A Critique of the Maastricht Road to European Monetary Union: Bringing Labour Market Analysis Back in

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Abstract

This thesis criticises the current project of European Monetary Union, based on the Maastricht convergence criteria. It attempts to reinterpret the issue of economic convergence by looking into structural aspects from a political economic point of view. Taking a structural approach, I examine the socio-political sustainability of EMU.

The thesis applies the theoretical framework set forth by the French regulation school. Drawing on the regulationists' notion of 'regime', the concept of structural / regime compatibility among member states is introduced. The need to study non-monetary regimes in assessing the viability of monetary union is stressed by drawing on the historical experiences of monetary unions in the 19th century - the Latin Monetary Union, the Scandinavian Monetary Union and the American Monetary Union.

Among the non-monetary structural regimes, the examination of national labour market regimes is crucial. After the loss of exchange rates as a means of adjustment, labour market adjustment becomes the key in coping with asymmetric economic shocks. Labour market flexibility is considered to be the main weapon of adjustment in post-EMU Europe. The comparison of three main labour market regimes in Europe - France, Germany and Britain - shows that they diverge substantially in their adjustment mechanisms and in the nature of their flexibility. Following Robert Boyer, I argue that there is fundamental incompatibility in national ideologies, concepts and practices of labour market policies in Europe. Without a common labour market regime, such differences could lead to major tensions between the Anglo-Saxon model of 'external flexibility' and the continental European model of 'internal flexibility'. The thesis aims to show where the difficulties lie for the management of the future 'Euroland', including Britain, in order to indicate the tremendous task facing European policy makers.

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Introduction

The project of European Monetary Union (EMU) set forth by the Delors report (1989) was formalised by the Treaty on European Union in Maastricht, 1992. (thereafter, Maastricht Treaty). It set out to create economic and monetary union in Europe in January 1999. This thesis criticises the Maastricht approach to EMU as flawed by not taking account structural factors which affect the sustainability of monetary union.

Article 109(j) of the Treaty, and the protocol on the convergence criteria in particular, define specific quantitative targets which member states should meet, in order to qualify for EMU. The convergence criteria set quantitative limits for member states' inflation rates, budgetary positions, and long-term interest rates. In addition, in order to qualify, a member state should not have devalued within the two years prior to the decision to enter EMU. The four basic criteria are as follows: first, a rate of inflation close to that of the three best performing member states (within 1.5%); second, budget deficits less than 3% of GDP, and national debts of less than 60% of GDP;[1] third, the observance of normal ERM fluctuation margins for at least two years without any devaluation; forth, convergence in long-term interest rate levels to the three best performing member states (within 2%). The relevance of these particular indicators is heavily contested. Some works representing the argument will be reviewed in Chapter 1. Although these studies often propose alternatives to the current convergence criteria, very few have put forward a fundamental critique concerning structural aspects.[2] I argue that the

[1]These quantitative criteria along with others which are not mentioned in Article 109 (j) are written into separate protocols on the excessive deficit procedure, and on the convergence criteria. However, these quantitative criteria can be altered in accordance with article 104c(6) in case of excessive deficits. The rest of the quantitative criteria can be replaced by unanimous council decision.

[2]The most widely known critique of the convergence criteria, in favour of focusing on structural features distinguishing national economies, is a

convergence criteria are insufficient for the following two reasons: first and foremost, the criteria attempt to assess the plausibility of monetary union only through a small number of superficial demand-side macroeconomic variables. Second, except for the devaluation criterion, they only focus on static convergence: that is to say, the EU countries' qualification for becoming members of monetary union will be assessed by their economic performance at a particular point in time, i.e., the economic conditions in 1997. Thus, in an extreme sense, if a country put all its effort into getting the figures right, even if it were only for 1997, it would qualify for EMU. Indeed, there were some attempts at creative accounting to cope with the budget deficit criteria. France and Italy took one-off special measures to boost their fiscal revenues, which were heavily criticised by the British: Italy introduced the Euro-tax, and France used the pension fund of French Telecom to boost their budgets. Even Germany unsuccessfully planned to use foreign exchange profits of the Bundesbank, and successfully used the reclassification of hospital debt to cosmetically reduce the budget deficit. Since the decision was made on the basis of reports provided by the European Monetary Institute and the European Commission, conventional wisdom argued that the extreme scenario described above was highly unlikely. However, the convergence criteria did not **require** a dynamic interpretation in measuring economic performance. This is a paramount flaw, as such criteria ought to assess the medium to long-run **sustainability** of future monetary union. In its report of 25 March 1998, the Commission assessed the economic performance of member states against the convergence criteria and recommended 11 out of 15 member states to adopt the Euro on the 1st of January 1999[3].

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proposal to include unemployment criteria, suggested by Eddie George, the governor of the Bank of England.

[3]In this report, the Commission assessed member states' performances, by examining the convergence of inflation rates, budget deficits, public debt, long term interest rates, and exchange rate stability. As for the inflation rates, all 14 countries except for Greece cleared the criteria, and so they did for long term interest rates. A political decision had to be made for the other two criteria. For the exchange rate criterion, Italy and Finland posed

Accordingly, eleven countries converted to the Euro.

The convergence criteria only focus on main demand side measures and deliberately avoid proposals for an assessment of supply side conditions in the economy. However, if countries are serious about deeper integration of Europe, there has to be at least a broad agreement on the kind of European supply side model they want. It is a well-known fact that macroeconomic performance depends on an effective supply side[4]. Jacques Delors, the architect of EMU deliberately left the question unanswered in the ill-defined 'subsidiarity principle'. Thus, there is an on-going debate between federalists and anti-federalists regarding the correct dimension of 'European' influence. Those sympathetic to the Federalist European model would push for further harmonization of taxes, labour standards and social policy. The social charter may not be sufficient to fill this gap. They argue that what is needed is a European-wide coordination of supply side policies, which promotes, is consistent with, and complementary to the demand side. Those who subscribe to the 'Europe of the nation-states' model argue that supply side policy should be controlled by the member states, and for the need to allow divergent responses and outcomes to keep monetary union afloat. Indeed, there seems to be an unreconcilable difference between these two camps, without any political or ideological

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a problem, as they had less than 2 years of continuous ERM membership. The Irish punt was revalued by 3% against the other ERM currencies in March 1998. Nevertheless, under the political interpretation, all 12 currencies were considered not to have experienced severe exchange rate tensions in the two years under review. The Greek drachma, the Swedish krona and the British sterling did not qualify as these countries did not participate in the ERM during the review period. As for budget deficits, 14 member states managed to get their figures either below or equal to the 3% of GDP reference value in 1997. A political interpretation was also necessary in case of the public debt criterion, where most countries had government debt/GDP ratios of 60-80% in 1997, and some, notably Belgium, Greece, and Italy had more than 100%. For these three countries, however, given the level of surplus on the primary balance they had achieved, it was interpreted that they were on the path of a continuing and steady reduction of their debt ratios. For more detail, see the European Commission (1998).

