# Why Won’t Wages In Europe Rise As They Should?

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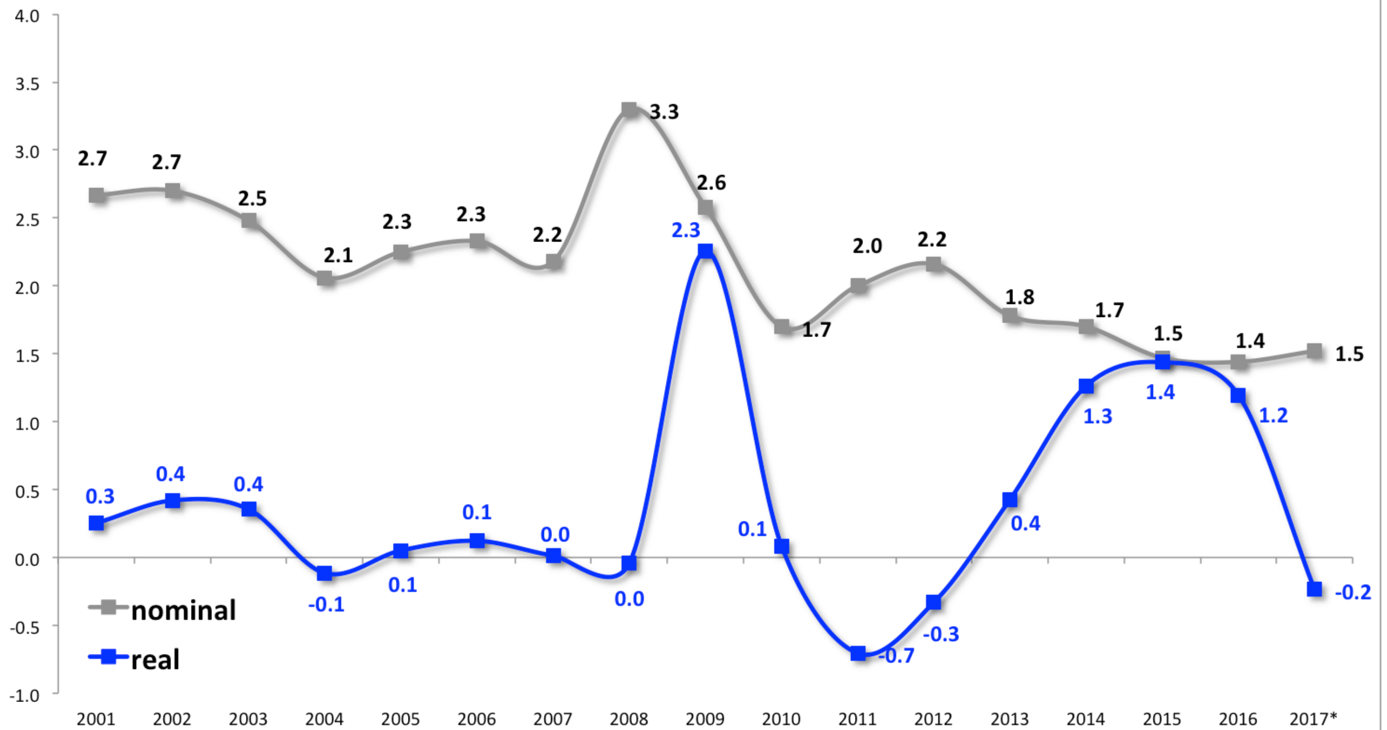
The economic mainstream is perplexed: growth is finally taking hold across Europe, economic forecasts have been revised upwards, and employment is expanding. The only indicator that stubbornly refuses to follow suit is wage growth, defying textbooks and economic orthodoxy alike. Bloomberg has called it the “mystery of missing wage growth,” the Financial Times writes about the “Eurozone’s strange low-wage employment boom,” and the European Commission has put forward the diagnosis of a “wage-poor recovery”. Moreover, there is a growing consensus among economic policy-makers that wages should indeed grow much faster that they do.

