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Common monetary policy with uncommon wage policies: Centrifugal forces tearing the euro area apart

Kazimierz Laski and Leon Podkaminer*, ***

Are we all Keynesians now?

Extraordinary actions taken by EU governments and the European Central Bank (ECB) averted a catastrophe. However, while these actions are acknowledged to be Keynesian, ›we are not all Keynesians now‹. Little has changed in the decision makers' minds. Numerous statements emanating from the ECB and the EU Commission make this point crystal clear. It is worth quoting the opinion of J. Stark, a member of the ECB Board:

> »There is no doubt that the exceptional fiscal policy measures and monetary policy reactions to the crisis have helped to stabilize confidence and the euro area economy. Following the substantial budgetary loosening, however, the fiscal exit from the crisis must be initiated […] to be followed by ambitious multi-year fiscal consolidation. This is necessary to underpin the public's trust in the sustainability of public finances. The Stability and Growth Pact constitutes the mechanism to coordinate fiscal policies in Europe. […] Sound and sustainable public finances are a prerequisite for sustainable economic growth and a smooth functioning of Economic and Monetary Union.« (ECB 2010: 7)

The revival of pre-crisis instincts is manifest also in discussions about ›exit strategies‹, and hurried fiscal consolidations already underway throughout the EU. According to the European Commission's 2010 Spring Economic Forecast, EU public consumption is projected to rise by about 1% in 2010 and hover around zero in 2011 (it used to rise by more than 2%). The

* Vienna Institute for International Economic Studies (wiiw).
** Wyzsza Szkola Adminstracji in Bielsko-Biala, Poland, and Institute of Economic Sciences of the Polish Academy of Sciences.

general government's primary deficit in the euro area is projected to fall from 3.6% of the GDP in 2010 to 2.9% in 2011. Interestingly, the fiscal stringency in the USA will be very symbolic, with the primary deficit/GDP ratio dropping from 7.2% in 2010 to 6.8% in 2011. Public consumption in the USA does not show any signs of restraint: it is to rise by 2.3% and 2.7% in 2010 and 2011, respectively. These characteristics should be seen in the real context: GDP growth is expected to remain weak in Europe – and to rise fairly vigorous in the USA.

Even before the global storm is really over, the orthodox opposition to Keynesian economics seems to be gaining the upper hand once more. Is Keynes only relevant under exceptional circumstances? We would claim otherwise. While Keynesian prescriptions have proved invaluable precisely under such circumstances, they may be equally essential during ›normal‹ times. In particular, what is termed ›sound macro-policy‹ as conducted in ›normal‹ times may have led to disappointing results – anaemic or stagnant long-term growth in Europe that has prevailed since the early 1990s. That might change for the better with policies becoming ›more Keynesian‹. Moreover, the ›sound macro-policy‹ paved the way for the external imbalances across the Union. The overall EU economic policy framework seems to be in need of repair. That repair must acknowledge, among other things, the inadequacy of the Stability and Growth Pact as a mechanism for policy coordination in Europe. Of course, the repair of the coordination mechanism requires a depth of analysis that goes beyond the current economic policy paradigms – and even beyond Keynes. The common monetary policy must be reconsidered first.

The single monetary policy unleashes centrifugal forces in the euro area

The litany of complaints and objections aimed at the common monetary policy pursued by the ECB is quite lengthy. Unlike the US central bank (the FED), the ECB displays no sensitivity towards real-economy developments. It focuses on inflation; it adheres to an exotic and outdated monetarist criterion, etc. Furthermore, its policy lacks balance: it is very swift to tighten things up even if the signs of rising inflation are largely imagined, but is very slow to relax things if the threat of inflation is no longer seen. Moreover, the 2% upper limit for acceptable inflation seems too restrictive (and in practice unattainable anyway). While rejecting any outside ›interference‹ in its goals or operating practices, the ECB feels obliged to censure fiscal, social, ›structural‹ or wage policies of individual member countries. Until recently the ECB did not care about the financial stability of the euro area banking system.

The above objections are surely valid, yet they can be constructively addressed, even while leaving the gist of the relevant EU treaties intact. But a fundamental flaw in the design of the ECB policy requires more resolute modifications. Carrying through these modifications could well call for a more radical overhaul of European politics, far beyond the narrow monetary domain. The future will show whether it is realistic to expect such changes. In any event, it is important to realize that the fundamental flaws in the design of the common currency incur the possibility of also derailing the whole European Union.