[4] c.f. Begg, Fischer and Dornbusch (1987).

consensus on what kind of Europe the member states want. Such a political rift not only makes crucial decision making difficult, but sometimes impossible. The absence of member states' ideological harmony, and enthusiasm, as well as a willingness to work together to create a common destiny has resulted in numerous incidents of long and fruitless discussions. This has promoted the image to the public of European institutions as being inefficient and ineffective. The most basic but foremost precondition for creating such a historical project as monetary union must be political: there has to be convergence in policy stance among the participating states. In a situation where power in a monetary union would be distributed in a highly asymmetrical fashion, it would be conceivable that such convergence could be established through the hegemonic power of a dominant state. In the European case, where monetary union is characterised by a relatively symmetrical distribution of power among the big member states, coherence of economic policies requires a high degree of cooperation. It would be easier for countries to agree on a common economic policy framework if their social and economic structures were similar.

In this thesis, I shall review the current Maastricht road to monetary union by evaluating the precondition behind establishing monetary union, and propose an alternative perspective focussing on structural factors. I shall argue that successful monetary union without political union requires a high level of economic, social and political congruence among member states. The Maastricht criteria only set out partial economic guidelines for national economies to become sound. Maastricht criteria set out narrow economic benchmarks for national economies to converge to, reflecting the prevailing macroeconomic orthodoxy of monetary and fiscal soundness. The standardised numerical convergence criteria do not capture qualitative differences between economic infrastructures. A much broader concept of convergence has to be examined, as monetary union involves a regime shift.

This thesis applies a two staged analysis in its empirical part. Chapters 1 to 3 deal with methodological and theoretical questions. The first two empirical chapters, Chapters 4 and 5, examine historical experiences of monetary union to see whether domestic structural differences matter for the success or failure of monetary union. Three 19^{th} century monetary union projects have been chosen as case studies. Except for EMU, the 20^{th} century does not offer an equivalent case of large-scale monetary union. Having established that structures mattered for the sustainability of the three historical monetary union cases, I move to the second set of my empirical chapters, Chapters 6 to 8, for a study of the current EMU case.

Chapters 1 and 2 provide review of literature. By reviewing the literature, Chapter 1 introduces the central focus of the thesis: it establishes the need for an investigation of structural factors, especially labour market structures, to assess the issue of sustainability EMU. By reviewing the debate about the pros and cons of the Maastricht convergence criteria, I shall take a critical stance towards the criteria and propose an alternative perspective by extending the 'economist approach'. Then, the EMS experience as a precursor to EMU is examined to see whether monetary cooperation has empowered policy makers to push through domestic structural reforms. In my view, the EMS, together with the prospect of EMU, did successfully empower policy makers in the ERM member states to adjust some key domestic structures and mechanisms of national monetary policy-making. However, in terms of labour markets, there are mixed outcomes: as the French and Italian cases show, the efforts of policy makers regarding labour market reforms were only partially successful and sometimes resulted in unintended outcomes. This indicates that labour market structures, being a unique segment of market relations with a strong social dimension, work as serious constraints upon policy makers' intentions and their policy commitments. Hence, it makes sense to study the nature of these constraints in determining the task ahead for policy makers to turn EMU into a successful and sustainable project in the long run.

Chapter 2 reviews different approaches to the analysis of monetary union by political scientists, economic historians and economists, and assesses their advantages and limitations. Some mainstream approaches by different disciplines point to the importance of structure, but are insufficient for exploring my research question: how different are national labour market structures, and how do these differences affect the prospects for sustainability of monetary union. For that, a more comprehensive structural analytical framework is necessary. In Chapter 3, I introduce the French regulation school approach which meets these analytical demands. Unlike neo-classical economists, and like Keynesian economists, this school takes the view that money is not neutral. The success of monetary union cannot rely on the monetary sphere alone: it depends on non-monetary regimes as well. Among them, the labour market regime is crucial, as it will have to predominantly bear the adjustment costs. Labour market structures are important for the following three reasons: first, the loss of the exchange rate instrument as a means of adjustment, second, interest rates are no longer available as a tool of adjustment for individual member states due to the 'one size fits all' monetary policy of the European Central Bank, and third, national fiscal policy is constrained by the Growth and Stability Pact. Therefore, it is crucial to examine how labour markets adjust among EMU member states for the sustainability of EMU. If these states subscribe to totally different modes of labour market adjustment, and/or if their labour markets do not adjust fast enough, persistent conflicts over the issue of economic management among EMU states will be difficult to avoid. If member states cannot agree on a dominant mode of adjustment, close coordination of economic policies, which is necessary once EMU takes place, would be difficult. This is hardly a scenario to achieve successful and sustainable monetary union.

Chapters 4 and 5 examine historical monetary unions in Europe and America in order to extract relevant lessons for the current EMU project. Though these monetary unions took place within a different international context, the issues confronting them in regard to managing monetary union were remarkably similar to the challenges faced by EMU. Indeed, cohesion among the member nations was one of the decisive factors for success or failure. Following the methodological argument in Chapter 3, Chapters 6 to 8 examine the labour market regimes of France, Germany and Britain as potential participants of EMU. This choice of countries may well be contested, as Britain, in particular, did not become an initial member of EMU. The three countries are chosen for comparison in the empirical study as they represent the 'top league' of the EU. Together with Italy they are G-7 members, and are more similar to each other in the combination of GDP, per capita income, population, and size than to the other EU member states. Italy, although in terms of its economic indicators in the same league as Germany, France and Britain, was deliberately left out from the empirical study. This is because Italy is not a key player in the regime competition about the future shape of Europe's social and economic make-up. Italy's political and social structure has been persistently in flux and unstable, with a particularly weak record in its fiscal and labour market regimes. Although Britain is not in EMU yet, it is worth considering it in the empirical study because of the following three reasons: first, the current administration is committed to the project of EMU and likely to join in 2002. Second, having a competitive economy, it is a player in regime competition, and third, it is willing to influence the economic management of the Euro-zone even from the outside as a leading player in the EU. Thus, the three most active and influential players in the Euro zone have been chosen for comparison.

Those who question the participation of Britain in EMU normally do so because of diverging business cycles between Britain and the continent. Obviously, such cyclical differences are an obstacle to interest rates management by the European Central Bank. When Britain experiences boom, the continent may be in recession. The interest rate that the European Central Bank sets would be a compromise, thus, sub-optimal for both regions. Or, it may be set in favour of the core countries, ignoring the needs of the periphery. In such a case, the periphery countries may have to pay the cost by uncontrollable boom or bust.[5] Rather than pursuing this line of argument, my contribution lies in the introduction of structural elements: behind the problems of and potential conflicts over satisfactory interest rate management by the European Central Bank lie structural and policy differences particularly in labour markets, as the three major countries in Europe have distinctly different labour market regimes. Unless policy makers give greater consideration to the problem of differences in labour market regimes, these regime differences may well become the cause of severe difficulties in managing the Euro.

[5]For a detailed argument, see De Grauwe (1998).

Chapter 1

The Maastricht Approach to EMU

This chapter reviews the Maastricht process of EMU by examining the convergence criteria in particular. The objective is to clarify the context which leads me to explore my central thesis - that domestic structures, in particular, labour market structures, matter for the sustainability of EMU, once established. I suggest that the neglect of labour market structures in the Maastricht process poses severe risks for the future of the whole EMU project. Structural differences can be overcome if there is enough political will and commitment in member states to do so. However, the examination of structural differences gives us an indication of the scope of possible causes for policy conflict and the parameters within which difficulties in the economic management of the EMU zone can be expected to arise.

