

The coordination of economic policy in EMU

What contribution can the Macroeconomic Dialogue make to higher growth and employment?

*Andrew Watt**

1. Introduction

This article seeks to make the case for an alternative, cooperative approach to macroeconomic policymaking in EMU, one that does not require major, and thus difficult, reforms of the institutional architecture established by the Maastricht treaty. It begins (section 2) by characterising the policymaking architecture of European Monetary Union (EMU) and emphasising the theoretical underpinnings of that policy assignment. It is then shown that these theoretical preconditions are deeply flawed and that there is scope for a cooperative strategy, centred on wage-setters and the monetary authority, that could generate better economic and employment performance in EMU. Section 3 briefly addresses political-economy concerns: it is shown that major institutional change to the Maastricht policy assignment is difficult, but that it is not in fact necessary. A change of behaviour by actors is a sufficient condition for improved outcomes. On this basis section 4 develops a simple formal model of policy cooperation between wage-setters and monetary policy. Section 5 examines the role that the Macroeconomic Dialogue could play in ensuring the required institutionalised cooperation between actors. Section 6 reflects briefly on other political-economy issues regarding the feasibility of such an alternative strategy and the interests of actors.

2. The policy mix in EMU

The theory of how EMU is supposed to work is pretty straightforward (cf. Issing, 2002; Allsopp and Watt, 2003). In the institutional architecture set out in the Maastricht Treaty, and developed since – most notably the Stability and Growth Pact – there is a clear assignment of responsibility. The monetary authority, the ECB, is responsible primarily for price stability, which it itself has defined as medium-term price increases (HICP inflation)

* Senior researcher, European Trade Union Institute (ETUI-REHS).

below 2%.¹ Subject to that it is to support the ‘aims of the Union’, which include economic growth and employment, amongst other things.²

The fiscal authorities must keep their current budget deficits below 3%, strive to attain balanced budgets (or slight surpluses) over the economic cycle and otherwise refrain from discretionary interventions.

The social partners – unions and employers – are responsible for ensuring that wage growth is conducive to full employment, which is often interpreted as meaning that wage growth must lag behind productivity growth until full employment has been achieved (European Commission, 1993; for the theoretical justification cf. Sachverständigenrat, 2003: 361–376).

In this framework, fiscal policy is disciplined, on a country-by-country basis, by the SGP, and is under the shadow of a ‘collective punishment’ in the form of higher interest rates. Similarly, wage (and price) setters are disciplined, at the national level, by price competitiveness considerations in increasingly open, transparent and competitive goods markets, and, collectively, by the monetary authority: the ECB will raise interest rates if overall wage and price pressures increase beyond its stability ceiling. Monetary policy is not similarly disciplined by other actors. It is delegated to an independent, technocratic body. Its mandate is set by the Treaty, but there is no formal sanction on its failure to fulfil that mandate. In this system, then, the central bank holds the whip-hand. The coordination mechanisms between the policy areas, apart from this ‘coordination through domination’ approach are extremely weak: participation (in an observer role) of the eurogroup³ president at ECB Governing Council meetings and, *vice versa*, of a representative of the central bank board at eurogroup meetings; and the Macroeconomic Dialogue, a forum for informal, biannual discussions between policymakers, which we consider in some detail below. This lack of institutionalised coordination is by design: it is thought to be not only unnecessary but also undesirable as it would tend to blur responsibilities (Issing, 2002).

¹ This was specified in March 2003 as ‘close to but below 2%’ (for a commentary see Watt and Janssen, 2003).

² If the proposed constitutional treaty is adopted, they will also include price stability, virtually immunising the ECB from criticism that it is failing in its obligations to also pursue real economic goals.

³ The monthly meetings of the finance ministers of the EMU member countries.

At first sight, and viewed through the eyes of mainstream economic theory, such a system would appear to have numerous advantages. If member countries are ‘in equilibrium’ in terms of their goods trade with one another – if their ‘real exchange rates’ are appropriate – and in the absence of severe shocks that affect different member states in different ways, such a system will at least ensure balanced non-inflationary growth, while avoiding policy conflicts between the main actors. In a standard natural rate or NAIRU model, in which inflation is always costly in terms of growth and employment, and never positive in the medium to long run, and in which equilibrium unemployment is determined by labour market and other institutions, that rate of non-inflationary growth will also be the maximum that the economy can obtain in anything but the short run.

It is not clear that any of these conditions hold in the real world, however. Moreover, if one of the actors fails to adhere to the rules it is supposed to follow – or, indeed, if it is *perceived* to be doing so by other actors – it is not clear whether other actors are entitled (or even obliged) to take counter action. Responsibilities become necessarily blurred and conflict between actors is likely.

Take, for example, the case of ‘excessive’ public deficits in some countries. This could be the result of fiscal profligacy. In that case, clearly, the fiscal authorities are to blame and must change course. The SGP is designed to ensure this, and the monetary authority can raise interest rates (although this would impact on all countries). Suppose, however, that a country entered EMU at an overvalued exchange rate (see also Allsopp in this volume). It will have to undergo a period of sub-par growth and relative disinflation. This – necessary – adjustment will manifest itself not least in the form of rising public deficits. Counter-action by the fiscal authorities will worsen the economic situation and may induce a self-reinforcing negative effect on employment and the budget itself.⁴ In recent years Germany offers an illustration that this mechanism is by no means of merely theoretical interest. It is also possible that fiscal deficits are the result of a failure by monetary policy to adequately shield the economy from external restrictive influences (such as exchange rate appreciation or rising commodity prices). This may, for example, be because inflation is distorted by transitory factors that are a poor guide to the appropriateness of the level of demand in the

⁴ There will be a counteracting effect via an improvement in national competitiveness, but this will take some time to become apparent (ETUI/ETUC, 2004: 103f.)

economy or due to dangerously rapid inflation in other countries (which will tend to generate fiscal surpluses there!). There is unlikely to be a consensus between actors as to whether or not this is the case. Clearly in the real world there are serious risks of the seemingly transparent and simple system breaking down into recrimination and, either, inaction or, worse, destabilising, inconsistent actions. The policy mix will be inappropriate and growth and employment will suffer⁵.

2.1. Theoretical assumptions on which the Maastricht architecture relies

It will be useful to consider some of the theoretical conditions that must apply for the Maastricht assignment to generate optimal outcomes. This points the way to possible reform strategies.

The debate about the long-run neutrality of money is an old one in economics, and has been subject to various phases in which different theories have been predominant. Modern economics has little truck with the, until fairly recently popular, extreme New Classical Economics view that monetary policy has no real effects at all, not even in the short run. Indeed, the very policy of inflation targeting, in which short-run output gaps play a central role (most clearly exemplified by the Taylor rule), and which is now widely considered best-practice central banking, explicitly recognises the power of central banks to influence demand and output in the short run. It remains a central tenet of central bank orthodoxy, however, certainly in Europe, that ‘in the long run’ monetary policy cannot have an effect on output, i.e. cannot influence the growth potential of an economy. All that the central bank can do is to create an environment of monetary stability, reducing risk premia on market interest rates and thus supporting investor and consumer confidence.

