



## **ETUC Economic Discussion Paper 2010/6**

### **Central bankers and their simple rules of thumb.**

Just like in the 'good old days' before the 2009 crisis, trade unions and workers throughout Europe are once again being lectured by finance ministers and central bankers on the need for wage moderation.

The European Central Bank is a case in point. The ECB's argument goes as follows: 'Over the past decade, the ECB has delivered on average an inflation rate of 2.01% and it will continue to do so in the next ten years. So if local wages increase more than this 2%, then the country loses competitiveness'.

The threat can't be much clearer: 'Discipline wage formation or jobs will perish'.

However, a closer look at this argument reveals a hidden agenda.

To understand this, we need to look at the reality of a monetary union that is characterised by large 'imbalances' in particular concerning (unit) wage costs developments: With average wage increases in Germany limited to only 1% a year over the past eleven years, almost all other members but especially the Mediterranean block of the euro area (Spain for example had an annual increase in wages of 3% over the same period) have accumulated a big cost disadvantage compared to Germany.

Let's now apply the ECB's logic of limiting national wage increases to a maximum of 2% while also taking into account this enormous accumulation of wage cost divergence in the euro area. The example described below is a simple one since it, disregards developments in labour productivity. In any case:

- If wages in Germany grow by 2% and
- if wages in the South of Europe are cut by 2% a year (for example) to catch up in cost competitiveness with Germany, then

- the average wage increase in the euro area will not be much higher than zero<sup>1</sup>
- If, at the same time, the ECB delivers an average 2% price increase, then average profit margins in the Euro Area will systematically increase since business is hardly paying a wage increase but instead cashes in on an additional 2% increase in prices each year.

In other words, if the ECB succeeds in what it is boasting about and continues to deliver an average 2% inflation rate over the years, then its wage guideline simply boils down to a structural redistribution from wages to profits. This redistribution will continue as long as the accumulated divergence in wages inside the euro area persists.

However, another possible outcome is that euro area business is not able to transform wage moderation into higher profit margins, for example because of fierce product market competition for example. In this case, wage moderation will be transmitted by business in lower price setting and inflation will systematically fall below the 2% price stability target of the ECB.

Conclusion: There are but two possible outcomes of the ECB's simple '2%' wage rule. Either business' profit margins are boosted. Or the 2% price stability target of the ECB is breached. Neither outcome serves to promote the credibility of the European central bank.

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<sup>1</sup> The German economy represents around 30% of the Euro Area's economy and so do the Southern European economies. If wages increase by 1% in the remainder of the Euro Area, then the average euro area wage increase is limited to 0.8%.