This chapter first aims to clarify the Maastricht framework of monetary union by criticising the convergence criteria. It sets out with a conceptual debate over convergence regarding the establishment of monetary union, then argues for the extension of the 'economist framework' by bringing in the structural *problematique*. Accordingly, the convergence criteria are critically assessed by reviewing the literature. Additional factors worth considering, including political integration, are also discussed. Second, it examines whether the European Monetary System (EMS) as a precedent for EMU prepared the ground for EMU by affecting member states' economies. The external constraint imposed by membership of the EMS empowered policy makers to push through domestic structural reforms. Using empirical evidence, I study how and to what degree EMS membership contributed to the creation of structures needed for a viable EMU. Furthermore, I examine how domestic structures, in particular, domestic labour market structures, constrained policy makers' willingness and ability to undertake structural reform. By doing so, I establish the rationale to study structural differences in labour markets as a pivotal intervening factor to be considered for the long term sustainability of EMU.

1.1. Pros and cons of convergence: the economist vs. the monetarist arguments

In a monetary union, inflationary behaviour among the member states should be similar as the common central bank can set only one interest rate, thereby imposing a 'one size fits all' monetary policy. Hence, the nominal convergence of price performance becomes a prerequisite for the creation of monetary union. However, the convergence of price performance can only be maintained in the presence of underlying economic factors which do not put pressure on prices to diverge. Therefore, a certain degree of real convergence, convergence of working conditions, living standards, economic institutions and structures, matters for the long-term process of deeper European integration and in particular for the viability of EMU. (Anderton et al. 1992, p.2)

As no single member state participating in EMU in history and at present has been and is the clear and undisputed hegemon to dictate terms, economic convergence has become the paramount issue for discussion in deciding the entry criterion for monetary integration. Economic convergence refers to a dynamic movement towards a common level or goal. According to Kaufmann (1987), there are two dimensions to the concept of economic convergence: first, a narrowing of international differences in present and expected future policy objectives and second, a confluence of economic developments. (p.239)

There are two schools of thought which debate the convergence of economic variables as a prerequisite of monetary union. These two stances have been named the monetarist[1] and the economist stance. Originally, this debate was instigated by the first publicly debated EMU proposal, the Werner Report (1970)[2]. The countries with balance of payment deficits and higher inflation, France, Belgium and Luxembourg, were 'the monetarists'. They took the stance that monetary union would drive economic developments towards conditions that would be suitable for EMU. For them, economic convergence would inevitably and eventually result from increased Community measures in the monetary field, and particularly from the irrevocable and immediate fixing of exchange rate parities. In addition, they took monetary integration as a driving force to economic integration. On the other side, surplus and lower inflation countries, Germany and the Netherlands, took the position of 'the economists'. Taking a cautious stance, the economists argued for the necessity of a long period of converging economic performance before the creation of monetary union. In particular, they put emphasis on convergence of inflation rates, budget deficits, government debt and interest rates, as in the current case of EMU, as well as the establishment of a single European market and an EEC fiscal agency to promote further fiscal policy coordination.

With the re-emergence of the EMU proposal in the Delors Plan, the debate between the monetarists and the economists resumed. The arguments are essentially the same as those a decade ago. The monetarist stance, taken by France and other Latin countries, believes that monetary union is important for the success of economic integration. These countries believe

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[1]The term "monetarist" here does not have any relation to the monetarist school represented by Friedman in conventional economic theory.

[2]There were other monetary union proposals in post-war Europe. The first EMU concept was developed along with the creation of the European Payment Union of 1949 by the US Agency administering the Marshall Plan. The first major in-house EEC proposal for monetary union was advocated by Action Committee for the United States of Europe during 1959 and 1961, which was later followed up by Action Programme of the Community for the Second Stage in 1962. For details, see Dyson (1994).

that economic convergence would come along once monetary union was implemented. The monetarists argue that the external constraints brought about by monetary union would force member states to harmonize their policies, which would eventually lead to the convergence of economic performance. Believing in spill-over effects, the monetarists share the same views as neo-functionalists. For example, Marquand (1982) says that "once the toboggan had been given an initial push, the governments, parliaments and peoples perched on it would be carried along with willy-nilly, by the momentum of the integration process itself." (p. 235) This expectation, however, could be too simplistic. If they integrated prematurely without sufficient economic foundation or political willingness, those integrated might really 'toboggan' all the way down to a major economic breakdown.

The economist stance, represented by Germany, argues that a monetary union should come only after the completion of the single market and economic integration. The economists presuppose that monetary union requires a certain correspondence of domestic economic and political conditions. They would have to provide "a conducive background". (Kaufmann, 1985, p.56) The prior convergence of policy goals and economic performance is a prerequisite for monetary union. The latter position has prevailed in the Maastricht Treaty with the stipulation of convergence criteria and central bank independence, but not to the extent that the Bundesbank would have wanted.

The economist stance shares my concern about studying economic structures. The economist approach asks for an agreement over economic policy goals and their ranking, in addition to the agreement that no trade-off exists between inflation and unemployment. It also presupposes a similar understanding of how economic policies are transmitted to the various domestic sectors and the international economy. Economic policies, however, do not have to be the same in response to disturbances. Policies have to match the seriousness and characteristics of the internal and external disequilibria and the internal structural differences among countries. (Kaufmann 1985, p.60) A comparison of domestic socio-economic structures with respect to their institutions helps in understanding the structural differences in different countries, which could become an obstacle to managing a successful monetary union.

If there is a strong political necessity and will, however, convergence is not a prerequisite as the example of German reunification demonstrated.[3] Yet, the German case has been sustained with the semi-permanent fiscal transfer from West to East Germany. In Europe where there is no incontestable political need nor overwhelming economic logic for a common currency and without an effective redistribution mechanism present, some degree of economic as well as socio-political convergence may be necessary to keep monetary union viable in the long run. In this thesis, I shall extend what the economists call "conducive background" by using the concept of **regime**. I will argue that the establishment of a coherent European-level regime through some degree of compatibility of domestic regimes is desirable for a successful European Monetary Union.

1.2. "Regime" as an overarching structural framework

As the economist stance requires deeper structural integration of economies as a prerequisite for monetary union, using the concept "regime" seems to me appropriate here. Regime is a word often used by social scientists, but without firm agreement on its definition. Economists use it at its face value in a positivist framework: one may characterise their definition of regime as a regular pattern of occurrence, action, or behaviour.

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[3]It should be noted that it was possible because West Germany had a considerable current account surplus to finance unification. However, even in the German case, the effects and costs of reunification have turned out to be far bigger than anticipated.

Other social scientists look for more normative elements in the definition of regime. A school of political science defined it as:

> sets of implicit or explicit principles, norms, rules, and decision-making procedures around which actors' expectations converge in a given area of international relations. Principles are beliefs of fact, causation and rectitude. Norms are standards of behaviour defined in terms of rights and obligations. Rules are specific prescriptions for actions. Decision-making procedures are prevailing practices for making and implementing collective choice. (Krasner, p.2)

Using this conceptual framework, regime theory became fashionable in the early 1980s, and was widely applied to analyse issues in political economy. It is a simple static theory which explains the continuity of the international system after the decline of the hegemon, by interpreting a hegemonic system as a regime.[4] Although it was also applied to other areas than issues related to American dominance, the theory has been most useful in analysing specific and confined economic areas of activity.

