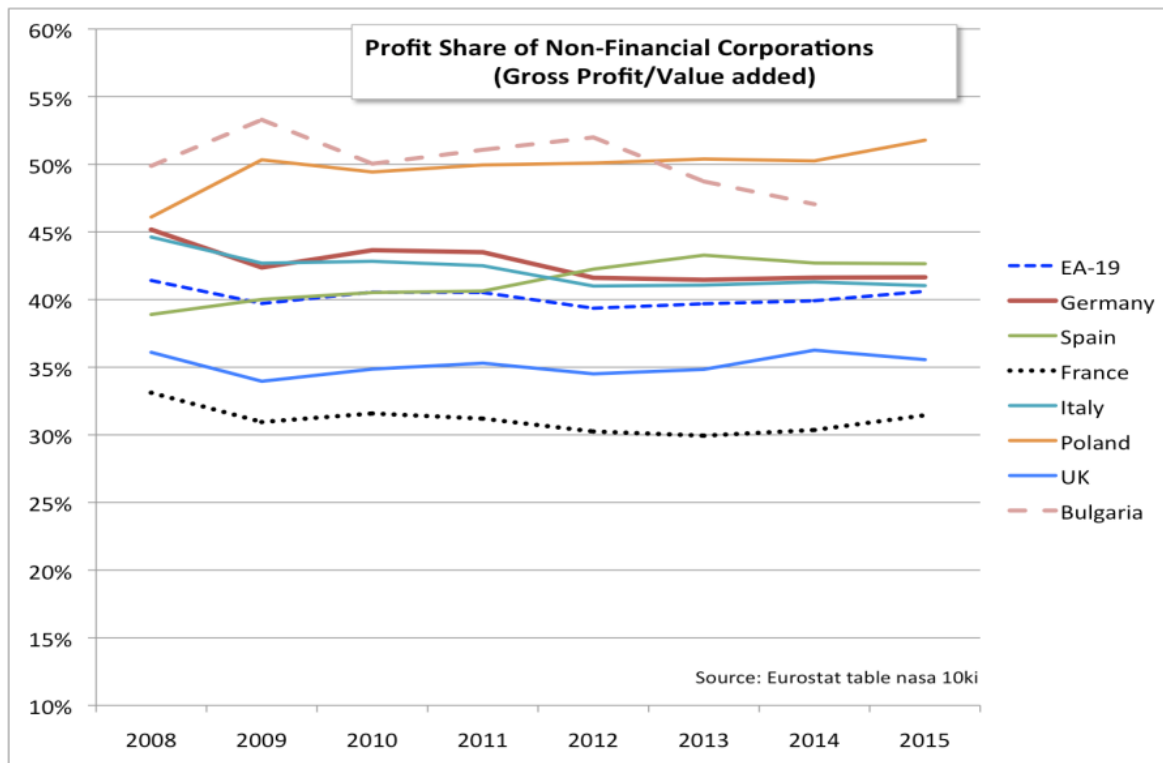
Source: AMECO Database

This is particularly outspoken in what is known as the euro area troika countries (Spain, Ireland and Portugal), many of the Central and Eastern European countries, followed by the euro area's core countries themselves (Germany, Austria, Belgium, Netherlands).