›One size fits all‹?

The original sin of the common monetary policy lies in its being defined as applying uniformly to a vast area comprising countries that had differed greatly in many aspects before switching over to the common currency. The nominal convergence process (the fulfilment of the Maastricht criteria) could not eliminate the deeply-rooted differences. Conditions defined in the theory of Optimum Currency Areas were not met. Different national inflation rates (and the rates of growth of nominal wages and unit labour costs) refused to leave their entrenched paths and align themselves. Inflation in traditionally low-inflation Germany remained lower than in the traditional high-inflation countries such as Italy. The common monetary policy abstracts from the variations in inflation rates. It responds to the *average* inflation calculated for the whole area and determines policy interest rates to control that average euro-area inflation. But the interest rate for controlling average inflation rate may be unsuitable for controlling inflation in each and every individual euro area country. For low-inflation countries, the ECB policy rates may be too high, while they may be too low for the high-inflation countries. The principle of ›one-size-fits-all‹ may not work well in real-life economics. The fiction of one (›optimal‹) currency area with one inflation rate being served by one monetary policy leads to higher (and positive) real interest rates in low-inflation countries and lower (or negative) real interest rates in high-inflation countries. Other things being equal, expansion of lending to the real economy decelerates (or stagnates) in low-inflation countries and accelerates in high-inflation countries. Consequently, real growth in low-inflation (thus presumably slow-growth) countries gets slower, while the opposite happens in high-inflation (thus presumably fast-growth) countries.

The common monetary policy acts pro-cyclically as it strengthens the trend towards stagnation/deflation in weak-growth/low-inflation countries and accelerates growth-cum-inflation in countries that are close to a boom. Overall, the common monetary policy has the potential to *enlarge* the cross-country differentials in inflation and growth rates. That potential has materialized in the euro area: low-inflation Germany has remained a low inflation (and low-growth) country; high-inflation Spain and Ireland have gone through a decade of high inflation and exuberant (credit-driven) real growth.[1]

1 A question arises as to the conditions under which the uniform monetary policy may not produce these destabilizing effects. The conditions, however, are well known from the theory of optimal currency areas (OCA). The euro area is not – and never was – such an OCA. The so-called ›endogenous OCA theory‹ which claimed that an area comprising differing countries would become an OCA upon the introduction of a common currency turned out to be obviously inadequate. The conduct of the ECB policy could become easier, if inflation rates throughout the euro area converged to a common, possibly not too low value. Otherwise, the ECB might perhaps be given ›dictatorial‹ powers over discriminating lending in/to individual countries. Making the ECB a genuine central bank (and not only an institution presiding over the determination of policy interest rates for the whole area) is quite certain to encounter just as much resistance as, for example, the idea of setting up of a super-ministry of finance for the euro area (with the national finance ministries being reduced to departments of the super-ministry).

The differential effects of the uniform policy have also helped to generate high fiscal deficits in some countries. Low (or negative) real interest rates on public debt facilitated public debt servicing in the high-inflation countries. This may have induced some of them (e.g. Greece) to pursue a rather lax fiscal policy. Servicing public debt in low-inflation countries has been much more troublesome, thus encouraging those countries to undertake renewed attempts at fiscal consolidation. Those attempts, however, did not always succeed (as proven in 2003 when the French and German governments initiated a ›reinterpretation‹ of the Stability and Growth Pact). The reason for the difficulties of implementing fiscal consolidation in low-inflation countries is straightforward: fiscal austerity under overall stagnant growth/very low inflation is almost certain to have a negative impact on both real growth *and* the fiscal position.

The other side of the (euro) coin: The rise of external imbalances within the euro area

The policy-induced divergence in inflation nurtures diverging trends in average wages. Nominal wages in high-inflation/growth countries tend to rise faster than in low-inflation/growth countries. Diverging price and wage developments erode the high-inflation countries' competitiveness vis-à-vis the low-inflation countries. Devaluation of the nominal exchange rate, which had been the winning strategy for securing the competitiveness of the Italian economy, for example, has been unavailable since 1997.[2] Certainly, rising wages in high-inflation countries need not anticipate losses in external competitiveness against the countries with stagnant (or less rapidly increasing) domestic prices and wages. Under conceivable conditions, labour productivity growth may outstrip the rate at which wages increase. The unit labour costs in the tradable sector of such a high-inflation country might even decline or rise less than in a low-inflation country, thus even strengthening the competitive position of the high-inflation country.[3] But, should productivity keep increasing at more or less equal speeds across the euro area, the low-inflation countries would inevitably gain at the expense of the high-inflation countries. Under the current conditions prevailing in Europe, the differential developments in wages have proved to be quite essential to developments in relative unit labour costs. As expected, Germany has been out-competing Italy and Spain (and

