REVIEW SYMPOSIUM

Europe would be better off without the Euro: a comparative political economy perspective on the Euro crisis

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Unions, Central Banks, and EMU is the first book that applies the insights of the comparative wage bargaining literature to the Euro crisis. Hancke convincingly shows that the usual economic interpretations of the Euro crisis need a comparative political economy complement. My enthusiasm for his narrative has several reasons. Among them are my general interest for the intersection between comparative political economy and European integration research, the high readability of the book and its power of persuasion, and my German origin. I suspect that the gap between the publicly (and in significant parts, also scientifically) discussed causal narratives of the Euro crisis, on the one hand, and Hancke’s comparative political economy interpretation, on the other hand, is nowhere as huge as in Germany.

In my home country, the most influential narrative still argues that the Euro crisis was brought about by unsustainable budget policies of irresponsible southern European governments. Few participants of the debate accept what most American scholars perceive as a matter of course and what Hancke takes as his starting point: that the European debt crisis is the symptom of a much deeper inner-European competitiveness crisis, and that the emergence of that crisis has to be equally blamed on high and low inflation countries, on countries with current account deficits and surpluses, and on debtors and creditors.

Interestingly, Hancke’s interpretation is not only in sharp contrast to the conservative mainstream’s preferred crisis narrative, but also to that of the German political Left, from which two varieties can be distinguished. The first variety of the narrative is: blame it on the financial markets. The Euro, the narrative implies, was a good idea that became the victim of over-financialization. It is true that the financial crisis triggered the Euro crisis. Also, the availability of cheap credit stood at the beginning of the sequence of events that led to the Euro crisis (see later). But the inner-European competitive crisis at the core of the multitude of interrelated crisis phenomena was and is not an invention of financial market participants.

The second variety is: blame it on Germany. If German wages had been higher, if Germany had reacted faster and if Germans were less nationalist and more solidaristic, the Euro crisis would not have occurred or it would have at least unfolded less dramatic. I have to admit that there is some truth here. In fact, if we correctly interpret the ECB’s 2% price

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inflation target as an implicit wage inflation target, we have to conclude that no other Euro member was as much off the target as Germany.\textsuperscript{1} But let us not forget that other countries, primarily in southern Europe, were actually off the target as well. Also, let us not forget that Germany had good reasons to disinflate: Germany was the first victim of the Euro, being confronted with too high interest rates set by the ECB, and being blamed for breaking the Stability and Growth Pact vis-à-vis a fiscal policy that, given the necessary transfers from the West to the East, was rather neutral than expansionist.\textsuperscript{2} The resulting phase of wage restraint, social reforms, and labor market liberalization was as unpopular as it was painful. And let us also note that Germans have a good point when they remind the rest of Europe of the promise of a common currency without a federalist-like transfer union, without Eurobonds, and without government financing performed by the central bank.

In contrast to these competing interpretations, Hancké’s book draws our attention to the structural roots of the Euro crisis, which lie in the mismatch between the heterogeneity of European varieties of capitalism, on the one hand, and the imperatives of fixed exchange rate regimes, on the other.\textsuperscript{3} More precisely, Hancké draws our attention to the fact that two things are unequally distributed among Euro members: first, the institutional preconditions for wage restraint, and second, the preconditions for intersectoral wage leveling. Under such conditions, the synchronization of inflation rates without which a fixed exchange rate regime cannot work well is not likely to occur. All Euro members, in the south and in the north, were thrown into an institutional logic which they had not understood ex ante and which did disservice to the overall goals of European integration ex post: to promote friendship, understanding, and solidarity among European peoples.

\textit{The sectoral logic}

In this section, I focus on some details of Hancké’s narrative and I, from the perspective of my own research, suggest some extensions and clarifications.

1. Hancké rightly points out that in order to understand the Euro crisis, we have to understand why inner-European nominal unit labor cost (hereafter: NULC) rose so differently among European member states since the introduction of the Euro. The main contribution of his book lies in the analysis of a special kind of regime type effect: the one that derives from the heterogeneity of European wage bargaining regimes. While I strongly believe that the wage regime effect exists and that it is of significant magnitude, I also believe that the author goes too far when he pitches his regime type argument against yet another effect, which we might label the credit-driven demand effect or the growth effect. This latter effect explains, Hancké says, “at best only a small part of the variation in wage inflation within EMU” (p. 67; but compare p. 105).