Indeed, regime theorists present almost any international issue as a regime. According to them, there are a vast number of international regimes such as international regimes of "whaling, the conservation of polar bears, the use of electromagnetic spectrum and human activities in Antarctica." (Young 1989, p.13) Whereas regime theorists permit regimes often to involve only a narrow constituency, I shall, instead, interpret regimes as overarching structural factors which influence the society in a broader sense. I perceive economic regimes as a wide social networking of economic arrangements or organisations which influence all members of society directly or indirectly. For example, issue areas such as international trade, money, production, or environment are regimes. However, those mentioned above by Young are not

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[4]It is presented as an alternative to hegemonic stability theory, in order to explain the continuity of stability in the international economic system even after its loss of absolute hegemony. For a detailed criticism of regime theory, see Strange (1982).

considered to be regimes in my definition. Regimes do not necessarily need to be international. Any domestic structural arrangement, such as how domestic economies are organised and how labour and capital interact, can be considered as domestic regimes. In order to study domestic labour market structures, one needs a deeper interpretation of the concept of regime. For my purpose, therefore, the notion of regime needs more sophistication and a deeper conceptual framework.

Here, scholars of the French regulation school can offer a more refined interpretation of regime. Since their theoretical framework will be explained in detail in Chapter 3, it will suffice to be brief here. As a critical theory, the regulation school is rich in interpreting structural interaction among social actors.[5] The French concept of *régime* takes a holistic approach, combining the notion of system, regime, and regulation. Most of the works of the regulationists are geared towards the analysis of the domestic economic structure - what they call the 'domestic regime of accumulation'. The regulationists study almost every topic within the realm of political economy--inflation, growth and economic crisis, the role of the state, wage formation, and industrial relations, monetary relations and the international division of labour from the angle of regulation[6] (Noël, p.304) in order to explain stability and cohesion in advanced economies. They argue that it is the correspondence of the economic organization with social norms and institutional structure which accounts for the legitimacy of specific regimes over a certain time. They emphasize the importance of relations between social structure and political economy and their complex interplay. This integration of social, political and economic dimensions seems to

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[5]Depending on which branch of social science they belong to, regulationists have slightly different versions of defining "regime of accumulation and regulation". For details, see Appendix 1 of Boyer (1990).

[6]The word 'regulation' has wider connotations in the French language than in English. It includes the scientific meaning of "study of the role of a set of negative and positive feed-back loops in relation to the stability of a complex network of interactions." (Boyer 1988a, p.126)

be a very important way of analysing the dynamics of the world economy today. The regulation school framework will be discussed in detail in Chapter 3.

In plain language, my definition of regime is the mode of economic management and interaction of organisations in the domestic as well as in the international economy. In a democratic society, in order for a regime to be successful and sustainable, it has to be accompanied by legitimacy as well. One can perhaps also call it 'socio-economic order'.[7] Such regimes are social institutions, but do not necessarily directly 'govern' states or markets. Instead, they constrain them by explicitly or implicitly setting the dominant rules of the game.

1.3. The debate over the convergence criteria

The convergence criteria set forth four elements to be fulfilled by member states to qualify for monetary union. There has been much debate about the need for these criteria, in particular regarding the fiscal criteria.

As argued in section 1.1., the economist stance supported by Germany and the Netherlands is predominantly reflected by the convergence criteria in the Maastricht Treaty. A further rationale of convergence in the context of EMU comes from the particular nature of European integration. Monetary integration will not be sustainable unless all member states have enough incentive to do so. The benefits have to outweigh the costs. As De Grauwe (1994) suggested, the convergence criteria cater for German interests. Once EMU materialises, Germany - the strongest economy in the EU - may have to bail out countries or regions in

[7] Young (1989) presented two subsets of international institutions: international orders and international regimes. The former is a "broad framework, arrangement governing the activities of all the members of international society over a wide range of specific issues." and it "subsumes a collection of more specific arrangements." (p.13) My definition of international regime is closer to what he conceived as international orders than what he sees as international regimes.

distress by increased payments of fiscal transfers. Leading economists argue that theoretically it is perfectly feasible to assume that fiscal crisis or default in one country participating in monetary union would not bring about any external effects. As Buiter et al (1993) argue, "the cost of these market imperfection are borne only by defaulters and their creditors" (p.79). Bean (1992) also questions the need for fiscal transfer given the Maastricht treaty includes both 'no monetization' and 'no bail-out' clauses. (p.28) It is true that the current scheme of the Structural Funds financed by the European Union budget works to some degree as a partial insurance in the case of asymmetric economic disturbances. But the size of the current Structural Funds is far from enough to make any significant impact.

McKinnon (1996), on the other hand, argues that monetary union would give leverage to a country facing fiscal breakdown, as it is likely that some union-wide action would be taken to prevent union-wide bank failures and financial instability. It might take the form of the European Central Bank buying the troubled government's bonds, or direct government-to-government lending. As he put it, "knowing this *ex ante*, politicians in the errant countries might become less willing to take resolute fiscal action". (p.73) Beetsma and Bovenberg (1995) argue that the credibility of the European Central Bank would be undermined as the union becomes larger. This is because "in a larger union, each individual fiscal authority faces less of an incentive to contribute to this public good (of credibility) by building up less debt, because the (perceived) beneficial effects of less debt (and thus lower second-period taxes) in terms of lower inflation are smaller." (p.i) In the presence of such monetary and fiscal distortions, EMU might create fertile ground for excessive debt.

The reluctance of Germany and other 'economist' countries to admit highly-indebted countries to EMU is better understood from a political psychology point of view. West Germans are still suffering from the considerable tax increases arising from German reunification in 1990.[8] In Germany the experience has led to concern about the future of EMU. It has been argued that a monetary union including not only weak countries like Italy or Belgium, but even a comparatively strong country like France, could face problems similar to those experienced by the German Economic and Monetary Union. The community budget is not big enough to cover major economic disasters. The total EU budget is only a fraction of national budgets. Indeed, the budgetary expenditure of the European Commission is a mere 1% of total EU GDP. This is in stark contrast to the expenditure of national governments, which is around 50% of their GDPs.[9] The possibility cannot be ruled out that such inadequate fiscal resources could have seriously detrimental systemic effects - such as a financial or liquidity crisis - on the overall financial system linking the countries which introduce the single currency.[10] If a local economic and/or financial crisis develops into a system-wide crisis, massive fiscal transfers may be required to stabilise the market. This is one of the important reasons why less developed European member states were more enthusiastic proponents of monetary union than their developed counterparts. This possible systemic need for bail-outs is another reason for the reluctance of the Germans to go for monetary union, apart from their well-established argument against it: i.e., the loss of monetary stability provided by the Deutsche Mark and Bundesbank. Indeed, on German insistence the Maastricht Treaty includes a 'no bail-out principle' in article 104b (Buiter et al. 1993). Germany wants to have symmetric monetary integration which benefits it as well.