An unlikely cheerleader for higher wages is the European Central Bank (ECB), whose failure to nudge inflation upwards has led it to look for outside help. “The case for higher wages is unquestionable,” Mario Draghi has neatly put it. Likewise, the Commission argues that “the outlook for wages has now moved centre-stage for the sustainability of the recovery,” and even the IMF – pointing fingers at Germany – has discovered the virtues of wage growth. It looks as if the European trade union movement has found some improbable allies in its campaign, “Europe needs a pay rise”.

Malte Luebker

To make stagnant wage growth worse, there is now a clear danger that the purchasing power of wages could stagnate or even fall as energy and food prices have started to rise again.

This is bad news for private consumption, currently the main engine behind European growth. For some years, low inflation had at least ensured modest real wage gains despite low pay settlements. Across the Euro area, these have remained far below of what they used to be prior to the crisis of 2008/09 (see Chart 1).



So, what is holding wages back? Ask any economist with a neo-classical outlook, and she – or, more likely, he – will tell you that wages follow prices and productivity. Both have, of course, grown at an anaemic pace of late. But are low inflation and the lacklustre productivity performance the cause of subdued wage growth, or merely a symptom? Start with inflation. Traditionally, central bankers have been obsessed about wage-price spirals and called for wage moderation to rein in inflation. Now, they are discovering to their detriment that wage-price spirals work in reverse, too. The poor performance of wages is, in fact, seen as one of the key reasons why domestic price pressures have been subdued and core inflation has disappointed consistently over the past few years.

The case of productivity is more complex. Economists like to treat productivity growth as exogenous, determined by hard-to-quantify factors such as technical change. For all the buzz about the digital revolution, by this account the 1960s and 1970s were the heydays of rampant innovation, producing productivity growth at up to ten times the current pace. Strange, also, that productivity growth went into a sudden reverse in 2008/09, just as the financial crisis hit, and has been stuck in low gear ever since. Did technical change come to an abrupt halt, by sheer chance at about the same time Europe faced the biggest demand drop in a generation?

Some find this story hard to swallow. Surely, if wages were to rise, entrepreneurs would buy new machinery and find ways to make more efficient use of scarce workers? In the economic jargon, this is called capital–labour substitution and is generally recognized as a driving force behind long-run productivity growth. But it is no longer happening. According to the ECB, capital deepening has been virtually absent since 2013. But then, why should firms invest in labour-saving technologies when there is no cost pressure from the wage front and aggregate demand remains feeble? Accept this logic, and productivity growth becomes endogenous – something that is itself driven by macroeconomic factors, with wages playing a prominent role.

But maybe we are about to witness a return to robust wage growth? All the signs seem to point that way. “As economic activity gains momentum and the labour market tightens, upward pressures on wages are expected to intensify,” was the ECB’s assessment just over a year ago. Now, the verdict is that “Euro area wage growth remains low”. In fact, the ECB has a long history of predicting that wage growth is just around the corner, only to revise forecasts downwards again and again. For Europe’s workers, it’s a case of always jam tomorrow, never jam today.

So why do standard economic models keep on predicting wage growth that then fails to materialize? One possibility is that they are fed with wrong or misleading labour market data. There are indeed good reasons to believe that headline unemployment rates underestimate slack in the labour market, given that everyone who works for at least an hour per week counts among the employed. With the spread of precarious contracts and often involuntary part-time employment, there now are millions of workers in Europe who would happily move to a regular job.

The more worrying possibility is that the models were trained to predict the behaviour of wages in a world that no longer exists. In the name of flexibility and competitiveness – and often at the behest of the Commission, the ECB and the IMF – post-crisis labour market reforms have put the axe to centralized collective bargaining and a myriad of other protections. Taking into account that wage-setting institutions have been severely weakened, the failure of wages to grow looks much less surprising.

Almost everyone now seems to agree that wages have to grow if Europe wants to escape the cycle of weak demand, low inflation, stagnant capital deepening and low productivity growth for good. But wage growth will not pick up in response to a magic wand held by central bankers. Instead, Europe needs to re-build wage-setting institutions – chiefly by actively supporting collective bargaining, by providing for extension mechanisms that increase coverage of collective agreements, and by developing a European minimum wage policy that guarantees a decent living wage to all.

*This is the latest in a series on Inequality in Europe sponsored by SE, the Hans-Böckler-Stiftung and the Friedrich-Ebert-Stiftung*