Yet by accepting the impact of monetary policy on real outcomes via confidence effects, this line of argument opens up a contradiction. For it implies that ensuring price stability will in all circumstances maximise consumer and investor confidence. While stable prices may well be critical for financial investors, consumers and investors in real capital will be more

⁵ Note that, because of the nature of the regime, and the special role of the central bank, which can set interest rates autonomously, the price stability goal can always be enforced. As long as the Bank sticks to this – and all its incentives are to do so – such policy conflicts can only ever be to the detriment of demand and the real economy, but not to price stability.

concerned with stable demand prospects and employment prospects than with inflation rate numbers to the right of the decimal point. There are two points here. One is that, because the inflation rate and the output gap are not perfect substitutes as indicators of demand pressure in the economy – otherwise the Taylor rule could dispense with one of them – the central bank will sometimes be forced to choose between economic stabilisation and short-to-medium-run deviations from its price target. Thus central banking is not purely ‘technical’ or ‘neutral’ and must reflect social choices. Secondly, it is also a question of the message that the central bank sends out. Europe’s consumers and investors are convinced that the ECB will defend price stability (which is why inflationary expectations remain below 2% even though headline inflation has been significantly higher). They are less convinced, however, that the ECB will step in to shield the economy from shocks or internally generated downward shifts in confidence (Allsopp and Watt, 2003). Thus the central bank’s communication strategy is crucial to get the most benefit out of the inflation-targeting regime.

On top of these come more fundamental reasons why a monetary policy that is more sensitive to the real economy can have positive effects also on the *potential* growth rate. Briefly (further details in Watt and Janssen, 2005), there are two main channels by which monetary policy can affect growth potential: investment and the labour market.

An increasing capital stock is key to raising the potential growth rate. This means that a reduction in interest rates stimulates not only the actual growth rate, but also, by inducing additional investment (due to lower costs of financing and brighter sales prospects), the potential future non-inflationary growth rate of the economy.⁶ The capital stock is increased and modernized (vintage effect). As demand rises many firms will also reap economies of scale. This raises both the main components of labour productivity (capital deepening and total factor productivity) and thus also the rate of non-inflationary growth (see also Schubert in this volume).

On top of this comes the labour market channel. Deep and prolonged economic slumps mean that unemployed workers lose their skills as well as the motivation to stay engaged in the labour market. There is a danger of them becoming permanently excluded from the labour market, as ‘discouraged workers’ who no longer have an impact on wage negotiations, or are only

⁶ The ECB’s own research (*Monthly Bulletin*, July 2003) shows that aggregate demand expectations are the most important determinant of the level of investment.

qualified for lower-productivity jobs. All these effects increase the rate of unemployment below which inflation begins to rise (NAIRU) when the economy recovers. This effect, by which cyclical unemployment is converted into structural unemployment, is known as ‘hysteresis’. The prime task of macro policy must be to ensure that the extent and duration of downturns and thus unemployment spells is minimised, otherwise the damage will be not just to current, but also to potential economic growth.

It has been argued that, while macro policy can ‘cause’ structural unemployment, it cannot then reduce it (e.g. Bean, 1997). However, there are a number of channels by which an aggregate demand policy that tests the limits of so-called structural unemployment by reducing unemployment – gradually – through demand led growth, will set in motion labour market mechanisms that will improve the functioning of the labour market and reduce structural unemployment.⁷ Of course, this process can usefully be accompanied by appropriate labour market policies (for an evaluation of the European Employment Strategy in this spirit, see Watt, 2004a).

In short, the positive effects of aggregate demand policies are not limited to the short run; they also impact on the economy over the medium and even the long term. Consistent with this view, the IMF and OECD have noted that the longer the slump in European growth lasts, the more the estimates of Europe’s growth potential have been revised downwards. Indeed the Commission’s estimates of potential output have been revised downwards by almost one percentage point in recent years (European Commission 2004: 22ff.). In light of the previous arguments, this is hardly surprising. The failure of Europe to arrest the downturn and to stage a real recovery has depressed investment and capital accumulation and had lasting negative effects on productivity and on the labour market. It also implies that a return to effective growth will lead to an increase in potential growth through the channels of capital accumulation and the labour market.⁸

⁷ For instance, firms experiencing difficulties in finding skilled labour will see the need to provide and finance more training for (unemployed/young) workers. In turn, unemployed workers and those ‘discouraged’ from entering the labour market at all due to the lack of jobs, realising that there are indeed increased job openings and opportunities will again ‘tune in’ to the labour market. Also, ‘ladder effects’ (firms engaging higher skilled workers for lower skilled jobs) will be put in reverse, thereby alleviating low skilled unemployment.

⁸ For estimates of the likely size of such effects see M. Leon-Ledesma and A.P. Thirlwall (2000).

A final relevant theoretical consideration relates to the issue of uncertainty and time lags. Both interest rates and wages are set today on the basis of expectations about events in an uncertain future: wage agreements typically have a duration of one or two years. Changes in interest rates are generally regarded as influencing the real economy and prices with a lag of some 12–15 months. This implies that actors take decisions based on their suppositions about what other actors will do. As has been suggested above, the division-of-responsibilities approach has a solution to this: as monetary policy has ‘the last word’, all actors can rely on it to anchor inflation in the medium term. Price stability is always ensured. That is not a sufficient condition for an optimal policy, however. The inevitable uncertainty on the part of the monetary authority about the actions or reactions of other actors during the policy horizon will, given its incentive structure, cause it to adopt a tighter monetary policy ‘just in case’ – an empirical example is given in the next section – causing an unnecessary contraction of current output (with knock-on effects on potential growth, as we have argued). At the very least, this suggests that a mechanism for a regular exchange of forward-looking information between policy actors would generate better solutions.

In previous work (Watt and Hallwirth, 2003) the empirical relevance of such theoretical issues has been demonstrated. Economic downturns, leading to a (lasting) rise in unemployment can be interpreted in terms of a conflict between policymakers, and in particular between wage-setters and the monetary authority. This has also occurred under EMU: economic growth in the euro area in the course of 1999 and the start of 2000 was robust. In response, the ECB began to raise interest rates from their low level. However, it continued to raise rates until the middle of 2000 (by a total of 2.25 percentage points), although economic growth had already started to decline sharply (and in spite of the well-known monetary policy lags of 12–18 months). This was to counter the danger of imported inflation from higher oil prices and a lower currency being passed on in the form of higher wages and so into prices.

If, in this situation, it had proved possible to convince the ECB that the inflationary pressure could be kept under control without monetary tightening (or with a more moderate increase in interest rates), monetary policy could have been more supportive of growth, offsetting the decline in foreign demand by strengthening domestic demand. Trade unions attempted to do this, particularly by pointing to the long duration of wage agreements

already in force, especially in Germany.⁹ However, lacking confidence that wage (and fiscal) policy would be sufficiently stability-oriented, the ECB tightened policy sharply. The pronounced downturn in 2001 was the inevitable result.

Before welding the above theoretical arguments into a case for a more proactively coordinated approach to policymaking, I will first consider how far reforms of the Maastricht architecture can feasibly go, and how far they need to go to achieve a marked improvement in economic and employment outcomes.

3. Difficulty of fundamental reforms, but scope for behavioural changes

In light of both disagreements with the theoretical underpinning of the Maastricht architecture and the disappointing growth and employment performance of the European economy, and especially the euro area, there has been no shortage of reform proposals by critical economists in the Keynesian tradition for an alternative architecture. In most cases such proposals have been directed either at the Stability and Growth Pact – up to and including calls for its complete abolition – or at the monetary policy of the ECB, typically in the form of a call for the ECB to be given a ‘balanced’ mandate, including growth and employment as specific policy targets. Particularly from French commentators has come the call for a *gouvernance economique*, the idea that fiscal policymakers, by coordinating their activities, could act as a political counterweight to the ECB.

