FOUNDATION FOR EUROPEAN PROGRESSIVE STUDIES
FONDATION EUROPÉENNE D'ÉTUDES PROGRESSISTES

A wage-led growth strategy for Europe. An alternative to the crisis of debt-led and export-led growth models

Engelbert Stockhammer

Professor of Economics at Kingston University

Neoliberalism set out to deregulate markets. The promise was that while it may lead to a rise in inequality, it would boost growth and eventually the crumbles of the pie would trickle down. A profit-led growth process would create income and jobs for everyone. This is not what has happened in Europe (nor anywhere else).

Conference Paper, Call to Europe, September 2013

call to europe III

Neoliberalism set out to deregulate markets. The promise was that while it may lead to a rise in inequality, it would boost growth and eventually the crumbles of the pie would trickle down. A profit-led growth process would create income and jobs for everyone. This is not what has happened in Europe (nor anywhere else).

Actually existing Neoliberalism has not given rise to a sustained profit-led growth process in Europe, but to a skewed growth regime where growth either relies on financial bubbles and rising household debt (*debt-led growth*) or on net exports (*export-led growth*). Two different growth models have emerged, both unsustainable. Both growth models are intrinsically linked to the process of European integration. The European Commission had fostered financial deregulation (e.g. in the form of the Financial Services Action Plan) and, as a consequence, financial flows that fuelled the housing bubbles in Spain and Ireland. The origins of the bubbles in Spain and Ireland may be national; the reason why they could grow so big has to do with what Borio calls the 'excess elasticity of international capital flows'.

The other side of the coin is export-led growth in Germany and its smaller cousins (Netherlands, Austria). In the aftermath of German unification Germany has used the disintegration of its labour relation system to suppress wage growth more than other Europe economies. It has consistently undershot the ECB's inflation target and has experienced a decade of real wage stagnation prior to the crisis. The result has been a mediocre economic performance, flat domestic demand and a growth process essentially driven by export surpluses. It's easy to forget now that prior to the crisis, Germany has had one of the worst economic performances in Europe.

The two growth models are complementary: Firstly, there would be no Germany export surpluses without high growth and export deficits in the Southern European countries (the EU's net exports are for all practical purposes balanced – the trade imbalances are an *intra-European* problem). Secondly, the bubbles that would have grown in Southern Europe and Ireland would not have been grown as big if the financial deregulation and integration had not encouraged the recycling of trade surpluses via transnational capital flows.

The two growth models are the two different sides of the same coin. Both of them are unsustainable. Pushed to their logical conclusion, both are unsustainable. The debt-led growth model implies exploding (domestic) debt ratios. The export-led growth model ultimately requires ever growing export surpluses. It effectively requires exploding foreign debt ratios of its trade partners!

The financial crisis that began in the market for derivatives on the US subprime mortgage market has translated into the worst recession since the 1930s. In the USA the crisis has been by countered (to a moderate extent) by fiscal and in the form of Quantitative Easing (QE) by monetary policy. This resulted in a weak recovery. In Europe the crisis has been amplified by an economic policy architecture (the Stability and Growth Pact) that aimed at restricting the role of fiscal policy and insulating the monetary policy from national governments while encouraging financial integration and deregulation of labour markets – this is a profoundly liberal economic policy package and it is at the root of the Euro crisis. The result has been a fragile recovery in the export-led economies and a depression in the debt-led Southern European countries. The crisis turned into a sovereign debt crisis only in Europe (but not in other neoliberal countries).

What are the main ingredients of this policy package? First, there is no substantial (central) European fiscal policy. Second, national fiscal policies are several constrained. The Fiscal Compact and the TSCG has made this worse by writing the balanced budget requirements into constitutions and mandating budget cuts with the 1/20 rule. Third, monetary policy has been inflation targeting and it has regarded financial integration (and financial markets in general) as benign. Forth, exchange rates are frozen by design. Effectively this policy package ties the traditional policy instruments (fiscal policy, monetary policy and exchange rate policy) to the mast. All that is left is wage policy. Thus the ECB and EC encourage 'wage flexibility'. Deficit countries should engage in 'internal devaluation', which is a new name for an old policy. It essentially means that in a crisis you have to cut wage and reduce public expenditures. It is exactly the type of policy that made things worse in the Great Depression of the 1930s and will lead to high unemployment, shrinking wage and deflation. We have shown elsewhere that the 'internal devaluation' strategy will have devastating economic and social costs in Southern Europe (Stockhammer and Sotiropoulos 2012).

This policy package is profoundly anti-Keynesian. Keynesians have long argued that financial deregulation will result in financial bubbles. Moreover wage cuts are unlikely to solve the problem as they will come with deflation and thus amplify the debt overhang problems. In times of recessions active fiscal policy is needed.

So what is a Keynesian alternative for the EU? Europe needs an economic strategy that allows to restore growth and prosperity and is consistent with the European Social Model. In the present situation, Europe needs an *inflationary* adjustment.

Wage policy should aim at an equitable distribution of income and it has to be consistent with moderate inflation. Wages should grow with the inflation target and (national) medium-term productivity growth. This will stabilise income distribution and consumption demand. Wage growth should be above this benchmark in trade-surplus countries, i.e. it is the surplus countries, not the deficit countries that should be doing the adjustment.

Fiscal policy should be actively used to restore high levels of employment. This requires countercyclical spending. As European states are no longer in a position to borrow at efficient rates, the additional spending required has to come either from the EU level or the EU has to provide finance for growth projects in recession countries, e.g. via the EIB.

Monetary policy has to support high employment-policies by maintaining low interest rates and underwriting sovereign lending. The inflation target has to be revised upwards such as to allow a rebalancing process that does not force Southern European countries into deflation. In the medium term monetary policy should follow a macroprudential strategy that recognises the frequent occurrence of financial crises and leans against them.

Call to Europe III

An event organised by

FOUNDATION FOR EUROPEAN PROGRESSIVE STUDIES
FONDATION EUROPÉENNE D'ÉTUDES PROGRESSISTES

With the support of