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[8]All West Germans are required to pay 7% of their income as a solidarity surcharge. In addition, other taxes have increased since unification in order to finance the reconstruction of East Germany.

[9]For detailed statistics, see the statistical annex of European Economy. (1997) Tables 5, 63A, p. 118.

[10]As introduced later, Begg et al. (1991) take the same view.

Obviously, Germany cannot expect all member states to become as prosperous as itself. Then, what extent of convergence is necessary? Are the criteria suggested in the Maastricht treaty of the right kind? Does it cover enough preconditions to create a viable monetary union?

1.3.1. Criticism of the convergence criteria

The Maastricht criteria have been widely questioned and criticized by many economists. Most agree on the need for some convergence criteria, but none seems to endorse the criteria fully. De Grauwe (1994) dismissed both nominal and fiscal convergence criteria as "obstacles" (p. 159) to monetary union. He argues that monetary union would bring about nominal convergence anyway, thus, there is no need for prior convergence. He states:

> to meet the nominal convergence criteria a regime shift (the monetary union) must occur. After the regime shift, nominal convergence is easy. The Maastricht treaty has it back to front. It wants nominal convergence before the regime shift. This makes it unlikely that the regime shift will occur, thereby also preventing nominal convergence. (p.159)

Whereas his argument holds very well from the point of view of economics, it does not do so as far as practical politics is concerned. It can be interpreted as a monetarist stance. Those who subscribe to the economist stance would disagree with his argument. Buiter (1995) argues along the same line as De Grauwe, but put it more realistically. He also takes the view that the interest rate criterion is meaningless, as complete interest rate equalisation immediately follows monetary union. This criterion, however, makes sense as "yet another stratagem for keeping out of the monetary union governments whose debt is subject to a significant default risk premium." (p.30) As for the exchange rates criterion, it is useful since it avoids "the risk of 'endgame' devaluations aimed at achieving a transitional competitive advantage or at reducing the real value of (public) debt denominated in domestic currency." (p.31) Concerning the inflation criterion, as De Grauwe (1994) put it, the logical order would be to have monetary union first which, then, brings about inflation convergence. Buiter (1995), however, points out the possibility of "inheritability of inflation inertia" (p.31). If such an inheritability exists, it is important to have inflation rate convergence prior to monetary union. The concept of inflation inertia denotes the situation of a sluggish response of an inflation rate to changes in the current economic conditions. If inflation inertia is inheritable, its presence or the different speed of inertia would cause relative price differentials between the countries sharing the single currency: this means that the value of the Euro circulating in France could be different from that in Germany. The concept of inflation inertia is interesting because it has structural implications. However, it is very difficult to rigorously conceptualize and estimate.

Although some dismiss its relevance, nominal convergence is not a very contentious issue. It is probably because all EMU core countries have no particular problem meeting the Maastricht targets in practice. What is debated is whether, and to what extent, the fiscal criterion and real convergence are relevant. Most academics argue that fiscal policy has to be flexible as a primary adjustment mechanism. With the exchange rate being lost as a means of adjustment, other policy instruments, such as fiscal policy have to bear more of the burden of adjustment in the case of external shocks. Consequently, they argue against fiscal federalism - the establishment of an European-level central fiscal mechanism.[11] Some practitioners, however, tend to disagree with the academic argument, and support harmonization. The Delors Report (1989) argues for fiscal policy coordination and binding limits on national budget deficits. As an extension of this line of argument, sometimes even support for fiscal federalism is voiced. This argument, however, is logically flawed since "the monetary union really requires *either*

[11]As reiterated in Chapter 2, Sachs and Sala-i-Martin (1992), Feldstein (1992), Krugman (1993) and Goodhart (1995) are among the few economists who have argued for the need for fiscal federalism for the efficient operation of monetary union.

fiscal harmonization *or* common knowledge that monetary policy cannot later be used to correct a member's fiscal policy errors." (Graboyes 1990a, p.16) The Maastricht Treaty has already ensured the latter option through no monetization and no bail out clauses in Article 104b.

For this reason, Bean (1992) does not see the point of introducing fiscal rules on top of Article 104b. He argues strongly against the Maastricht fiscal criteria. The Maastricht treaty assumes fiscal restraints in order to ensure price stability. The fiscal criteria excessively boost its deflation bias and "could greatly handicap the Community in the long run" (p.29). He even repudiates the case for monetary union if the enforcement of "inappropriate fiscal policies" (p.36) stays as its prerequisite.[12]

De Grauwe (1994) also argues against the fiscal criterion on the ground that the particular ceilings set are arbitrary, and fiscal norms are unrelated to the working of monetary union. Given no monetization of budget deficits has been agreed, and the global finance penalising fiscally adventurous countries, he does not see the need for a fiscal criterion as a precondition for monetary union. In a nutshell, he dismisses the Maastricht criteria as having no economic rationale. Instead, he subscribes the theory of optimum currency areas as a sound economic basis for monetary union, which sets out criteria such as labour market flexibility (wage and/or price flexibility), labour mobility, a degree of symmetry among different economies sharing a single currency, and the presence of automatic fiscal redistribution.

Buiter, Corsetti and Roubini (1993), in their article, thoroughly evaluate the Maastricht fiscal criteria. Like Bean (1992), they argue that convergence criteria on fiscal policy can be harmful by promoting an over-disinflationary and recession biassed stance. Assessing the case for fiscal rules, they examine the logic behind the criteria, and conclude that the rationale behind

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[12]Kenen (1992) puts forward a similar train of thought, but takes a much more moderate stance on the Maastricht fiscal rules. He implicitly encourages the changing of numerical ceilings through Council voting, as explicitly stated in the Protocol on the Excessive Deficit Procedure.

the Maastricht fiscal criteria is not economic but rather, a political concern. They question the attempt to set universal numerical targets for heterogeneous economies. In other words, "debt and deficit ceilings impair that flexibility and with it each Member State's ability to respond to nationally differentiated shocks." (p.90) They suggest that the Maastricht negotiators may have had German as well as EC average (in the year 1990) public investment behaviour in mind when selecting particular quantitative targets of 3% and 60%. Eichengreen (1994) argues that fiscal criteria should not have been applied in stage two of EMU, which started in January 1994. In his opinion, the theoretical ground only holds at stage three when monetary union is in place. As he argues, whether the fiscal deficits of EU countries are somewhat below or above a certain GDP fraction should not be the prime factor for being selected for monetary union. Rather, whether a country possesses credible "fiscal discipline" (p.174) is the issue to be looked at. Given European countries have such different levels of fiscal deficits (not to mention the Belgium and Italian cases with a debt/GDP ratio of over 100%), it does not seem sensible to ask all countries to take the same fractions of GDP as a target.

Begg et al. (1991) also reject the binding rules on budget deficits, for the same economic reasons. In addition, they question the de facto effectiveness of the 'no-bail out clause': they point out that it "does not guarantee, however, that they (the indebted governments) *actually* travel alone, without infecting others with their crisis" (p.38). Thus, they propose to add a regulative framework on sovereign borrowing in order to protect banks and financial institutions from being exposed to systemic risk. Such proposals include setting an upper limit for lending by banks and other financial institutions to any single government, as a certain proportion of their assets, and strengthening their capital base.

