COLLECTIVE BARGAINING INFORMATION BULLETIN 2008/2

THE OECD AND WAGE FORMATION IN THE EURO AREA: HOW IDEOLOGICAL PRIORS LEAD TO A MISREADING OF THE EVIDENCE

In an economic survey on the euro area, published in January 2007, the OECD provided two remarkable policy messages. The first message is that demand side policy, by stabilising activity when the economy has been hit by a negative shock, has a structural and positive impact on growth performance over the longer term. In other words, monetary policy is not to be seen as a simple 'flash in the pan', having only temporary and short term effects on the economy. For European policy makers used to the idea that 'money is a veil' and that monetary policy only exists to fight inflation, this should come as quite a shock.

However, the OECD immediately comforts European policy makers in their traditional priors. The report goes on to argue that, unlike in the US, it is quite impossible for euro area monetary policy makers to deploy a growth-and-jobs friendly monetary policy. 'Rigid' wages on this side of the Atlantic keep inflation 'sticky' and tie up the European Central Bank's hands to support demand in the case of an economic downturn.

MONEY DOES MATTER

The ETUC has often pointed out that, due to a lack of active demand side policies, the euro area tends to get caught in a situation of several years of sluggish growth after being hit by an initial slowdown; This poses the risk of cyclical unemployment becoming structural through labour market 'hysteresis' effects. In becoming long term unemployed workers are in serious danger of losing their qualifications and work motivation as well as being vulnerable to employers "cherry picking" from the queue of workers applying for a vacancy.

The OECD's euro area study not only confirms but even strengthens this line of argumentation. According to the OECD, the euro area has difficulties in shrugging off the impact of large shocks in demand, leading to a pattern of persistently weak growth in the aftermath of such a shock. This pattern was once again clear from the latest 2001 downturn in which it took the euro area not less than 4 to 5 years to recover from it.

The OECD stresses that there are self–reinforcing mechanisms at play so that what starts out as a temporary downturn ends up as a structural slump. It is somewhat stunning to read how labour market hysteresis effects like the ones referred to by the ETUC are described by the OECD (loss of morale and skills, stigmatisation of the unemployed, ratcheting up of structural unemployment).

However, there is more. The OECD goes even further by underlining similar hysteresis effects on potential growth coming from the side of product markets[1]. A long slump in economic growth may be detrimental to:

- **Innovation**. Research and development are more likely to produce results if supported by continuous and stable investment However, slumps in overall growth and demand disrupt cash flows, obliging cash-strapped firms to scale back research efforts. Therefore, an unstable macro-economic environ-ment does not provide the right incentives for business to invest in research and innovation.

- **Investment activity.** This 'uncertainty' channel also plays out for investment in general. Demand side policies can be thought of as a kind of general insurance for investments. If business knows that a negative demand shock will be quickly dealt with by macro economic policy makers, its propensity to invest will be higher[2]. If, on the other hand, business takes into account the possibility that a shock in demand might turn into a long slump, the incentive to invest will be damaged. And in turn, if investment efforts are constrained, this means the economy's potential to expand at higher rates of growth is reduced as well.

- **Labour mobility.** Workers are more risk averse in economic downturns. This implies that long slumps in growth will work to reduce employment turnover for an equally long time. However, new workers and fresh ideas are important drivers of innovation at the firm level. Long slumps therefore tend to drag innovation performance down, resulting in less innovation coming from workers' mobility.

- **Entrepreneurship.** When economic times are difficult, people will be less willing to gamble on starting a new company. On top of that, banks will have tighter credit standards and be less willing to lend money to this purpose. Innovation may suffer considering that new firms often introduce new products, services or new ways of working.

- **Training and lifelong learning. In the face of a downturn, f**irms tend to hoard (skilled) labour for a while. However, this is less possible if there's a long slump in activity. If firms

[1] See page 38 of the OECD study

[2] This effect is over and above the 'mechanical' effect of low investment activity on growth potential. Lower growth performance causes investment activity to fall because of lack of immediate demand prospects. And lower investment activity in turn drags potential growth down. Higher demand growth can not be sustained because the investment in machines and/or offices and networks has not been made.

know that recessions tend to be drawn out and that they can not keep skilled workers on board, the incentive to invest in the human capital of their work force will suffer.

- **Growth-enhancing reforms.** Structural reforms might get postponed in economic downturns because, for example, of lack of fiscal margins to invest in people and well functioning labour market institutions (access to training, active labour market policies, care facilities….).

ARE WAGES AND TRADE UNIONS TO BLAME?