I am not unsympathetic to such proposals: a Treaty change (Article 105) towards a balanced mandate for the ECB would certainly be welcome. The problem is a political one: because of the specific nature of the European policymaking regime, fundamental reforms of the policy framework are simply not on the political agenda and remain unrealistic for the foreseeable future (Watt, 2005a). The key point is that the Maastricht consensus was ‘set in stone’ at a particularly fortuitous – for neo-liberal economic policymaking – juncture, the early 1990s representing the high-water mark of neo-liberal influence in Europe. Most provisions of the Maastricht architecture are set out in a treaty, changes to which require unanimity and national ratification¹⁰. It is

⁹ A two-year agreement had been signed in the metal sector, which serves as wage leader in Germany (and indeed more widely in Europe).

¹⁰ The SGP, which is not in the Treaty, is a partial exception.

abundantly clear from the failure of the European Convention, despite its rather federalist leanings, to agree on any major reforms to the economic governance system, that the democratic majorities for major reforms just do not exist at present. But even if they did, in the EU governance system, small blocking minorities are usually enough to defeat pressure for change.

Fortunately, however, fundamental reforms – defined here as those requiring modifications of the Treaty – however desirable they might be, are not a *necessary* condition for a better policy mix. Conversely, behavioural changes by the key actors *within the existing framework* are a *sufficient* condition for generating better employment and economic outcomes. To show this is the task of the rest of this paper.

To start building this argument three key points about the existing regime can be briefly noted at this point (see also Watt, 2005a). The first is that the employment and economic performance of the euro zone has, at times, been quite satisfactory, namely in the first two years, when the currency area was on the trajectory for the Lisbon targets: Europe *can* create jobs at the required rate. The problem is that, as we have seen, this growth process was unnecessarily curtailed by, at heart, a lack of coordination between the monetary authorities and wage-setters. It is the establishment of such an effective signalling mechanism that lies at the heart of a politically feasible reform strategy.¹¹ Secondly, while fundamental reform is a political non-starter, the rhetoric of European policymakers (especially central bankers and some fiscal policymakers) must not blind us to the fact that the economic governance regime has undergone some piecemeal reform and is actually more flexible than is commonly realised. Examples of this include the changes to the SGP (on the most recent reform see Watt, 2005b) and the (minor) revisions to the ECB monetary policy strategy in March 2003 (Watt and Janssen, 2003). Moreover, the ECB has in fact tolerated headline inflation above its 2% target, clearly showing that it is aware of the real-economic costs of swiftly correcting inflationary up-ticks. The third point is that the institution that could perform the coordinating role between monetary

¹¹ The link between monetary and wage policy is, of course, not the only one. My justification for focusing on it here is two-fold. Firstly, the issues of coordinating fiscal policy between member states and fiscal and monetary policy have received widespread attention from economists and commentators, whereas the monetary-wage link has received scant attention. Secondly, while reforms of the fiscal framework are certainly desirable, the monetary-wage link is a sufficient condition for improved performance. Some reference is made below to coordination between wage policy and fiscal policy in each country (cf. also Hancke and Soskice, 2003).

and wage policy already, in an embryonic form, exists: the Macroeconomic Dialogue. This is taken up in section 5.

The remainder of this article seeks to make a case for reforms that are both politically feasible and economically effective, centred on a wage/monetary policy coordination 'rule', operationalised through an expanded and extended version of the current Macroeconomic Dialogue.

4. A model of monetary-wage policy coordination in an EMU-type context

This section¹² describes a simple model of how actors could behave to ensure a consistent policy mix that maximises growth and employment opportunities, while ensuring price stability. It begins by abstracting from national differences, considering a single economy with a single monetary, fiscal and wage policy. In a second step we move closer towards the reality of EMU, with a single monetary policy, but national fiscal and wage policies.

4.1. A single-country model

In this simple model the central bank, via its control over short-run nominal interest rates, controls the rate of expansion of aggregate nominal demand in the economy. This aggregate nominal demand has a quantity (real) and a price component (in accordance with the quantity or Fisher equation), such that changes in nominal demand are the sum of changes in real output and prices. For presentational reasons, in this first approximation nominal demand is proxied by the money supply.¹³ Expressing rates of change in lower case letters, we can write:

$$m = y + p \text{ or } y = m - p$$

¹² This section develops previous work by the author (Watt and Hallwirth, 2003; Allsopp and Watt, 2003) and draws also on Koll (2005) and Hallwirth (1998).

¹³ This assumes, problematically, a constant velocity of circulation of money (v). The mathematical model presented should in no way be construed as condoning the use of monetary targets as a guide to operational monetary policy. In the real world the central bank sets interest rates and then the supply of money is determined endogenously by demanders of credit. Opinions differ on the ability of central banks determine nominal demand trajectories using interest rates. Further work is needed in this area, but it will be assumed here that, in a reasonably stable environment, at least, central bank to policy transposes, over the medium term perspective with which this chapter is concerned, into a predictable amount of nominal demand.

Output is also defined as labour input (employment, E) multiplied by the productivity of labour (Y/E),

$$Y = E * Y/E$$

Thus changes in output (economic growth) are also equal to the sum of the change in employment and in productivity (π), or

$$y = e + \pi$$

Combining the two equations for y and rearranging, we obtain our basic equation:

$$e = m - p - \pi$$

where the rate of employment growth is equal to the growth of nominal output less inflation, less the rate of productivity growth. We can now consider, in this simple model, ‘optimal’ behaviour by the different actors.

The task of the inflation-targeting central bank is to ensure that inflation stays, in the medium term, close to a target (p^*).

The question is, what determines, as m rises, the way nominal output divides between increases in y and p ; for now we will assume that productivity is determined exogenously. More specifically, given the mandate of the central bank, how can y be maximized and p be limited to its target rate (p^*). In standard models it is the level of aggregate demand with respect to the existing productive potential that does this. Assume that, at the outset, the rate of inflation is constant at the central bank’s target. (We abstract, for the moment, from external influences – exchange rates, import prices – on the domestic price level). At the point where the stock of existing capital is at its ‘normal’ capacity utilisation and where the level of unemployment is such that trade unions are sufficiently weakened to prevent them pushing through inflationary wage increases, and firms cannot raise prices, the economy is considered to be in equilibrium: inflation will be constant at the target rate (p^*), output will be equal to productive potential (Y^*) and unemployment will be at the NAIRU. In the standard model, this is nirvana: macroeconomic policymakers can do no better than this.¹⁴ Note that it is the lack of pricing power of workers and firms (wage and price-setters) resulting from ‘sufficiently high’ unemployment that ensures price stability.

¹⁴ Hence the focus is on ‘structural reforms’ at the micro level to reduce the NAIRU and thus raise the potential rate of economic growth.

Clearly, this standard model relies on a number of assumptions. One is that the capital stock is constant in the short run. Another is that wages are determined in a simple way such that, when unemployment is above the estimated NAIRU the growth of nominal wages is higher than the sum of productivity and the current rate of inflation, and below that sum when unemployment is below it. In a market-driven wage-setting environment (provided the NAIRU estimate is 'right' and everyone, the 'representative' wage-setter and the central bank believes in it) this may be true.

However, in reality nominal wages are set in complex institutional structures. Particularly in highly organised, centralised bargaining environments, which remain typical in much of Europe (Schulten, 2004), the 'social partners' reach agreement on rates of nominal wage growth for thousands or even millions of workers at a time. Let us suppose that they can set this rate at will, just as the central bank sets interest rates. Specifically, we will assume that wage-setters agree on (and are able to enforce) a formula whereby, *whatever the current rate of inflation and level of demand*, nominal wages will increase at a rate equal to the rate of medium-run productivity growth¹⁵ plus the target inflation rate of the central bank. Subject to the further condition that the scope for price setters to raise prices is tied to the rate of wage increases (see Box 1) – in other words that in the medium term the capital and wage shares of national income are constant – in such an environment, when nominal output increases, real output will increase by the same rate of change, *whatever that rate is*, minus the target inflation rate of the central bank:

$$y = m - p^*$$

Thus the labour costs of producing a unit of output are the decisive variable in determining inflation and thus the extent to which rising nominal aggregate demand is 'lost' to price increases rather than raising output and employment.