Indeed, there is more or less consensus among leading economists that the Maastricht fiscal rules are irrelevant or detrimental for the well-being of European economies.[13] Hutchison and Kletzer (1995), and Beetsma and Bovenberg (1995) are almost the only proponents of quantitative limits of budget deficits. The former argue that there is a rationale for fiscal federalism, as it improves allocative efficiency after the establishment of EMU. The expectation of eventual fiscal federalism may give European governments an incentive to accumulate excessive debts, as their debt burden may be taken over by the federal fiscal authority in future. For this reason, they argue that the fiscal criteria make sense. As already mentioned in the earlier section, the latter argue that monetary union brings about excessive debt in the presence of both monetary and fiscal distortions. Monetary distortions stem from the inability of central banks to make a credible commitment to price stability and fiscal distortions are generated from myopic governments' fiscal conduct. With the presence of both distortions, "the second best can be achieved by supplementing a conservative, independent central bank by debt ceiling. In this way, institutional arrangements are targeted directly at the origins of the monetary and fiscal distortions". (Beetsma and Bovenberg p.13) Therefore, they believe that the quantitative debt ceilings set by the Maastricht Treaty is useful to prevent governments from misbehaving.

Yet, leading economists raise doubts about the assumption of governments' tendency to overborrow. They assert that financial markets penalize such behaviour, and governments' tendency to overborrow is a matter of the past and not the present. In addition, Bean (1992) proposes administrative measures to cope with this problem by making "payments into the Central Community budget dependent on debt and deficit levels in a way that lead national governments to correctly evaluate the costs of their tax and spending decisions." (p.28) Hence, there has been exhaustive debate over the fiscal criterion, but discussion over the other criteria

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[13] In addition to the authors discussed in this chapter, similar arguments are made by Kenen (1992), Boverg, Kremers, and Masson (1991), van der Ploeg (1991) and Wyplosz (1991).

as well as what the treaty left out has been very limited.

The logic of the Maastricht Treaty stems from the separation of monetary and economic policy under the concept of subsidiarity. Article 3b of the Treaty states that the Community only takes action in case the objectives cannot sufficiently be achieved by member states. As Caravelis (1994) points out, this logic is in line with traditional monetary theory, where "monetary policy can be divorced from economic policy." (p.17) The Maastricht Treaty, on the one hand, promotes " . . . a high degree of convergence of economic performance, a high level of employment and social protection, the raising of standard and of quality of living, cohesion and solidarity among Member States." (Article 2), but on the other hand, allows for maximum freedom for member states to decide economic policies. Does this combination necessarily constitute a reasonable and efficient way to create EMU? The following sections introduce proposals to improve the path to monetary union.

1.3.2. The need for additional criteria?

The Maastricht criteria left out several important aspects which relate to the performance of the real economy, except for the fiscal position. Eddie George, the Governor of Bank of England, proposed to add the unemployment rate to the convergence criteria. There are other economic variables which can be potential candidates. What Collignon (1993) calls the "hidden agenda", i.e., the convergence of the balance of payments, the rate of economic growth, and of unemployment, is worth noting, because these variables are "either related to underlying real factors which have some impact on nominal parameters, or they are related to the long-term sustainability of EMU." (p.56)

In addition, structural variables, such as productivity increase relative to wage increase, can be used as a more integral benchmark to assess sustainability. This particular variable is worth paying attention to for the following two reasons: first, it has been already applied in French macroeconomic strategy; and second, it has been introduced as a principal guideline in the strategy for managing wage settlements under EMU by the Deutscher Gewerkschaftsbund (DGB), the German trade union confederation. In France, the concept of wage increases in line with productivity rises is one of the factors behind the success of the 'Franc Fort' policy as a sensible macroeconomic strategy, as will be elaborated in section 1.7.2.1. Credibility is a very important factor for the Franc-Fort policy to succeed. This is because "credibility would have the effect of accelerating the adjustments needed to bring about a return to full (or rather higher) employment". (Fitoussi et al. p.4) This strategy is beneficial for the economy as a whole, because nominal depreciation is prone to induce undesirable inflationary pressure. However, scholars have so far concluded that the strategy has been successful in bringing down inflation, but not in lowering unemployment rates by boosting the economy.[14]

In Germany, the DGB believes that the concept - wage increase in line with the labour productivity growth - will become the key for European wage adjustment under a single currency.[15] What is important under EMU is the uniform wage formation process because of the following rationale:

> If in one country wages react systematically differently to economic changes compared to others, there will be a systematic divergence of competitiveness. In an economic and monetary union changes in competitiveness can no longer be compensated for by realignments of exchange rates or movements within the ERM bands. If the economies of the Community countries are similar in all other respects, it could be argued that only policy reactions or the convergence of the wage bargaining process could prevent systematic divergencies (*sic*) of competitiveness. (Horn and Zwiener, p. 83)

[14] For details, see Blanchard and Muet (1993) and Fitoussi et al. (1993).

[15] Their position is based on G. Horn, R. Zwiener and H. Goepel (1996), the study commissioned by the DGB and its think tank.

By making wage increases conditional on productivity growth, with a given level of technology, unit labour costs stay roughly constant. With the introduction of the Euro, countries will lose exchange rates as an adjustment mechanism. Thus, unit labour costs as indicators for external competitiveness must not be distorted by excessive rises in wage levels.

One should be very careful to distinguish wage levels from wage formation processes. The DGB argues that the single currency should not bring about the harmonization of wage levels. Rather, wage differentiation is crucial for the efficient allocation of capital and labour in order to prevent unnecessary unemployment in less competitive areas.

Connolly and Kröger (1992) put emphasis on the convergence of supply conditions for the efficient and proper working of the single market and successful monetary union. They focus on wage flexibility, lower taxes, better economic infrastructure, and structural policies to improve supply side performance as the key determinants for the positive expectations of higher rates of return. They believe that supply side flexibility and, in particular, labour market flexibility would be crucial for positive private sector expectations, which will induce investment, economic and employment growth. They focus on the concept of the domestic rate of return. A region or country where the expected marginal real rate of return is lower than that of other regions or countries would suffer: for investment and job creation would take place elsewhere. As labour mobility remains limited, that would result in regional unemployment. (p.11) In this context, they urge a regime change in wage formation processes towards greater flexibility, where wage levels develop consistent with an appropriate level of the rate of return. Just like the DGB, they are concerned about the possibility that greater labour mobility and the single currency will make the maintenance of wage differentials difficult. Unless wages rise in proportion to productivity growth, the experience of the former East Germany, a region which stays semi-permanently depressed, with wages being too high in relation to productivity and which survives only by absorbing huge fiscal transfers, would be repeated on a European scale.

Both the DGB and Connolly and Kröger are aware that wage and labour market behaviour have crucial implications for monetary union. Besides, unless European employment conditions improve through economic growth, people will start to **perceive** EMU as a cause of economic hardship.[16] In this respect, it is important to examine more structural demand and supply conditions, in particular labour markets, to measure the sustainability and the success of EMU.