But there is no logical contradiction between these two effects, and my own research suggests that both effects are of more or less equal magnitude.\textsuperscript{4} In Southern Europe, the introduction of the Euro led to a credit-driven demand boom, for two reasons: first, due to the convergence of risk premia on state bonds, and second, due to a dysfunctionally low nominal interest rate set by the ECB that simultaneously had to worry about stagnation in the North.\textsuperscript{5} Maximally simplified, Hancké’s narrative reads: regime types $\rightarrow$ NULC increases $\rightarrow$ competitiveness $\rightarrow$ trade imbalances $\rightarrow$ current account imbalances $\rightarrow$ debt crisis. The credit-driven demand effect interferes at two stages of this causal chain. First, national NULC
followed the national growth paths as much as they followed the paths prescribed by
different degrees of wage coordination. Second, differences in credit-driven demand
had an independent effect on trade imbalances. Trade surpluses are exports minus
imports. While exports are surely shaped by price competitiveness, imports are
largely driven by the development of domestic demand. If regional credit booms
lead to diverging domestic demand increases, which is precisely what happened
during the first ten Euro years, trade and current account imbalances will occur even
if relative price competitiveness among trading partners remains constant.

2. If I understand Hancke correctly, he predicts the regime type effect to mainly occur
in the sheltered sector: international competition exerts enough pressure to impose
wage restraint on the exposed sector, but it depends on the wage regime whether
restraint can be transmitted to the sheltered sector. I wonder whether theoretical
reasoning justifies this expectation. It is correct that exposed sector employees may
have an interest in nominal disinflation vis-à-vis trading partners (but not: in real
wage losses), an interest that sheltered sector employees lack. But this interest, if it
exists, is collective in kind, rather than individual. Counterfactually imagine an
economy that is entirely exposed. All insights of the corporatism literature still
apply: collectively, all employees might profit from holding down NULC, but
individually, once single workforces expect other workforces to engage in
inflationary wage settlements, it becomes irrational to stick to the collective interest.
Even if we assume that rising firm-level NULC directly translates into job losses in
the respective firm, nominal wage restraint will not occur when trade unions are
divided along ideological lines. Consider also what is likely to happen if exposed
sector unions overcome their coordination dilemma and restrain NULC, but fail to
transmit the respective wage restraint to the rest of the economy: Assuming that that
their preference for nominal disinflation must not be confused with a preference for
real wage losses, the exposed sector unions will face strong incentives to adjust their
wage strategy subsequently (but I assume that Hancke fully agrees here). In sum,
even in the exposed sector, it should depend on the degree of wage coordination
whether or not nominal wage restraint can occur.

The data confirm this. In the majority of Euro member states, NULC increases
were lower in manufacturing (our best proxy for the exposed sector) than in the
overall economy during the first ten Euro years. This, of course, perfectly fits with
Hancke’s narrative. But interestingly, the wage pressure variance was even higher –
rather than lower – in manufacturing, compared to the overall economy. And no
other variable explains this variance as good as wage coordination.6

3. Even after having read the book twice, I am still confused about the status that the
public sector has in its narrative. Is Hancke’s point that sheltered sector NULC
pressures were mainly driven by public employees, or does he rather, as he implies
on p. 63, use the public sector as an arbitrary proxy for the sheltered sector? If it is
simply a proxy, I wonder whether it is well chosen. First, the main characteristic of
the public sector is not so much that international competition is absent, but that any
kind of competition is absent anyway (compare this to service providers who do not
compete internationally, but nevertheless compete regionally). Second, the public
sector is precisely the sector for which we cannot calculate sectoral NULC because
information on the denominator – productivity – is lacking. If the public sector was
not chosen as one among other possible proxies, but because of its particular role as a
driver of sheltered sector NULC, it would have been helpful to provide a table that compares nominal wage increases in the public sectors to the increases in other sheltered sectors.

In any case, it is interesting to note how different paths in different countries led to similar sheltered sector NULC pressures to which the exposed sectors had to react, and how their reactions differed. In Spain and Portugal, unsurprisingly, NULC pressure was mainly exerted from construction. But in Ireland, for example, we find above-average NULC increases in trade, finance, and market related services. While high sheltered sector NULC increases were typically associated with high increases in manufacturing as well, some countries, such as Finland and Ireland, and to a smaller extent also the Netherlands, managed to hold manufacturing NULC down despite significant wage pressure from the sheltered sector. Their exposed sectors, in other words, remained competitive by non-leveling NULC increases.

The impracticity of a fair burden share

The European varieties of capitalism are too heterogeneous to productively fit into a common currency regime – this is what I perceive as Hancké’s main message. I could not agree more. Interestingly, the author nevertheless tries to let his book end with slight optimism. Wage coordination in countries that so far lacked the respective institutional preconditions, he writes on p. 113, is difficult to build, but “not necessarily impossible”. Let us take this gleam of hope as a starting point for some reasoning about how the crisis could be ended inside the Euro.