¹⁵ Productivity growth varies cyclically. Orienting wages to the medium-run rate stabilises wage trends and also demand and the economy more generally. The precise rate of productivity growth chosen is an important empirical question for policy, but does not alter the fundamental properties of the model.

Box 1. Wage inflation and the scope for product price increases

There is a great deal of literature on firms' aggregate pricing policies (much of it, in this context, goes back to the seminal Layard, Nickell and Jackmann, 1991). What basis is there for the assumption that domestic prices are labour-cost driven, i.e. determined by the growth of nominal wages compared with productivity, i.e. the growth of the costs of producing one unit of output? For the purposes of this chapter I merely refer to the extremely tight empirical correlation between changes in unit labour costs and prices.

Figure 1: Inflation and nominal unit labour costs, EU-12, 1981–2002



Source: European Economy 6/2002, Tables 24, 30 and 33, calculations by the author

As can be seen from Figure 1, there is a very close empirical relationship between changes in nominal unit labour costs (ULC) – total labour costs, in nominal terms, per unit of output – and changes in prices (inflation). Virtually throughout the disinflationary period of the past 20 years, nominal ULC growth has been somewhat below inflation. This has been reflected in a slow but steady decline, broken only for brief spells in the early 1990s and in 2000/2001, in the share of national income going to wages. Although such a correlation as such tells us nothing about causality, it is theoretically plausible to assume that the scope for profit-maximising firms to raise prices depends on medium-run demand and cost developments and that these are tightly circumscribed precisely by the development of unit labour costs. In any case, the empirical evidence implies that, if it is possible to exert control over the development of nominal unit labour costs at the level of the economy as a whole, it is also possible to keep inflation under control.

The two variables determining nominal unit labour costs (ULC) are the growth of overall labour costs and of productivity. In the short to medium run the growth of productivity is relatively insensitive to policy influence. Thus nominal wage growth becomes the decisive variable determining the distribution of M between Y and P . Formally we arrive at the simple equation that, given the above assumptions,

$$e = m - w$$

In words: employment growth is equal to the rate of nominal output growth minus the rate of wage growth. (Mathematically this result is obtained by inserting the assumed $w = \pi + p^*$ into our basic equation $e = m - p - \pi$.)

This, in turn, puts the institutional mechanisms of (nominal) wage determination (and the link to monetary policy) centre stage. We will briefly consider the extent to which they are able effectively to determine nominal wage trends independently of the state of nominal demand later.

But first let us draw a provisional policy conclusion from the model. *Provided wage-setters are able to set nominal wage growth at the rate of productivity growth plus the target inflation rate of the central bank, the central bank is able to set interest rates at the level that expands nominal demand at the rate required to hit a target rate of growth for the economy.* For a given productivity trend, this also determines the rate of employment growth.

It is simple enough to put some rough numbers on this. Suppose, more or less as in the EU's Lisbon Strategy, a goal of annual employment growth of 1% is considered a feasible target over a ten year period. The above equation ($e = m - p - \pi$) indicates that, if productivity remains close to its medium-run trend¹⁶ (2%) and inflation can be anchored by wage policy close to target (2%), then the rate of nominal demand growth should be around 5%. If the trend decline in the velocity of money is around 1% p.a., the appropriate interest-rate policy would see the money supply growing at around 6% p.a. on average. Unsurprisingly, this is considerably higher than the ECB's reference value of 4.5%. To repeat: this is not, however, a policy

¹⁶ It is not clear whether productivity will be systematically affected by faster demand growth. Mainstream economists tend to emphasise that the additions to the workforce will tend to have below-average productivity. But this is offset by the capital deepening and other productivity-enhancing effects of higher investment, economies of scale, etc. Experiences such as the USA in the 1990s are suggestive that the latter effects predominate; cf. also Leon-Ledesma and Thirlwall (2000).

target variable for the central bank. Its short-run fluctuations make it next to useless for that purpose. It will, however, emerge *ex post*, over the longer run, as the appropriate rate of monetary growth, given the other parameters, for the desired employment growth.

Recalling what was said earlier, that monetary policy is set in the light of fundamental uncertainty about future developments and also that prices are often influenced by factors other than the level of aggregate demand and domestic wages, notably by the prices of imports, we can revisit the policy coordination failure that brought to an untimely end the expansion of 1999–2000, as prices rose due to higher demand and imported inflation. In such a case, if nominal wage growth continues to be oriented towards trend productivity growth plus the target inflation rate of the central bank, there will be no pass through of domestic demand pressures, *nor* of higher imported goods prices into wages and prices. Headline inflation will initially rise somewhat, but the rise will be contained by the ‘anchor’ function that nominal unit labour costs have on inflation in the medium run.¹⁷

Similarly, if an economy is affected by a deflationary external shock and inflation falls below target, inducing counteraction by the monetary authority, nominal wage growth will continue unaffected, helping to sustain private consumption and avoiding cumulative causation effects until the monetary stimulus kicks in (and/or the shock is reversed).

An important implication of this model is that, subject to its conditions, the NAIRU, as traditionally understood, loses its role as a guideline for monetary policy (cf. Hein, 2004). So-called ‘structural reforms’ (lowering unemployment benefits, weakening trade unions, etc.), whose aim, in different ways, is to reduce the NAIRU, become superfluous (and possibly damaging). This is the result, of course, of the assumed ability of ‘social partners’ to set the pace of nominal wage growth autonomously. For this model and the policy prescriptions associated with it to be considered relevant, we cannot duck the question of how long a process of nominal demand expansion cum stability-oriented wage development can continue. Otherwise it would appear that there is no limit to the increase in output and

¹⁷ In addition, unit labour costs will themselves be lower than if demand and output are curtailed by monetary tightening, as in the short-to-medium run productivity is pro-cyclical. Falls in productivity caused by sudden drops in output are one reason why, in an *ex post* analysis, unit labour costs sometimes appear to overshoot in the year an economy begins to decline, leading to claims that wage policy has ‘killed jobs’ (see Bibow and Janssen in this volume).

employment. We return to this question in the next section. Before doing so, we must consider some implications of the fact that, in EMU, wages and fiscal policies are largely set at national level, while monetary policy is set at the level of the currency area as a whole.

4.2. A multi-level model

Moving one step closer to reality, by considering the case of a single monetary policy with multiple wage-setting and fiscal ‘authorities’, gives rise to some complications, although not necessarily those that might appear at first sight. It is frequently argued, for instance, that both productivity levels and trends and collective bargaining institutions in Europe are too diverse to permit wage coordination. This argument rests on a misunderstanding, however. Such diversity does not pose problems in itself: all that is required is for aggregate wage trends at the national level to conform to the productivity plus target inflation rate rule. This is easily shown.

Consider two countries in a monetary union. Let the rate of productivity growth in the first country be 2%, in the second 3%. The (common) target inflation rate is 2%. Then a sufficient condition for medium-run price stability (and also for an unchanged competitive position between the two countries) is a nominal wage increase of 4% and 5% respectively.