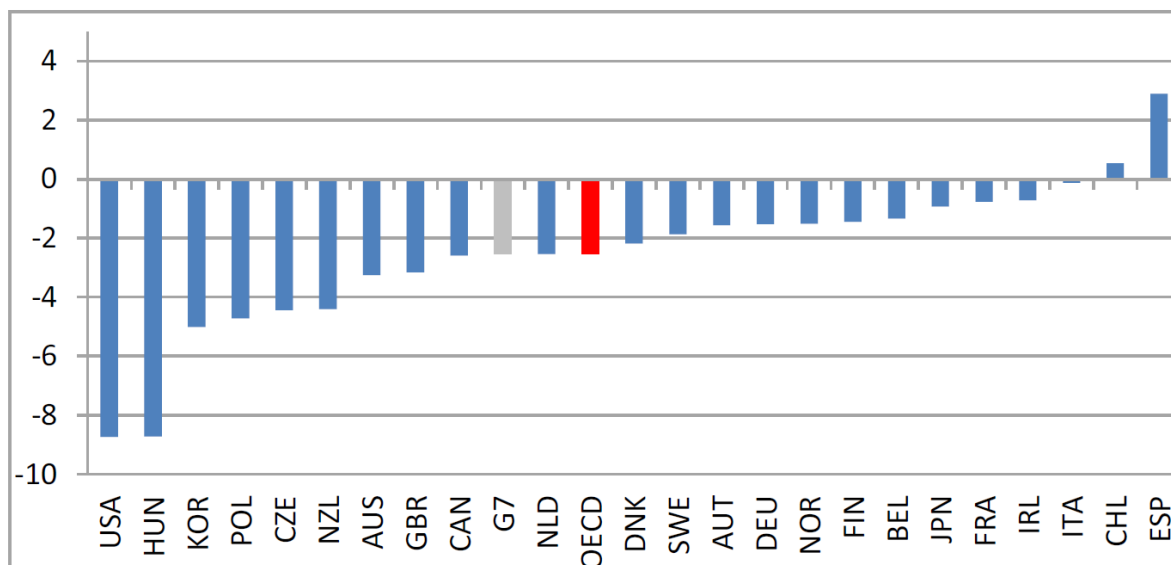
Source: OECD ECO Working paper 2017/5

High or rising profit shares are the mirror view of declining labour shares. The graph below shows that, despite the crisis, profit shares across Europe have not really gone down, that a crisis country as Spain has even seen rising profit shares and that in Poland and Bulgaria, the profit share takes up more than half of value added of the non-financial corporate sector.



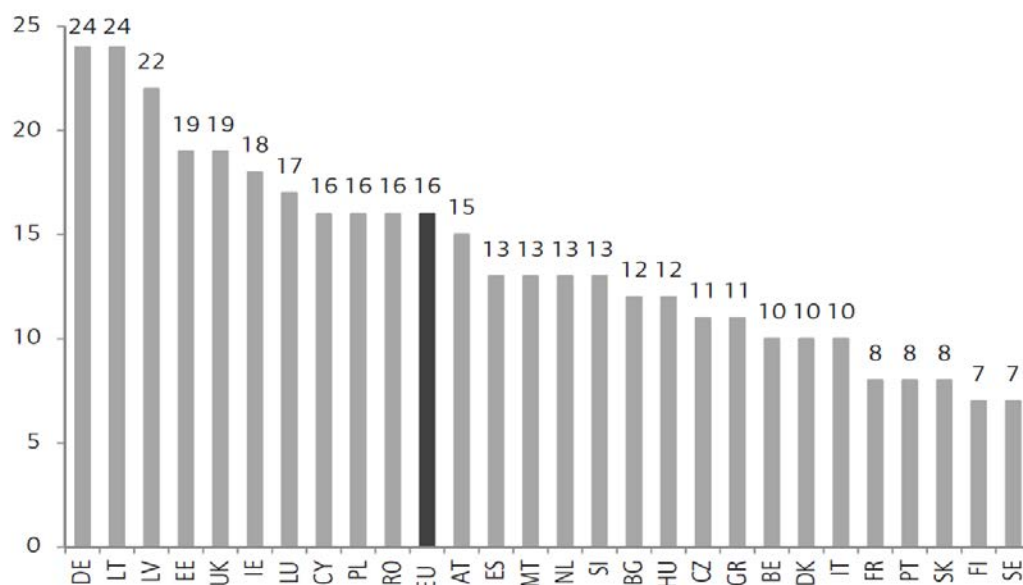
What about inequalities *within* the group of workers themselves? Statistics that focus on this are rather scarce but recent research from the OECD reports that wages at the median (which is the wage of the worker exactly in the middle of the distribution) have not kept up with the wage of the average worker. As the average workers' wage is much influenced by what is happening at the extremity of the wage distribution, the decline in the ratio of the median wage to the average wage is pointing to the fact that the top 10% or even just 1% of wage earners are capturing much more than their share of the fruits of economic progress while the majority of workers is left behind. The graph below from the OECD shows this to be the case for 15 European economies, with very outspoken inequality trends in CEE countries as well as the UK.

**Figure 7. The ratio of median to average wages has declined in a wide range of OECD countries**  
Percentage points, 1995-2013



Top wages pulling away from regular worker pay are one concern. The other concern is also what is happening at the bottom of the distribution. Here, the situation is that across Europe 1 in 6 workers (16%) is earning low wages (defined as a wage below 60% of the median wage). In several member states, the share of low wage earners even reaches 20 to 25% (1 out of every 4 workers).

### Share of workers earning less than 60% of the national median wage (2010)



Source: Aumayr-Pintar *et al.* (2014), p. 112, based on EU-SILC and SES.

### VIII. Robust wages force business to become innovative

Wages can also function as a beneficial constraint. To see this, one needs to understand that the relation between workers and employers is one of subordination. It is the employer who ultimately decides over the organisation of the work. In doing so, employers face two radically different options: Invest in a high performing and innovative workplace. Or, instead, choose for the less challenging option of putting downwards pressure on wages while leaving potential productivity gains unexploited.

Here, robust wage standards can act as an incentive for employers to improve efficiency and/or innovation performance. Vice versa, without such robust wage standards, management may become 'lazy' and loose interest in innovation or in working smarter as they know that downwards wage flexibility allows them to face competitive shocks by simply squeezing wages a bit more. If however, there are wage floors and wage increases that need to be respected, firms cannot afford not to search for continuing improvement in their products and production processes.