Any solution to the current problems has to come with a plan about how to realign the price levels among Euro members. The Troika has demonstrated that it is, in principle, possible to impose harsh interventions that bring NULC down. But this strategy has a huge price in terms of de-industrialization, loss of democratic quality, and above all, social deprivation of peoples (55% youth unemployment in Spain, 65% in Greece!). Is there an alternative? The north could relieve the south from at least a part of deflationary pressure by inflating on his part. Recall that some northern countries, especially Germany, failed to meet the ECB’s inflation target at least as much as the south did. So, would not it be fair to cut the adjustment pressure in equal parts and to share it? What if the European social partners engaged in a respective transnational social pact that lasts for the next, say, 10 years? And what if the ECB promised to level state bond prices at least during the period of the pact? This could, in principle, be a reliable middle-term crisis treatment strategy. No southern Euro member would have to leave the Euro, and the capital market participants could be convinced that the European south will, after the respective period, find itself in a macroeconomic environment in which its firms can discover new comparative advantages. Of course, for this reasoning, we have to ignore the structural deficiencies that will still be built into the Euro. The Eurozone will still consist of different wage regimes, and every inflation differential will still translate into real interest rate differentials that steer the economy in the wrong direction.

But the prospects of our rescue plan are not good anyway. As the new literature strand on export led and domestic demand led economies has shown, the export orientation of German industry is not only encouraged by the institutions of its production regime, but also deeply built into its economic structure. A decade of German NULC increases of about, say, 5.5% every year? Such wage inflation would raise product costs not only vis-à-
vis Euro members, but also vis-à-vis China and the USA. Who believes that IG Metall and Gesamtmetall would ever agree to intentionally inflate in order to shrink the German export sector back to a “normal” size? The logic is rather the other way around: Once the export sector shrinks, German social partners react with wage restraint.

Also, we have to understand the actual structure of the German wage bargaining system. It consists of strong unionization in manufacturing and in the public sector, and of weak or entirely absent trade unions in the low productivity sectors. In manufacturing, we face a strong dualization of core employees, on the one hand, and a periphery on which wage increases are difficult to impose, on the other. And even among core employees in manufacturing, a two-level-system has emerged in which strong works councils are prepared to trade wage increases against job security. Even if the export unions engaged in a transnational social pact of the above described kind, the firm-based productivity coalitions would defect. And by the way, recall that the EU has just set up an “excessive imbalance procedure” that puts sanctions on countries that raise their NULC by more than yearly 3% during three or more years. Given this impracticality of a fair burden share and given the social catastrophe that internal devaluation implies for the south, I strongly believe that Europe would be better off without the Euro.

But what is the alternative? Floating exchange rates? In theory, this is not a bad thing. But in practice, the available option is not a regime in which we can expect exchange markets to free countries from dysfunctional over- and undervaluations, but a flexible-currencies-cum-financialization constellation. Today, states that raise their key interest rates in order to contain inflation face the threat of carry traders who step in with huge amounts of money in order to profit from interest rate differentials. The disturbing outcome is that states that actually need a currency depreciation may face a currency revaluation, until the resulting current account deficits become unsustainable and carry traders flee out of the country. The result, in other words, may be real exchange rate distortions that are not so different from those that we observe under today’s fixed exchange rate regime. Current examples of currency speculation victims are Brazil, Turkey, and South Africa.

Given this alternative, European politicians had a good idea when they decided to take the nominal exchange rates away from the financial markets. Today’s challenge, if we wonder about alternatives to the Euro, is the design of a currency regime in which currencies are sheltered from speculation, but in which exchange rates can nevertheless be adjusted to the inflation differentials from which we can be sure that they will not disappear in Europe’s foreseeable future. The details are unclear. But the Euro disaster reminds us that, from today’s point of view, the European Monetary System that was in place between 1979 and 1998 worked not that bad. It should be the starting point for future reasoning.

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Notes
1. Flassbeck and Lapavitsas, Systemic Crisis of the Euro.
2. Scharpf, Monetary Union.
3. See also Hall, “Economics and Politics.”
4. Höpner, Die Verschiedenheit der europäischen Lohnregime und ihr Beitrag zur Eurokrise and Höpner and Lutter, One Currency and Many Modes.
5. Scharpf, Monetary Union and Jones, “Future of the Euro.”
6. See the details in Höpner and Lutter, One Currency and Many Modes.
7. Hall, “Economics and Politics”; Iversen and Soskice, “Modern Capitalism”; and Soskice, “Macroeconomics and Varieties.”
8. See Thelen, Varieties of Liberalization, 47–58.
9. See also Chap. 3 in Streeck, Buying Time.

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