For a currency area (CA) of n countries ($a, b...n$) we can write this more formally as follows:

$$w_a = \pi_a + p^*, w_b = \pi_b + p^* \dots \dots \dots w_n = \pi_n + p^* \Rightarrow w_{CA} = \pi_{CA} + p^*$$

Clearly this result is independent of the relative size of the countries, as unit labour costs in all countries will grow at the same rate, namely the target rate of the central bank. Moreover, the institutional arrangement that generates this outcome in each country is, in principle, irrelevant; we return to this briefly below.

Matters are more complex, however. So far, we have talked only in terms of average inflation rates. While this is the key concern of the central bank, this overall figure consists of the (weighted) average inflation rates in the member states. For various reasons these are likely to differ, and, moreover, the patterns of such differences will also change over time. This national rate is also likely to be of greater interest to national wage-setters and fiscal policymakers than the area-wide rate. It can be argued, as in the above equation, that if all actors, in their respective national contexts, stick to the

overall guideline, these inflation differentials will disappear. This is logically correct. However, it assumes that inflation differentials are ‘a bad thing’, that they should be eliminated. Or, to put it another way, that the initial competitive position of countries in the currency area is in some sort of sustainable equilibrium and remains that way. This is not the case, however. Differential inflation rates remain, even within a developed monetary union, and certainly within an ‘immature’ union, an important adjustment mechanism for national economies.

Two cases can be considered.¹⁸ The first is where countries enter the monetary union at an incorrect real exchange rate. Countries that enter at too high (low) a rate will have to undergo a period of below-average (above-average) inflation if they are to regain competitive equilibrium. If this adjustment is blocked by adhering to the above wage norms, the former countries will suffer higher, the latter lower unemployment (with knock-on and probably pro-cyclical effects on fiscal policy). The second case is where, even though countries enter at the right rate, subsequent developments necessitate an adjustment of the real exchange rate. Again, two main possibilities come to mind. One is the case of an asymmetric shock, a shift in commodity prices or a shift in demand for certain products, that disproportionately affect certain countries of the currency union. The other is the need to allow for what might be called ‘historical’ adjustment mechanisms. The obvious example here is the Belassa-Samuelsun effect. Countries undergoing a catch-up phase tend to have a lower domestic price level at the exchange rate that ensures external balance. As their productivity in the traded sector rises, this pulls up wage levels also in the non-traded-goods sector, and the price level rises. This is a normal and welcome adjustment process, and the wage norm should not seek to counteract it (and the inflation target of the central bank should be high enough to allow it).

On the other hand, it is clearly not the case that national wage norms should focus on the current national inflation rate. This would perpetuate inflationary (or disinflationary) processes that result from imported inflation, overheating etc., and destroy the inflation-containing properties of the model. In fact, the price level that should be the basis for the wage norm should normally lie

¹⁸ Further work is necessary to address this complex discussion in detail. The aim here is to set out some basic principles for the approach advocated. Problems of competitiveness within the euro area are beginning to tax the minds of economists and policymakers. For further discussion see Allsopp and Artis (2003), DIW (2005) and Allsopp in this volume.

between the central bank target rate and the national inflation rate. What is required is that the (weighted) average of the price components in national wage norms is consistent with the overall price target, i.e. that countries in which wage and price inflation is above average are offset by those in which it is below, and that this reflects necessary adjustments in competitive position (and thus that they come to an end or are reversed as circumstances change).

Thus the wage-policy condition for a currency area with countries a to n needs to be rewritten as follows:

$$w_a = \pi_a + p_a^*, w_b = \pi_b + p_b^* \dots \dots \dots w_n = \pi_n + p_n^* \Rightarrow w_{CA} = \pi_{CA} + p^*_{CA}$$

where p_n^* represents the country-specific target inflation rate for country n . In each case this rate will lie between the current national inflation rate and the target rate for the currency area as a whole, i.e. either $p_a < p_a^* < p^*_{CA}$, or $p_b > p_b^* > p^*_{CA}$ for below- and above-average inflation countries respectively. In addition, the weighted average of the national price components must be equal to the overall price target: $\alpha p_a^* + \beta p_b^* + \dots + \theta p_n^* = p^*_{CA}$ where $\alpha \beta \dots \theta$ represent the relative weights of the countries in the inflation 'basket' of the central bank (and sum to 1).

At this level of abstraction it is not possible to be more precise about the 'correct' price component for the wage settlement in each country. Determining the degree of competitive adjustment required (e.g. for the Belassa-Samuleson effect) is an empirical matter.

In terms of actual policy, two somewhat contradictory conclusions can be briefly stated here. On the one hand, the need to allow for competitive adjustment clearly makes it much more difficult to decide on the appropriate guideline for national wage policy in any given circumstances. The lack of clarity about whether prevailing inflation differentials are justified or need to be counteracted by wage policy will exacerbate the already difficult task of coordinating wage bargaining. On the other hand, it is also the case that such a guideline will be easier to follow in the sense that reduces the extent to which social partners or trade unions need to impose settlements (their *Bindungsfähigkeit*) on their members, because the distance between the pay norm based on the average target rate of inflation and the rate that market pressures will be pushing towards will be greater than when 'good' reasons for national prices to diverge from the average are taken into account.

This can be illustrated by an example. In the recent period Spanish unions would not have to convince their members to base pay settlements on

productivity plus 2% when price inflation in Spain is running at around 3.5%. That would imply real wage growth 1.5 p.p. below the rate of productivity growth, and that in a situation of a booming economy. Instead, allowing for Belassa-Samuelson and competitive adjustment effects, a guideline based on price inflation of, say, 3% would be the target. This would be offset by a lower target in, say, Germany, where unions find it very difficult to achieve pay increases as high as productivity plus 2%: currently wage drift means that actual pay increases are substantially below collective agreements. Importantly, this divergence would not be set in stone and would be reversed once competitive adjustment has been accomplished.

4.3. Questions regarding the degree of control over nominal wages

In the discussion so far we have heroically assumed that nominal wages are autonomously set by wage-setters, implying a monopsonistic trade union, or at least a highly centralised and cooperative collective bargaining system able to prevent individual wage bargains that contravene the agreed norm (upwards or downwards). Wage-setters can thus make a credible commitment to other actors to ensure a given rate of nominal wage increases. Although there is no space here to discuss collective bargaining structures in detail (Schulten, 2004; Traxler et al., 2001; Janssen and Mermet, 2003), both common sense and historical experience in national economies with social pacts, social contracts and the like suggest that, while a degree of control can be exerted by organised collective bargainers, that control is limited. Even if formal bargaining coverage is high, actual wages differ in practice from collectively agreed pay rates (wage drift). The ‘devil is in the detail’ and it is very difficult to determine the exact value of pay settlements in such a way that they can be compared with the wage norm. More basically, it is undisputed that an expansion of demand and falling unemployment will, at some point, lead to a breakdown of nominal pay discipline and inflationary pressure.

Is this a valid argument against the sort of corporatist, cooperative policy solution advocated here? It certainly means that the model will never work in reality in the ‘perfect’ way illustrated above. But in terms of real-world policymaking, the argument, while it certainly poses challenges, is not a fatal one. For it merely means that it is not possible in reality to bring the NAIRU to zero (to render it entirely indeterminate). Yet it is neither feasible nor necessary to reduce the NAIRU to zero. In other words, the litmus test on which the strategy, as a ‘policy recommendation’, must be judged is whether *unemployment can be sustainably brought down below that*

prevailing under the existing, non-cooperative regime. Or alternatively: whether employment goals, such as in the Lisbon Strategy, are more likely to be achieved than under current policies.