In spite of the importance of labour markets, they were not covered by the Maastricht criteria. The next section explores the reasons.

1.4. Why labour markets did not become an issue?

The convergence criteria are highly technocratic in nature and concentrate exclusively on monetary variables (Tsoukalis 1997, p.169). The exclusion of other aspects, particularly referring to social policy and labour markets have frequently been criticised. (e.g. Gros and Thygesen 1992, p.467) Neo-classical economists are aware that the achievement of the European Central Bank's aim of price stability depends crucially on the wage price mechanism.(Dornbusch et al. 1998, p. 51-52) Why have labour markets not been considered in the Maastricht convergence criteria? This may be partly explained by the neo-liberal consensus behind monetary union which hopes that the single currency, once established, would necessitate greater labour market flexibility.[17] As Tsoukalis (1997) put it, "EMU would put a premium on the

[16]Goodhart also made this point at a conference held at the London School of Economics on 10 March 1997.

[17]Reports by the European Central Bank persistently propagates this idea.

flexibility of labour markets." (p.136) Dyson (1994) focuses more on the role of the dominant economic theory - monetarism - influencing policy makers' decisions. He argues that the idea of sound money became predominant in partisan economic policy analysis in the 1980s, from which the key policy positions for EMU were derived. The predominance of this branch of economic thinking in turn may have constrained policy makers' decisions. Indeed, there is no doubt that "the structural power of economic policy ideas" (p. 253) affected the particular policy choices underlying the Maastricht Treaty. In addition, this ideological and practical preeminence empowered the Bundesbank as an institutional model of Europe. Hence, the ECB was modelled after the Bundesbank, and the convergence criteria strongly reflect German perceptions and interests. In addition, the independence of member states' central banks became a condition for the entry to EMU in the Maastricht framework. This means that the negotiators of the treaty were indeed aware of the domestic monetary structure, in contrast to other economic structures. Sound money theories believe in the neutrality of money, i.e., that money does not affect the functioning of the real economy in the long run. They believe that monetary policy can function independently from other economic policies, and consequently do not see the need to examine labour markets in establishing the conditions for creating monetary union.

In addition, of great importance is the politically charged nature of issues related to social policies and labour markets in the European integration process. The EU has until now avoided moving labour market institutions and regulations to the centre of attention. They lie at the heart of the identity of national regimes and are highly contested between the political left and right.[18] However, EMU has always been as much about politics as about economics. Against this background, the EU Commission made a strategic choice to leave labour market issues to be

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[18] A good overview of the politicised nature of social issues is given by Tsoukalis (1997 Chapter 6).

addressed under the subsidiarity principle.[19] In effect, it placed much faith in the ability of member states to deliver in reality what was implicit in the Treaty itself.

1.5. Fundamental critique of the convergence criteria - Is there a need for a different kind of criteria?

The real *problematique* of the convergence criteria is that they merely cover the surface of economic performance of member states. In other words, they do not capture the structural dynamics of economies or economic fundamentals which make it possible for a country to become or stay competitive with economic growth. The right economic policies should be implemented by taking account of the different socio-economic structures of the economy. There are some who proposed a totally different approach for establishing monetary union.

Panić (1992) sensibly suggests that the creation of a currency union should be conditional on two other criteria. First, member countries' efficiency and income levels have to be alike, and second, their socio-economic preferences must also be alike. He adds that close historical links and long experience of pursuing similar economic objectives and policies would make the union both advantageous and feasible. Countries would then easily agree on stabilisation or adjustment policies, because of a tacit agreement on policies, derived from the **internal cohesion** of the union. In other words, what Panić is arguing is that domestic economic regimes have to be similar. The 'domestic regime' incorporates the political, social and economic organization, state-market relations and similar historical experience. In Chapters 4 and 5, I shall study historical monetary unions, and then, in Chapters 6 to 8, I shall examine the current domestic regimes of Germany, France and Britain. In doing so, I focus on their labour market structures

[19] Confidential interview with the EU official.

and institutions.

De Grauwe (1993) takes a political economic perspective and argues that the difficulty of the EMU process has derived from a conflict of interests among the member states. There are huge gaps between Southern and Northern Europe on what they expect to achieve through EMU. Roughly speaking, the former aims at strengthening its credibility through EMU. The latter, notably France, supports EMU to weaken the asymmetric structure of the EMS, i.e., the dominance of Bundesbank. The dismissal of the convergence criteria by De Grauwe as 'mere non-sense' is extreme. Nevertheless, he is right to point out that it is more important to focus on where economic divergences come from, rather than setting an arbitrary number of convergence criteria, as in the treaty. Economic divergence brings about asymmetric shocks across countries and they are more important to focus on than mere numerical targets. Asymmetric shocks happen because of the difference in economic and industrial structures. They cannot be easily eliminated by the convergence of economic policies. Therefore, a much broader strategy to deal with the structural differences (such as labour market flexibility) should have more importance than reaching convergence itself. His thesis lays the ground to argue for the need for some degree of structural convergence.

1.5.1. Monetary union and political union

Some dismiss the possibility of EMU before the creation of political union.[20] Goodhart (1995) questions the rationale of the Maastricht project with monetary union so far ahead of fiscal and political union. (p.498) Generally speaking, a political union will be automatically accompanied by a monetary union, as historical examples show. The most recent example has

[20]This position is particularly favoured by Bundesbank officials. See Tietmeyer (1994), Jochimsen (1993, 1994).

been German reunification. One can also point to the case of the German monetary union of the last century. Historically, stable and successful monetary unions either accompanied political union or had a clear political hierarchy, as in the case of the CFA franc zone in Africa whose currencies are pegged to the French franc. An historical example of rather symmetrical monetary integration can be found in the Latin Monetary Union established in 1865, which proved to be a failure by the beginning of the 20th century. A similar fate befell the Scandinavian Monetary Union formed in 1873 and abandoned in 1931. A political union leads to the introduction of a monetary union, but it does not necessarily guarantee the success of the monetary union, as the American example shows. The historical monetary unions will be elaborated in Chapters 4 and 5.

Can EMU work without political union[21]? There is widespread consensus in the literature that the project of EMU as it stands now needs further development to become sustainable. EMU so far will either become an engine for further political and economic integration, or risks failure. It has therefore been described as gamble for policy makers in the future. (Tsoukalis 1997, Jacquet 1998) The huge political and economic task which lies ahead comprises a deepening and reform of European Union institutions and further restructuring of domestic economies, to bring them in line with the requirements of a single monetary policy (Jacquet 1998). The harmonisation of national economic and fiscal policy making and national economic structures to underpin the operation of the ECB may in future create new momentum for political integration. Political union could well become an ultimate result of the process to create sustainable conditions for monetary union. The question is, given these political

[21]There is already a certain level of political integration in Europe, as represented e.g. by the presence of the European parliament. For this reason, Europe could be considered to have imperfect political union. However, the degree of political integration at the European level is far underdeveloped relative to that observed in nation states.

challenges ahead, whether they can be tackled without achieving political union in the first place. It could be argued that political union should have preceded monetary union in order to facilitate policy steps necessary for its sustainability.