Two examples of this process of wage increases driving productive change can be given:

- The first one can be found in the 2016 Employment Outlook where the OECD finds that workers' skills are not fully used in many workplaces across several countries of the OECD. When looking for the causes of this, the OECD's research concludes that labour market institutions influence the use of skills at work. In particular, strong collective bargaining institutions work to encourage management to organise the workplace in a way that improves the use of workers' skills. Higher minimum wages, especially when these are set a

central level, higher union density, mandatory extension of bargaining outcomes, sectorial bargaining and stricter protection for temporary workers, all these institutions and practices increase the use of skills. In other words, they act as described above as a ‘beneficial constraint’.

- Secondly, research from the Belgian university of Ghent finds that there is link between wages and business investment in research and development. In particular in open economies where there is intense foreign competition or in economies where job protection is strict, wage pressure functions like a driving force to innovate. In order to survive and withstand wage pressure, firms simply need to innovate.

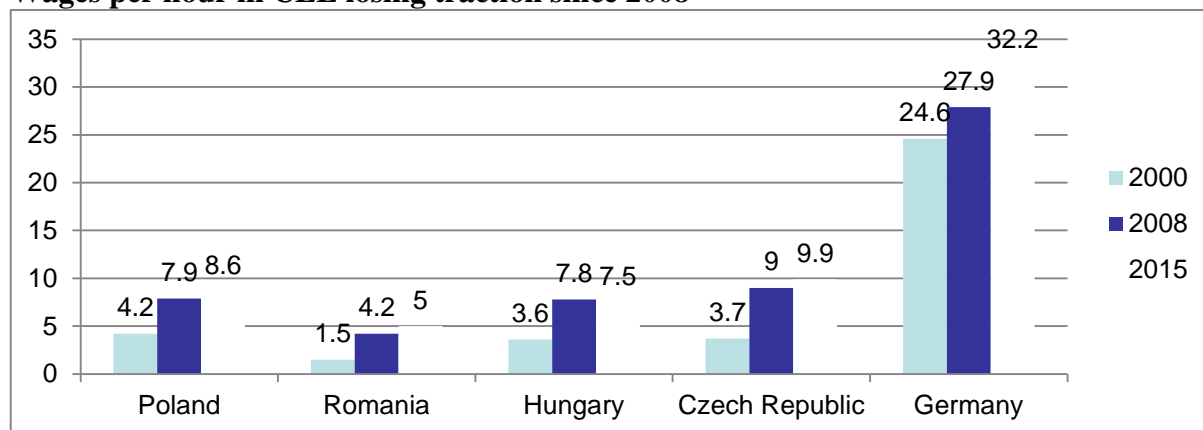
This latter paper estimates that business investment research and development in the core euro countries (Austria, Belgium, France, Italy and the Netherlands) would have been 20 percent higher in the absence of the strategy of wage moderation that has been operated in these economies (period 1981-2011). By contrast, in the Nordic countries, where wage pressure changed little, no such negative effect on business investment in research could be found. (Buyse,Heylen,Schoonackers. On the role of public policies and wage formation for private investment in R and D. Working paper Universiteit Gent September 2015).

**CEE: A low wage strategy that is unsustainable**

CEE countries represent a special case of the risks involved in adhering to a low cost strategy.

Whereas there has been some (but limited) process of CEE wage levels catching up with wages in Western European countries before the Great Financial Crisis, since then the catching up process has weakened.

**Wages per hour in CEE losing traction since 2008**



These gaps in hourly wages between CEE economies and West European countries cannot be explained by lower productivity numbers, on the contrary. For example, while hourly wage in the Czech Republic are 33% of their level in Germany, productivity in the former is as high as 67% of the level in Germany. Or, while wages in Romania are barely 9% of the German wage level, the productivity of Romanian workers is much higher, 44% of the German workforce. Moreover, as argued by an ETUI working paper, productivity statistics may be underestimated in countries such as the CEE economies that are on the receiving side of huge foreign direct investment flows. In such cases, traditional nation accounting statistics have it difficult to adequately measure the productivity increase that accompanies this direct foreign investment and productivity estimates are instead being based on the

wages paid. Low wage levels then show up in artificially depressed productivity levels (see ETUI WP 2016/08).

This low wage strategy is dangerous however. Sooner or later, other parts of the world will open up, develop themselves and become new competitors for the CEE with even lower wages. It is therefore imperative for the CEE's to keep ahead of this future competition by upgrading their economies into more sophisticated parts of the value chain. Higher wages provide business with the incentive to do so. Higher wages push business to become more innovative, in this way keeping the economy ahead of new low wage competitors before it is too late. Higher wages will also help to retain a skilled and educated workforce in the country, which is indispensable for CEE economies to engage with this process of upgrading and innovation.

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February 2017