Despite some recent trends towards decentralisation, most European workers continue to be covered by multi-employer collective agreements, typically at the sectoral level (Schulten, 2004). And, contrary to what media reports about individualisation and falling union membership might lead one to believe, not only does collective bargaining coverage remain high, but the 1990s saw a resurgence of ‘social pacts’, a new form of national corporatism that has led to a centralisation of wage negotiations in a number of European countries (Fajertag and Pochet, 2000). Moreover, there is an extensive literature suggesting that coordinated, centralised wage bargaining is associated with better macroeconomic outcomes (Calmfors-Driffill, 1998; see also Traxler et al., 2001). More recently even such market-friendly international organisations as the IMF and the OECD have been forced to recognise that, particularly in the context of independent central banks, such as the ECB, centralised collective bargaining enables inflation to be controlled at lower cost in terms of output losses (OECD, 1997; IMF, 2003; Howell, 2004). This is not least because a coordinated wage policy avoids the economic fluctuations that arise from using the national Phillips Curve, in both directions, to bring the economy back to a sustainable path.

Meanwhile, European unions are engaging in various activities to coordinate their wage demands and ensure that wage developments are consistent with non-inflationary growth, while ensuring workers a balanced share of rising national income. Space constraints preclude an extended description (cf. Schulten, 2004; Watt, 2004b; Janssen and Mermet, 2003). Experience with these wage norms so far has been mixed. The coordination mechanisms rely on similar forces (benchmarking, peer pressure) as the EU’s ‘open method of coordination’ and suffer from the same limitations: they are fine in good times, but when under pressure they exert little binding power over trade unions concerned primarily with national priorities and constraints. It is not yet the case that national union federations see such forms of coordination as being in their interest.

Ultimately, though, the extent to which nominal wage trends can be controlled cannot be known in advance. It must, in practice, be the subject of an iterative social experiment in which confidence is built between the actors (social partners and monetary authorities) and demand is expanded slowly to the point at which wage pressures start to occur. This iterative

process must be managed: and that is why the next section looks at the MED as a way to institutionalise that process. It needs to be stated clearly, however, that the strategy advocated here is inimical to a policy, advocated in some quarters, of an uncontrolled decentralisation or even ‘individualisation’ of pay setting. Countries with individualised wage-setting have no choice other than to use national fiscal policy to exert the required pressure on wage-setters, acting through the national Phillip’s Curve.¹⁹ On the other hand, a cooperative strategy does not require a system whereby individuals’ wage rates are determined ‘in Brussels’. It is perfectly conceivable for bargaining to be conducted at local level, provided it occurs within a framework that ensures that, at the macroeconomic level, the overall wage bill rises in line with the agreed norm (as has been the case, although without being embedded in a European framework, in Ireland and the Netherlands, for example). Finally, even in coordinated bargaining systems, national fiscal policy remains as an option to push wage-setters in the right direction (for a more developed wage-fiscal strategy at national level see Hancke and Soskice, 2003).

5. MED and policy coordination: what reforms are necessary?

In the last section a mathematical model characterising ‘optimal’ behaviour was presented, with some first reflections on what that implies in the real world, especially for wage setting. Similar considerations apply with regard to the need for coordination: no simple reforms of the MED, the trade unions or any other single institution will bring about policy coordination that conforms exactly to the theoretical conceptions derived above. Yet we have also emphasised how important it is to realise that institutions and actor behaviour do not need to be optimal to achieve better outcomes than the perennially disappointing performance of the European economy.

5.1. The MED

The Macroeconomic Dialogue was established in 1999, just after the start of EMU,²⁰ under the German Presidency. It remains a little-known institution.

¹⁹ That is, in the absence of an institutionalised ‘wage policy option’, countries must control inflation by tightening fiscal policy, slowing national demand and growth, raising unemployment and thus forcing a deceleration of wage inflation. Labour market institutions (unemployment benefits, dismissal protection legislation, etc.) would come under pressure.

²⁰ In theory the MED covers the entire European Union: in practice, however, and also in this analysis, the focus is very much on EMU and its common monetary policy.

Its main characteristics can be set out briefly as follows.²¹ The MED forms part of the European Employment Pact – the other two pillars being the coordinated strategy for employment (focused on the employment policy guidelines in the so-called Luxembourg process) and the economic reforms (Cardiff process): thus its aim is to contribute, via an improved macroeconomic policy to a ‘sustainable reduction of unemployment’ (Presidency conclusions), where ‘sustainable’ can be translated into ‘consistent with price stability’. The specific contribution of the MED is to institute a dialogue between the actors responsible for the policy mix – monetary, fiscal and ‘wage’ policies – to promote positive interaction between the actors. Importantly, the MED is the only institution that brings together all the relevant macro actors to discuss the policy mix.

The MED takes place twice a year at political level, in each case prepared by a meeting at technical level. The discussions are confidential and there is currently no provision for issuing formal statements or reports as an institution: ‘The substantive core of the MED is an exchange of information and ideas’ (Koll, 2005: 183). In particular, actors discuss their analysis of the economic situation and prospects, formulate their own intended responses to the unfolding situation with a view to the goals of higher employment and non-inflationary growth and, lastly, state their expectations of how other actors should respond. At no time is the autonomy of any actor called into question. The MED currently takes place virtually exclusively at the European level.

What does this brief thumbnail sketch of the MED, as presently constituted, imply in light of the discussion above? On the one hand, the MED is clearly located at the key nexus for determining employment outcomes at the European level. If Europe suffers from coordination failures, especially those linking monetary and wage policies, then the MED is ‘in the right place’ to resolve them. On the other hand, it is extremely weakly institutionalised, characterised by a very loose form of ‘soft’ coordination. Thus its ‘purchase’ on actor behaviour is also extremely limited, even at the European level. On top of this comes the problem of the inadequate links between the European and the national level, where fiscal and wage policy decisions are very largely taken. The political implications of this for the

²¹ Cf. the Presidency Conclusions of the Cologne European Council (http://europa.eu.int/council/off/conclu/june99/june99_en.htm). For a more detailed description see in particular Koll (2005).

way in which the MED needs to be developed to play a more constructive role are drawn out in the next section.

5.2. Reforming the MED: deepening at the EU level

The first and most obvious point is that the quantitative time devoted to policy mix coordination in Europe is woefully inadequate (13 hours per year at technical, four at political level!). The first and most simple step must be to accelerate the rhythm of these meetings.²²

This would also enable the focus of the meetings to shift increasingly away from discussions about ‘the facts’ and their interpretation, to a more policy-oriented debate oriented towards consistent, quantitative development scenarios for the European economy as a whole, and its component countries, and about the mutually compatible actions by the actors concerned that are required to achieve them. While the basis would essentially be given by the main identities referred to above, of course this would enable the weight of econometric know-how within the Union to be brought to bear in an attempt to quantify the key interrelationships within the European economy, while also addressing the problematic internal competitiveness issues touched on above. IF-THEN-type simulations could be generated and policy options discussed. This would, of course, be facilitated by the provision of a permanent secretariat, funding for the conduct of targeted research, and so on.

This would provide a basis of technical expertise and knowledge on which an expanded Dialogue at political level would conduct an ongoing, intensified dialogue on macroeconomic issues. This would make the process more open, transparent and politically legitimate, as its importance in policymaking increases. Alongside more regular, structured discussions, ways should be developed to enable informal coordination in response to sudden developments. Progressively, given the key role of expectations and confidence in a capitalist market economy, ways should be found for the results of discussions and orientations elaborated by the MED to be disseminated to investors and consumers outside the conference room.

²² This would be anything but unprecedented: an unpublished survey of ETUC affiliates conducted by the author revealed that, prior to EMU (and in some cases since), many national union federations met with government and the central bank to discuss policy-mix issues on a monthly basis.