The OECD study is probably one of the most convincing cases that have recently been produced to reappraise the role and the importance of demand side policies in creating more and better jobs, improving innovation and long term growth performance.

However, there's a catch. The OECD immediately adds the argument that the euro area is "intrinsically less resilient' to shocks and that "monetary policy takes longer to bring the economy back to equilibrium". This latter claim from the OECD is based on a meta-study done by De Grauwe and Storti (2005). This meta-study synthesised the results from 83 studies on monetary policy transmission, comparing the euro area with the US. According to the OECD reading of this study, it found that 'monetary policy is considerably weaker in the euro area'. The median impact of monetary policy on the US growth would be 1.5 times bigger and the impact on inflation would be 3.25 bigger in the US than in the euro area.

Still according to the OECD, one of the main factors (see below for a second factor) explaining this (relative) lack of power of the monetary policy in the euro area are structural rigidities in product and labour markets causing wages and inflation to be less responsive to economic conditions. Put differently, the Federal Reserve can more easily stimulate the economy without introducing inflationary pressures since the US economy is less rigid and workers and their wages are less protected.

However, what does the De Grauwe - Storti paper actually says? A closer look reveals that the authors are actually making the opposite argument of the OECD!

First of all, the De Grauwe/Storti paper observes that the standard argument that the ECB can't use monetary policy to support growth because wages and prices are sticky in the euro area is a surprising one. Indeed, economic theory insists that monetary policy can affect short run output and activity <u>only because prices and wages are rigid.</u> If wages and prices were flexible, any extra liquidity injection or interest rate cut by the central bank would immediately show up in higher inflation, not in higher economic activity.

Turning to the actual estimates, the authors found that the numerical, short run impact of monetary policy on economic activity and prices is “almost the same” in the euro area as in the US. After one year, a 1% cut in interest rates leads to an average increase in output of 0.28% in both the US and the euro area. The same finding holds for the effects of monetary policy on the price level (inflation). A 1% cut in interest rates would, after one year, increase average inflation by 0.06% in the US and 0.09% in the euro area[3].

How to explain the contradiction with the conclusions the OECD draws from the same figures? The answer lies in the fact that the OECD picks out the median (and not the average) figure. Technically speaking, these median figures are indeed 1.5 times bigger for the US than for the euro area (see table). However, as can be seen from the table we are here talking about small numbers so that 1.5 times a figure of 0.25 still yields a number (0.38) that is very close in absolute terms to the initial number.

Short run impact of a 1% cut in interest rates on economic activity

	Average	Median
US	+0.28%	+0.38%
Euro area	+0.28%	+0.25%

Source: De Grauwe, Storti (2005)

More importantly, in the econometric analysis that corrects these average and median numbers by controlling for a number of variables affecting these estimated coefficients, the authors find the coefficients between the US and the euro area to be equal.

In any case, the conclusion De Grauwe and Storti arrive is that ‘there does not seem to be evidence for the hypothesis that the ECB is handicapped by the existence of structural rigidities (…)”. This conclusion however is conveniently forgotten and ignored by the OECD euro area report.

A small sidestep: Once upon a time and not so long ago, there was the financial miracle of sub prime.

Another factor the OECD saw as causing protracted growth slumps in the euro area is the fact that off-balance securitisation of mortgages is less common in the euro area. This would make it harder for euro area households to borrow their way through a downturn. Of course, this has nothing to do with wages and wage formation as such. However, it does again illustrate how the policy agenda of liberalisation across the board made the OECD blind to sound sensible economic analysis. Now, at the beginning of 2008 and barely one year after the OECD’s

[3] As the OECD correctly notes, long term effects of monetary policy on prices are much more powerful in the US than in the euro area. This however implies that it’s the US and not the euro area which should be careful in using monetary policy to promote growth and demand because this would show up in five years time in two times more intense price pressures in the US!

publication, it is for the whole world to see how the model of securitisation without rules and regulation is devastating the US economy and risks dragging the European economy down as well.

CONCLUSION

The OECD can and will undoubtedly produce other econometric evidence of the presumed fact that workers' rights are a rigidity standing in the way of smooth adjustment and higher economic growth performance of the euro area. And also undoubtedly, their "evidence" can and will be challenged by independent analysis (see for example Howell (2004).

However, the OECD is stepping way out of line when presenting specific research as confirming its systematic attack on euro area wage formation systems when this research is actually saying the opposite thing. It illustrates to which extent institutions like the OECD, but also other institutions such as central banks and finance ministers, are prisoner of their own ideological priors.

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Brussels, April 2008

References

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