2 The lira/DM exchange rate rose continually from 200 in 1971 to about 1000 in 1988. On average it kept depreciating about 10% annually in nominal terms. That development was associated with Italy's rapid real growth (›real convergence‹) combined with huge current account and trade *surpluses*, still recorded as late as 1998. Under the euro, Italy's surpluses turned into snowballing deficits while real growth has come to a standstill. Conversely, under steadily improving productivity (and chronic trade surpluses) the DM kept appreciating in nominal terms vis-à-vis. the basket of currencies that later became the euro. In 1971 the DM/ECU rate stood at about 3.7 and in 1988 at about 2. Steady nominal appreciation of the DM (3.5% p.a. against the ECU/EUR basket) helped to keep the German trade *surpluses* in check. With fixed mutual exchange rates (after 1997) and the growing liberalization of capital movements throughout the early 1990s, German unit cost gains translated into growing trade surpluses.

3 This is not a purely hypothetical situation – but actually that of China.

most other members of the euro area) on unit labour costs. This, in turn, is well reflected in the growing external imbalances – with Germany becoming a country with a huge external (trade and current account) surplus, while most of its other euro area partners are slipping into high and rising external deficits. These trends temporarily weakened somewhat in 2009 when Germany's partner economies went into recession.

Germany's revenge for high real interest rates

The tendency of Germany to out-compete others on unit labour costs has *not* been entirely due to the free operation of market forces. Since at least 1995 the successive German governments have pursued policies promoting cuts in unit labour costs. Germany has gone through successive waves of ›labour market reforms‹ aimed at enhancing the market's ›flexibility‹. Increased labour market flexibility is a polite term for greater licence to revoke workers' traditional rights and to ›downscale‹ the labour codes that had safeguarded employees' living standards. Transfer payments to both low-income employees and the unemployed were curtailed – apparently to increase the labour supply (as if there were a labour shortage, not high unemployment). In its capacity as the employer of a large segment of the workforce active in the public service sectors, the German government has sought to economize on wages and employment levels. This has had a direct influence on wage negotiations between the trade unions and the private business. That the government mediated in these negotiations and demanded ›wage moderation‹ goes without saying. High unemployment – and the prospects of production being ›outsourced‹ to low-wage countries – helped to reduce wage aspirations. All these policies contributed to suppressing the growth of real (and even nominal) wages – despite the steady rise in labour productivity. Finally, these policies were capped by fiscal measures that lowered the non-wage labour costs borne by firms as well as the taxation of company revenues. In exchange, the indirect tax burden on domestic consumption (and imports in particular) has been raised. One direct consequence has been the external hyper-competitiveness of the German economy. However, the country is paying quite a high price for all this. Depressed wages result in depressed domestic consumption also of services which do not need to compete externally. All this helps to compound the overall stagnation/deflation character of growth. Average GDP growth in Germany (over the period 1999–2008) falls short of an unimpressive 1.4% – against 2% for the whole euro area. Germany's partners (taken together) grew much more rapidly, although they too were not very impressive either. However, the differences in the sources of growth are striking. Foreign trade generated most of the growth in Germany (0.9 percentage points out of the overall 1.4%). In the entire euro area (including Germany) the contribution of foreign trade to growth was symbolic (0.2 p.p.). Growth in Germany's partners in the euro area was *reduced* by foreign trade developments. The German ›beggar thy neighbour‹ policy does indeed work; however, it has turned out to be a ›beggar thyself‹ policy.

Further unpalatable consequences

The German wage developments have a number of consequences, of which the emergence of huge external imbalances across the euro area is but the first. Those consequences are harmful not only to Germany's euro area partners, but also to Germany itself. Germany's GDP gains actually represent its partners' GDP *losses*. While actually representing a loss, the trade deficit allows current domestic consumption-cum-gross capital formation to exceed domestic production. However, when a country's actual absorption is in excess of its own production (viz. Greece), it implies incurring foreign debt of whatever kind (or sale of domestic real assets to foreign parties, for example, via privatization). Sustained and rising external deficits are tantamount to accumulating net external debt. Mirroring the situation of a deficit country, a chronic surplus country (such as Germany) produces more than it can actually use (its domestic absorption is lower than domestic production). In effect, the surplus country accumulates claims against its partners; in essence, it is lending to them – one way or another.[4]

A ›normal‹ chronic deficit country (unlike the USA which – for specific reasons – is quite exceptional) cannot accumulate foreign debt indefinitely. Sooner or later, it becomes obvious that such a country will be unable to service its foreign debt, whereupon it will normally be refused any additional credit. After a decade of sustained and rising external deficits, several euro area countries (that have failed to emulate German wage and fiscal policies) are now becoming bad credit risks. Those countries will now have to pay dearly for the years of domestic consumption-cum-investment in excess of their domestic production.