5.3. Reforming the MED: widening at the national level

A key limitation of the MED as currently constituted is the almost total lack of articulation with the national level, which remains and almost certainly will remain for the foreseeable future, the key locus for decisions on fiscal policy and wage developments.

In order to intensify the weak vertical communication linkages, the establishment of a parallel structure of national MEDs must be pursued (cf. Koll 2005). Such meetings are already being held at technical level in Germany. Of course, in many EU countries diverse forms of tripartite coordination and exchange regularly occur between the social partners and government. On top of, or as part of this, and respecting national specificities, regular meetings of the national fiscal authorities, the national central bank and social partners should be held to 'shadow' the MED at EU level.

This has a dual aim. The first is to increase the degree of commitment that wage-policy actors can enter into at the European level by broadening and strengthening the national bases for such commitments. The second is to provide a European mantle for discussions at national level between governments and wage-setters (and the central bank). This is necessary to allow for the necessary competitive adjustment mechanisms (differentiated national inflation targets) described earlier, while also preventing 'strategic' wage setting (especially by smaller countries) that endangers balanced, inflation- and deflation-free growth in Europe as a whole (see also Allsopp and Watt, 2003: 662f.).

6. Actor interests and the prospects for reform

It is important to re-emphasise that the strategy advocated here depends on the behaviour of actors, on how they *decide*, autonomously, to behave. Thus it poses the question of political will, and that, in turn, calls for consideration of actors' interests in adopting such behaviour and their ability to change. Again, a full discussion goes beyond the scope of this article, and further research in this area is required (cf. the contributions to Hein et al. 2005). At this point it will merely be noted that institutionalising policy cooperation within an institution like the MED has a number of advantages for the participating actors.

It should be obvious that trade unions have much to gain (cf. Niechoj, 2005). They would have increased confidence that their efforts at stability-oriented wage policies, which, it should be recalled, they have maintained for many

years now in Europe without corresponding success in employment terms, will be rewarded with more employment-oriented macroeconomic policies. Worker's real wages will keep step with productivity, ending the shift in national income to unearned income that has characterised the last 20 years or so. It would help to avoid European workers engaging in beggar-thy-neighbour wage policies that seek to solve national unemployment problems (especially in small open economies) at the expense of exporting unemployment to others (especially large economies). Falling unemployment not only strengthens workers' bargaining power directly, but it also reduces pressure for welfare state cuts and anti-union policies as a supposed way to reduce the NAIRU. Last but not least, it would help to reposition unions as key actors at both national and European levels.

Europe's trade unions have strong incentives to make the necessary 'investment' in pay coordination. They have already made some steps in the right direction; they should continue down this road.

The position of employers is perhaps less clear-cut, but in fact they also have much to gain. The strategy rests on higher investment, growth and, not least, profits. Owners of capital would benefit as much as labour from the larger cake: conflict over the functional distribution of income would be minimised. The real interest rates paid by investors would be lower than in an uncooperative strategy, while demand-side expansion would be more stable and less uncertain. Currently, it is true, it seems that many employers and their representatives see their advantage in increasing their share of a very slowly growing cake, at the expense of labour, by playing off workers against each other and calling for the dismantlement of a welfare state they no longer see a need to maintain. However, there are both economic and political reasons why such a strategy, if it is indeed that, is unsustainable. Moreover, the media picture of footloose big companies relocating at will and continually searching for the lowest-possible costs is distorted. A considerable proportion of employers are not, in fact, internationally mobile, and rely on domestic demand; such a constituency would have a direct interest in supporting a coordinated strategy.

Fiscal policy has played a subordinate role in this account. Let us just point out, though, that faster and more stable demand growth is a *conditio sine qua non* of successful, sustainable budgetary consolidation, reducing public expenditure and raising revenues. In this context there is scope to initiate a virtuous circle of higher demand and employment, budgetary consolidation and a reduction of the tax and contribution burden on labour, feeding into

additional employment opportunities. If this were set in train, the debate on the SGP would become the side-issue that, in a fundamental sense, it is.

For the central bank – which, it should be recalled, must set interest rates now for economic conditions prevailing in 12–18 months time – a cooperative strategy as sketched out here offers additional security regarding future price trends. The Bank will have increased confidence that inflationary up-ticks will not feed into medium-run inflation. In short, it helps the central bank to do its job!. It is true that the Treaty-based independence of the ECB gives it a strong position to reject what it might see as constraints on its autonomy. So far, it has unequivocally rejected what it describes as ‘ex ante coordination’ (Issing, 2002). However, political pressure is steadily building on the Bank, as economic stagnation persists and each promised recovery proves a false dawn. It may see soft coordination within a MED-style set-up as preferable to the threat of a more serious curtailing of its mandate and role.

Overall, this suggests that the European Central Bank must come to recognise European trade unions as strategic partners that are key to it achieving its price stability goals while minimising sacrifices in terms of output and employment losses. If the economic analysis above is correct, such an approach would be in conformity with its mandate (indeed, refusing such a strategic option would be contrary to that mandate, at least if the ECB’s subsidiary goals are taken seriously). One first step towards this would be that, in its pronouncements on issues other than monetary policy, and in particular in the area of so-called ‘structural reform’ and collective bargaining, it should avoid giving the impression of lecturing to policymakers and wage-setters. More specifically, it must recognise that downward pressure on union membership and the decentralisation of collective bargaining over pay is not conducive to maximising non-inflationary growth in the European context. Wages in Europe are not set atomistically, nor will they be in the foreseeable future. The best solution is to use recognised existing bargaining structures as a strategic resource that offers a superior alternative to the domestic Phillip’s Curve in a non-cooperative environment which tends to exaggerate the amplitude of the economic cycle and causes real economic costs.

The central bank must not only actively engage in the MED as currently constituted – as it has done. It must contribute to the ongoing development of that institution. And finally it must indicate also in its rhetoric that it is concerned with the fate of the real economy and does not see economic growth as an implicit threat to the achievement of its own goals. I do not

actually think that this is the case, but it is an impression that the public at large has, and the public perception of the central bank's strategy is an important part of its mission. In the short term it would help if the Bank considered placing greater emphasis on core inflation, making the symmetrical nature of its inflation target more readily apparent, and in view of existing inflation differentials, setting a slightly higher average target.

Conclusions

This chapter is a mixture of economics and political-science arguments for a realistic, feasible alternative to current policymaking in the EU with the goals of higher growth and employment, without sacrificing price stability. A simple economic model was presented. More complex ones can be developed that take into account additional variables. But what is ultimately key is the political will on the part of the relevant policymakers to agree on a cooperative strategy and change their behaviour accordingly. A little progress in this direction has been made, but it is obviously very limited.

At heart, the problem here is a specific case of the prisoner's dilemma, or the 'chicken-egg syndrome'. The central bank's willingness to engage in a debate with trade unions and feed the outcomes of that debate into its actual policymaking is obviously contingent upon the latter's ability to commit its affiliates and members in order to provide the required underpinning from nominal wages. Unions may well be reluctant to do so as long as they feel that the central bank is insensitive to issues of employment and the real economy and is there primarily to serve the interests of *rentiers* in maintaining stable prices. Experiences at national level do give ground for optimism that such a low-trust equilibrium can be overcome. Recent examples, though (such as the Netherlands and Ireland) have tended to follow on recognition that the national economy was in crisis and that differences between policymakers needed desperately to be overcome in order to break out of deadlock. Yet the economic situation in Europe can be seen, in terms of the continent's actual potential to create wealth and jobs, as constituting a crisis. In any case, humans are not condemned to repeat their mistakes: they can learn from them. It would be encouraging if Europe as a whole could move towards a more cooperative form of macroeconomic policymaking, with all its undoubted benefits, without having to undergo a really severe economic crisis first. There is no logic of history driving us to that end, however. The actors concerned must institute the required policies.

