4. Policy-relevant conclusions

In this report we have developed an innovative measure for determining equilibrium wage levels. Our measure for equilibrium wages and competitiveness defines conditions under which wage increases are compatible with competitiveness. We have argued that wages matter for competitiveness, but without an appropriate benchmark it is impossible to say whether wages are too high or too low. However, it is also true that wages are an important component of aggregate demand. When austerity policies seek to lower wages in order to improve competitiveness, they cut demand and reduce output and therefore affect the productivity of capital and labour negatively, which in turn hampers competitiveness. Greece is the most dramatic example of such a vicious circle.

So-called wage-led growth theories have argued that because austerity is often associated with falling wage shares and rising unemployment, increasing the wage share could overcome the negative effects of austerity. But these theories ignore the effects of higher wages on competitiveness. They do not have an explanation for the equilibrium level of wages and the wage share (which is the same as real unit labour costs), and therefore suffer from not being able to assess whether the demand effect of higher wages is or is not compensated by a loss of competitiveness.

A reasonable benchmark for determining equilibrium wage levels in the European Union, we have argued, can be derived from the return on capital in a given country or industry relative to the average return on capital in the euro area. Wage levels are competitive if they are below equilibrium, contributing to levels of profitability that are above the euro area average, so that they can attract investment and accelerate economic growth. By contrast, wages above equilibrium hamper regional and sectoral growth. We have found a clear relationship between deviations of national and sectoral growth rates caused by the wage gap, and this relationship is better explained by our index than by conventional unit labour cost–based measures. Thus, competitiveness positions within the currency area will determine regional and sectoral divergences in growth rates and they are therefore an important variable for designing strategies of balanced growth.

With regard to balanced growth in the European Union, it might be justifiable to accept competitive wage undervaluations in catch-up regions with low per capita income, but this cannot be a sustainable strategy for more advanced countries. In fact, it would be reasonable to have wage levels slightly above equilibrium in rich countries and below in poor countries. Table 1 has documented that the new member states in central and eastern Europe have huge wage undervaluations, which clearly distort balanced growth in the European Union.

A correction of these disequilibria would generate a significant demand boom in all member states. However, left to market forces – that is, relying on Philips-curve dynamics and no deliberate wage policy – the correction would be slow; our estimates indicate that it would take on average three years and 10 months to reduce a wage gap by half. By contrast, a deliberate one-off wage increase of 20 per cent in all those countries in which actual wages are more than 20 per cent below equilibrium would yield a demand stimulus of 1.9 per cent for the EU (2.1 per cent for the euro area) in terms of GDP and 17.6 per cent in terms of intra-EU trade. Such a stimulus could improve the fiscal position in Europe's southern crisis countries and contribute to price stability in an environment in which inflation is presently hovering at zero per cent or falling into negative territory, although it would also slow down catch-up growth. Wage developments always have structural implications.

Implications for wage bargaining

Trade unions seek higher wages for workers. The margins for wage increases depend on the development of equilibrium wages. If we use the return on capital as the evaluative benchmark, capital productivity, technological change and the transformation of an economy's supply side move into the focus of analysis. In this case, wage setting rules become more complex than the frequently used Rehn-Meidner rule, whereby nominal wages ought to increase at a rate that is the sum of labour productivity growth and inflation. This rule ensures that the wage share remains constant, so that wage bargaining is distributionally neutral. However, the return on capital is defined as the product of the wage share and nominal capital productivity (which we have called average capital efficiency). Distributional neutrality becomes counter-productive when technological change modifies the capital intensity of production, thereby shifting the productivity of capital and labour and the share of capital required to remunerate capital. Hence, changes in average capital efficiency will affect the equilibrium wage and competitiveness and this needs to be taken into account in wage bargaining.

In general and ceteris paribus, the sector-specific equilibrium wage will increase if the productivity of capital increases faster in a given industrial sector or region than in the euro area as a whole. Thus, if an industry or country needs to improve its competitiveness, it must focus on policies that increase capital productivity. This is easily said, but difficult to do. Such a complex policy objective is not achieved by simple rules of thumb, such as the Rehn-Meidner rule.