The debt crisis of countries out-competed by Germany backfires on Germany itself. Ultimately, a large portion of that debt is owed to Germany.[5] Attempts to service that debt would require that the countries that have lost competitiveness and have followed an import-fed growth path suddenly become major net exporters. Obviously, those countries may be able to suppress domestic consumption and investment. But would this automatically make their tradable goods (assuming they exist) and services attractive – in price/cost terms – to potential foreign buyers? Where are such importers to be found? Surely not in Germany whose formidable competitive advantages will not disappear anytime soon. Ultimately, Germany may have to swallow some losses on these debts. More precisely, the German government may be forced to recapitalize German commercial banks and other financial market institutions owning large portions of bad foreign debt. Parts of Germany's past current

4 This is abstracted from the variations in the internal compositions of countries' external debts and claims. While the government, firms, banks and households may participate in the national foreign debt (claims) in differing proportions, in the final (macro) analysis, the overall totals are what really matters. The actual composition of debt may matter when it comes to detailed designs for remedying the crisis.

5 »The financing of current account deficits seems to have remained mainly intra-euro area during the financial crisis […] All things considered, it is likely that euro-area current account deficit countries have been important beneficiaries of German capital outflows before and during the financial crisis« (EU Commission, 2010a: 16).

account surpluses (and handsome profits earned by German private-sector exporters) will end up as increments to the German *public* debt.

The illusion of orderly ›rebalancing‹

The idea that diverging competitiveness trends within the euro area may have disturbing consequences only dawned on the EU Commission in 2008. The recent Commission Report (EU Commission 2010a) finally acknowledges the problem. However, it fails to recognize its fundamental causes. Worse still, the Report's *main* policy suggestions seem either irrelevant or counter-productive. ›Rebalancing‹, meaning the reduction of inter euro-area trade imbalances, is to be achieved essentially through the efforts of high-deficit countries which »need both to regain competitiveness and address the sources of persistent weakness in domestic savings« (EU Commission 2010a: 38). As far as the latter goal is concerned, not much can in practice be achieved if countries continue to run large external deficits – i.e. *not before* ›rebalancing‹. As long as those countries are offered competitively-priced foreign goods (and cheap foreign credits to purchase them) they will run external deficits. Only by regaining competitiveness can they raise domestic savings. As far as the former task is concerned, »Reforms of labour markets should naturally be top of the agenda to improve the functioning of competitiveness adjustment« (EU Commission 2010a: 41). In plain English, the policies of the deficit countries should be to bring about wage *deflation*, which would eliminate the unit labour cost advantages that Germany has accumulated over the past 10–15 years. Because of the impossibility of nominal exchange rate adjustments, ›internal devaluation‹ – or deflation – remains the only route to regaining competitiveness. However, bearing in mind that nominal unit labour costs in Germany have hardly changed since 1999, while rising about 25–27% in the euro area, the Report's advice is unconstructive on practical grounds. Actually, it is destructive. Strong and persistent wage deflation would push the economy into a deep and prolonged depression associated with a drop in domestic consumption and investment. This is the danger facing Greece. Besides, the levels of unemployment and overall misery that would have to be engineered in order to coerce labour into accepting double-digit rates of decline in nominal (and real) wages would have to be enormous. Finally, even if successfully completed, ›rebalancing‹ on this scale would at best make the country concerned similar in character to Germany: i.e. excessively dependent on exports and otherwise displaying anaemic growth. Worse still, the ›rebalancing‹ may induce others to tighten *their* wage policies still further. Achieving victory through an iron wage policy may prove impossible for nations lacking the German standards of discipline.

The Commission Report does not see anything wrong with the competitiveness gains achieved at the expense of domestic wages, consumption and investment.