References

- Allsopp, C. and M. Artis (2003) 'EMU, four years on', *Oxford Review of Economic Policy*, 19 (1), 1-29.
- Allsopp, C. and A. Watt (2003) 'Trouble with EMU: fiscal policy and its implications for inter-country adjustment and the wage-bargaining process', *Transfer*, 9 (4), 646-664.
- Bean, C. R. (1997) 'The role of demand-management policies in reducing unemployment', in D. J. Snower and G. de la Dehesa (eds.) *Unemployment policy: Government options of the labour market*, Cambridge: Cambridge University Press.
- Calmfors, L. and J. Driffill (1988) 'Centralisation of wage bargaining', *Economic Policy*, (6), 13-61.
- DIW (2005) 'Auswirkungen von länderspezifischen Differenzen in der Lohn-, Preisniveau und Produktivitätsentwicklung auf Wachstum und Beschäftigung in den Ländern des Euroraums'. Endbericht: Forschungsprojekt im Auftrag des Bundesministers für Wirtschaft und Arbeit.
- ECB (2003) 'The relationship between monetary policy and fiscal policies in the euro area', ECB Monthly Bulletin, February 2003, 37-49.
- ETUI/ETUC (eds.) (2004) *Benchmarking working Europe 2004*, Brussels: ETUI.
- ETUI/ETUC (eds.) (2005) *Benchmarking working Europe 2005*, Brussels: ETUI.
- European Commission (1993) *White Paper on growth, competitiveness, and employment: The challenges and ways forward into the 21st century*, COM(93) 700 final.
- European Commission (2004) 'The EU Economy Review 2004', http://europa.eu.int/comm/economy_finance/publications/european_economy/the_eu_economy_review2004_en.htm
- Fajertag, G. and P. Pochet (2000) *Social pacts in Europe – new dynamics*, Brussels: ETUI.
- Hall, P. A. and D. Soskice (eds.) (2001) *Varieties of capitalism The institutional foundations of comparative advantage*, Oxford: Oxford University Press.

- Hallwirth, V. (1998) *Und Keynes hatte doch recht: eine neue Politik für Vollbeschäftigung*; Frankfurt (Main), New York: Campus Verlag.
- Hancke, B. and D. Soskice (2003) 'Wage-setting and inflation targets in EMU', *Oxford Review of Economic Policy*, 19 (1).
- Hein, E., T. Niechoj, T. Schulten and A. Truger (eds.) (2005) *Macroeconomic policy coordination in Europe and the role of the trade unions*, Brussels: ETUI-REHS.
- Hein, E. (2002) 'Monetary policy and wage bargaining in the EMU: Restrictive ECB policies, high unemployment, nominal wage restraint and rising inflation', WSI Discussion paper No. 103.
- Hein, E. (2004) 'Die NAIRU – eine post-keynesianische Interpretation', *Intervention. Zeitschrift für Ökonomie*, 1 (1), 43–66.
- Horn, G. (2003) 'Five years of the ECB – a mixed experience', *Transfer*, 9 (4), 633-645.
- Howell, D. (ed.) (2004) *Fighting Unemployment: The Limits of Free Market Orthodoxy*, Oxford: Oxford University Press.
- IMF (2003) 'Unemployment and Labor Market Institutions: Why Reforms Pay Off?', Chapter IV, World Economic Outlook, April 2004.
- Issing, O. (2002) 'On Macroeconomic Policy Coordination in EMU', *Journal of Common Market Studies*, 40 (2), 345-358.
- Janssen, R. and A. Watt (2004) 'The world is showing us: Active macroeconomic policies do make a difference' ETUC contribution to the Macroeconomic Dialogue on political level (10th May 2004), <http://www.etuc.org/ETUI/Publications/ECB/May04Macro.pdf>
- Janssen, R. and E. Mermet (2003) 'Wage policy under EMU', *Transfer*, 9 (4).'
- Koll, W. (2005) 'Macroeconomic Dialogue development and intentions', in Hein, Schulten and Truger (eds.) *Macroeconomic policy coordination in Europe and the role of the trade unions*, , Brussels: ETUI and WSI, 175-212.
- Layard, R., S. Nickell and R. Jackman (1991) *Unemployment, macroeconomic performance and the labour market*, Oxford: Oxford University Press.
- Leon-Ledesma, M. and A. P. Thirlwall (2000) 'Is the natural rate of growth endogenous?', *Banca Nazionale del Lavoro Quarterly Review*, (215).

Morley, J., T. Ward and A. Watt (2004) *State of Working Europe*, Brussels: ETUI. www.stateofworkingeurope.org/.

Niechoj, T. (2005) 'Keynesian macro coordination at EU level – attractive to the trade unions?', in Hein, Niechoj, Schulten and Truger (eds.), *Macroeconomic policy coordination in Europe and the role of the trade unions*, Brussels: ETUI and WSI, 111-161.

OECD (1997) 'Economic performance and the structure of collective bargaining', *Economic Outlook*, July 1997.

Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung (2003) 'Jahresgutachten: 2003/04 'Staatsfinanzen konsolidieren - Steuersystem reformieren'. <http://www.sachverstaendigenrat-wirtschaft.de/gutacht/ga-content.php?gaid=1&node=f>

Schubert, L. (2003) 'Constitution, economic policy and full employment in the European Union', *Transfer*, 9 (4), 723-727.

Schulten, T. (2004) *Solidarische Lohnpolitik in Europa. Zur politischen Ökonomie der Gewerkschaften*, Hamburg: VSA Verlag.

Traxler, F., S. Blaschke and B. Kittel (2001) *National labour relations in internationalised markets. A comparative study of institutions, change and performance*, Oxford: Oxford University Press.

Watt, A. (2004a) 'Reform of the EES after five years: A change of course or merely of presentation?' *European Journal of Industrial relations*, 10 (2), 117-137.

Watt, A. (2004b) 'An extended book review and analysis of the policy conclusions of: Thorsten Schulten, *Solidarische Lohnpolitik in Europa. Zur politischen Ökonomie der Gewerkschaften.*', *Transfer*, 10 (4), 641-650.

Watt, A. (2005a) 'Can reform of the Macroeconomic Dialogue improve macroeconomic policymaking in Europe?', Hein, Niechoj, Schulten and Truger (eds.) *Macroeconomic policy coordination in Europe and the role of the trade unions*, , Brussels: ETUI and WSI, 237-259.

Watt, A. (2005b) 'Die unendliche Geschichte des Stabilitätspakts: Ist die Reform gut für Wachstum und Beschäftigung?', *SPW Zeitschrift für sozialistische Politik und Wirtschaft*, (143), 34-36.

Watt, A. and V. Hallwirth (2003) 'The policy mix and policy coordination in EMU – how can it contribute to higher growth and employment?', *Transfer*, 9 (4), 610-632

Watt, A. and R. Janssen (2003) 'Evaluation of the ECB's review of its monetary policy strategy', ETUI Report. <http://www.etuc.org/ETUI/Publications/ECB/Special%20rep.cfm>, auf deutsch erschienen in WSI-Mitteilungen 12/2003.

Watt, A. and R. Janssen (2005) 'The high growth and innovation agenda of Lisbon: the role of aggregate demand policies', European Economic and Employment Policy Brief, 1/2005, Brussels: ETUI. http://etui.etuc.org/etui/publications/EEEPB/2005/EEEPB_1-05.pdf.