Whether a sector will actually gain competitiveness will depend on whether actual wages reflect these improvements in capital efficiency. But this adjustment is usually determined by the political regime of wage negotiations. In decentralised regimes, where wage increases reflect marginal labour productivity, the gap between actual and equilibrium wages can be expected to be minimal. By contrast, with centralised wage setting, where actual wage levels reflect *average* productivity *levels*, the sectoral gaps may be substantial, so that the highly productive sectors attract additional investment. This is the case, for example, in Scandinavia, where highly productive sectors gain competitiveness at the margin, By contrast, decentralised wage bargaining, as in Anglo-Saxon-type countries, can sustain competitiveness by wage flexibility, but this will slow down productivity improvements and technological progress.

Because the average efficiency of capital in a sector or country is defined in nominal terms, competitiveness will depend not only on technological factors, but also on the relative prices of capital inputs and output relative to the euro area. In order to minimise distortive effects resulting from changes in average capital efficiency, economic and monetary policy ought to focus not only on the stability of consumer prices, but also on the relative stability of regional and sectoral indicators for GDP deflators and price indices for capital goods. If a country's average inflation (measured by the GDP deflator) exceeds that of the euro area, the equilibrium wage will temporarily increase, but as the prices for capital goods catch up with the general price level, the effect will be annulled (see equation 6). Thus, what matters most in the long run is the development of capital productivity.

The long-run factors determining sectoral and regional capital and labour productivity in real terms are complex and require further research. Our study has nevertheless revealed that equilibrium wages in euro area member states depend crucially on changes in the capital–labour ratio, which is dependent on the importance of relative factor prices (the cost of labour relative to the cost of capital) and technical change biases. We found that the actual performance in different countries varies partly because different sectors respond differently to varying technological change. While technological progress has a tendency to affect manufacturing and services in similar ways, outsourcing and exports do not have the same effect. This means that wage bargaining in different sectors has to be careful to take into account the effects of technology and the related reorganisation of labour relations on the productivity of capital and labour.

This analysis is of great importance for designing a balanced growth strategy for Europe. The relative importance of specific sectors varies significantly between member states of the euro area (see Table 3). As a consequence, the evolution of equilibrium wages will change as well. However, the sectoral distribution of economic activity alone is not enough to determine a region's competitiveness. As the Figures A1 in the annex show, it is frequently the case that an industry has a competitive advantage with regard to the average of the euro area overall, but not with regard to the specific European industry. In other words, while a particular sector may be a growth sector with attractive returns to capital in general, a given member state may not perform as well as its neighbours in this sector. For example, manufacturing in Belgium, which represents 15.7 per cent of value added, is competitive relative to the European average, but not with regard to manufacturing in the euro area. By contrast, this country is highly competitive in agriculture and IT services. In France, manufacturing has lost its competitiveness with regard to other countries' manufacturing industries, but its manufacturing sector still yields higher returns on capital than the euro average. In Germany most sectors have undervalued wage levels, although less competitive sectors – mostly in services and agriculture – account for slightly more than 20 per cent of total value added.

Dealing with these discrepancies does not make policy advice easy. There is no simple rule of thumb, although better knowledge would help to negotiate wage deals that generate sustainable wage increases. Of course, sector-specific wage gaps and imbalances can be corrected up or down by diversified wages settlements in each sector and country. However, as the aggregate picture for Greece shows, when nominal wage setting affects productivity and production functions, wage restraint can be as detrimental as wage exuberance. A more sustainable approach would require a coherent economic policy approach that removes inhibitions to technological progress and focuses on supporting the growth of productivity in labour and capital. The European Commission has suggested that national governments set up **National Competitiveness Boards.** However, uncoordinated national boards will not take into account relative competitive, which depends on the average performance of the euro area. It would be better to set up a **European Competitiveness Board**, possibly in the EESC (European Economic and Social Committee), where the national social partners are already represented.

Cooperation between social partners, especially if it is institutionally founded, is surely more likely to generate positive results in the long run. This raises the question of what the right social model for Europe would be.