> »The policy response to intra-euro-area macroeconomic imbalances should obviously not include a call for reduced competitiveness in surplus countries […]. Strong competitiveness in all euro-area Member States, including surplus countries, is in the interest of the euro area as a whole.« (EU Commission 2010a: 38)

What the surplus countries may try to do is »to tackle structural impediments to domestic demand« (EU Commission 2010a: 38).[6]

Some constructive proposals to defuse centrifugal forces

The euro-area countries that are unable or unwilling to emulate the Germany's restrictive policies with any degree of success may sooner or later find it expedient simply to withdraw their membership and reintroduce their former currencies. Such decisions may be facilitated by a severance of financial transfers (or lending) needed to service the snowballing foreign debts. Currently, the prospects of such a radical development happening seem remote: the European Council recently decided unanimously to set up a relief fund to provide the necessary support to countries in need. However, saving some countries does little to tackle the reasons for their present plight. Countries whose governments or private sectors (or both) are saved from bankruptcy by using foreign money do not become more competitive. Either they remain stagnant indefinitely or – if granted new credits – they will resume running external deficits and accumulating foreign debt once again. In due time, they would need yet another bail-out package financed by those who can afford it. This situation will not be tolerated indefinitely. At some point, transfers and new credits will not be forthcoming (or domestic stagnation will become intolerable), and this or that country may default on its foreign debt and leave the euro area. Of course, the costs of all this would be high to both the country deciding to leave and those staying on (as well as the creditors). The likelihood of this possibly triggering the disintegration of the EU as a whole cannot be dismissed.

Countless are the proposals on repairing the Euroland's overall architecture. One vision stipulates the transformation of the *monetary* union into a political union, with a centralized fiscal authority ruling over large cross-country fiscal transfers. This vision will not materialize anytime soon. If anything, premature attempts at fiscal centralization might derail political unification (which seems to be happening in Belgium). A less ambitious proposal might suggest that countries with external surpluses be requested to draw up (and implement) consolidation programmes aimed at strengthening domestic demand. Failure to bolster domestic demand (or to reduce abnormal savings) could be subject to *›excessive external surplus procedures‹* with clearly defined penalties for misbehaviour. Another

6 On pp. 45–46 the Report briefly lists macroeconomic challenges and imbalances underlying divergent competitiveness developments in individual euro countries. For Germany these are ›weak infrastructure investment and domestic demand/high saving rate; underdeveloped competition in service sector/unbalanced growth structure; insufficient wage differentiation‹. It is rather difficult to see how the government could help develop competition in the services sector or promote sufficient (whatever that may mean) wage differentiation – and especially how these developments could reduce Germany's external surpluses. Weak infrastructure investment is due to attempts to satisfy the restrictions of the Stability and Growth Pact and strengthen the ›export front‹. Weak domestic demand is part and parcel of the overriding policy of minimizing unit labour costs through the suppression of wages. With falling GDP share of wages and taxation becoming less progressive, higher saving rates are only to be expected.

modest proposal may require member states to enter into binding agreements on avoiding *beggar-thy-neighbour* tax/wage policies. Arguably, all countries might also agree on broad guidelines for national wage policies (e.g. stipulating that wages should be allowed to rise in line with labour productivity – no more, *but also no less*). Agreeing on such guidelines means more policy coordination at the EU level. A labour-productivity driven wage policy, with the individual countries' average nominal wages increasing in line with average labour productivity (augmented by a common ECB target pertaining to inflation) would result in national inflation rates approximating the common target inflation rate. Importantly, such a policy would help narrow divergences within the euro area. It would then be possible to run the *one size fits all* monetary policy, without provoking centrifugal forces within the euro area.

Finally, other possibilities exist for accelerating growth in the EU – which can also reduce the centrifugal tensions. But the realisation of these possibilities would require a radical revision of the unreasonable provisions of the Stability and Growth Pact. This topic remains to be properly addressed.

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*Wolfram Elsner**

Some prehistory – Veblen's foundations and the ›upward‹ decades

Evolutionary-institutional economics is more than 110 years old. It started with *Thorstein B. Veblen's* fundamental criticism, put forward in a bulk of papers and books from the 1880s on, of the then just-established ›neo-classical‹ economic mainstream. Veblen had worked empirically, and established on theoretical, methodological, and philosophical levels a new type of economics. He pointed out the *simplistic, equilibrium*-oriented, over-optim(al) istic, and *teleological* view that had emerged from the Scottish Enlightenment school to the

* University of Bremen, iino – Institute of Institutional and Innovation Economics.