The validity of this argument can be questioned by placing it against the background of the creation of EMU. EMU was established by independent nation states under the strong leadership of national politicians. If national politics and policy makers succeeded in launching an ambitious project like EMU for eleven member states, why should it not be equally possible to proceed with the process of creating sustainable conditions under the current political conditions? The problem here is that the priorities behind the creation of EMU differ from the priorities associated with its sustainability. The creation of the single currency has been a project driven by the primacy of high politics. Although there was a strong economic rationale in favour of monetary union associated with the completion of the single market and the problem of the inconsistent quartet, it was national high political concerns that played a key role in motivating national leaders to choose monetary union[22]. According to Sandholtz (1993) and Milner (1997), monetary union became essentially possible because the French and other non-German political elites took it as an opportunity to correct the asymmetry that was Germany's favour, inherent in the EMS. By moving towards EMU, the system becomes more symmetrical, and they can exert greater influence over EU monetary policy. German political leaders, on the other hand, perceived the "need to reaffirm the country's commitment to European integration in the wake of German reunification". (Tsoukalis 1997, p.170) Helmut Kohl spoke in this context of economic and monetary integration as a matter of "of war and peace in the 21st century."[23]

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[22]Tsoukalis (1997), p. 164. The single market logic behind EMU was used by policy makers on the EU level, particularly by ex-Commission president Jacques Delors, as an argument to push forward the project.

[23]Quoted in Tsoukalis (1997, p. 170) Garrett (1994) also emphasizes the importance of German political interests in maintaining the pace of European

With EMU in operation since January 1999, the central issue is whether high politics and national political leadership will continue to be sufficient to facilitate further integration. Given that the task lying ahead includes sensitive low politics areas such as domestic structural reform and closer coordination of the whole set of macro and microeconomic policy making, the political leadership faces a big challenge. Whether this challenge can be mounted is dependent on the degree to which national economic ideas, institutions and interests diverge at the outset, and whether these differences can be overcome by a united political leadership[24]. I will concern myself in this thesis with the current structural differences which have to be addressed in domestic structures, in particular labour markets, to cope with the pressures of the single currency.

1.5.2. Summary

In sum, the convergence criteria do not take account of economic structure. Despite the fact that the insistence on prior convergence reflects the German 'economist' position, as mentioned in section 1.3, the criteria do not go far enough to take into account structural convergence. Here, the monetarist stance prevailed insofar as it has been implicitly assumed that EMU, once established, would bring about the necessary structural convergence and the creation of institutions where needed. The question is whether membership in the single currency can indeed facilitate the reform of domestic structures, especially labour market structures, to bring about the eventual structural compatibility / convergence among EMU member states. To

integration.

[24]Dyson (1994) for example voices serious doubts as to the consistency of the policy processes behind the EMU project, since the project has until now lacked a single political actor at its center. He speaks of the 'hollow core' of EMU (Chapter 9).

investigate this question, a brief review of the European Monetary System (EMS) / Exchange Rate Mechanism (ERM) is useful in examining whether monetary cooperation / integration facilitates structural reforms. Let us therefore examine the EMS experience in the next section and see to what degree it affected member states structurally.

1.6. The European Monetary System (EMS)

The EMS, as the precursor to EMU, represents an altogether rather successful episode of close monetary cooperation by individual states, most of them now forming the Euro-zone, starting out with distinct national structures, particularly labour markets. The question to be investigated is whether the ERM facilitated structural convergence or structural reform towards compatibility of labour market structures among member states. Related to this question is the role of policy makers, as a possible agent pushing through structural changes.

In the 1970s, with the collapse of Bretton Woods system and the oil shocks, the world economy suffered from stagflation and a weak dollar. The EMS was created in 1979 by the strong political initiative of Helmut Schmidt, the Chancellor of the Federal Republic of Germany and Valéry Giscard D'Estaing, the President of France, with the intention to create a zone of monetary stability in Europe. The EMS was a fixed but adjustable exchange rate regime[25].

The performance of the ERM was, until the crisis in 1992-1993, generally regarded as successful (Tsoukalis 1997), despite several realignments. Whether the adjustment of the system through realignments and the final widening of the fluctuation bands indicate persistent structural differences, or can be explained solely by speculative pressure, has been debated in the literature. Gros and Thygesen (1992) evaluate the EMS under the following criteria: inflation

[25] For details of the functioning of the EMS and the ERM, see Gros and Thygesen (1992).

performance, methods used to defend exchange rates, attitudes to reforms in the EMS, and the EMS as part of the ambitions of European integration. (p. 97). The EMS had a turbulent start in the beginning until March 1983. There were seven realignments in this period due to a difficult international environment and member states' limited convergence in inflation rates and budget deficits. Divergence in national economic policy preferences became obvious with the election of President Mitterrand in France in May 1981, followed by his introduction of expansionary policies and the nationalisation of industries. There was policy divergence between Germany on the one hand and France, Belgium and Denmark on the other hand. The expansionary policies in the latter countries were corrected between 1982-83.

The period between March 1983 and January 1987 is characterised as a calmer phase for the EMS. Realignments were reduced to four, with a gradual convergence of national inflation rates. Capital liberalisation started and was confirmed as an objective of the Single European Act in 1986. The Single European Act also stipulated improvements in the decision making mechanism for a single market in good and services, including financial services, to be implemented by the end of 1992. It reaffirmed a number of long- run objectives including the enhancement of the EC's monetary capacity with the view of achieving EMU. Capital liberalisation fostered speculation against ERM currencies in the winters of 1986 and 1987, which brought about ERM realignments, and finally the speculative attacks during the ERM crisis of 1992-93. As a consequence, Gros and Thygesen (1998) suggest that these realignments are less related to divergent economic structures than to speculative capital movements.

There has been considerable inflation convergence at the lower level among the EMS member states. The Basel-Nyborg agreement of 1987 further improved the functioning of the EMS. The agreement helped to boost the credibility of the EMS by visibly increasing resources for intervention and enhancing closer coordination among central banks. The measures taken as a result of the agreement addressed the asymmetric nature of burden sharing in the EMS (Tsoukalis 1997). They helped to maintain the stability of the EMS until the onset of the ERM crisis of 1992-93. Does the ERM crisis, which has been interpreted as a de facto collapse of the ERM (Eichengreen 1996a), indicate that national economic structures in the ERM had not converged enough so that finally the system itself was not regarded as credible by the financial markets?

1.6.1. The ERM crisis

The Danish referendum in June 1992 served as a catalyst for a wave of speculative attacks against a number of ERM currencies between September 1992 and August 1993. Almost all the ERM currencies, except for the Dutch Guilder came under speculative attack. The crisis, which particularly hit the Italian Lira, Pound Sterling, Spanish Peseta, Portugese Escudo, Irish Punt and French Franc resulted in the exit of Sterling and the Lira from the ERM in September 1992 and a widening of the bandwidth in the ERM to ±15% in August 1993. The causes of the crisis have been widely debated in the literature[26]. Broadly speaking, three main explanations are given for the crisis: first, diverging economic fundamentals between member states, second, the removal of capital controls and third, the economic shock caused by German reunification.[27] Of these three reasons, the last two are of systemic nature, whereas the problems with economic fundamentals point to domestic structural differences among member states. As Tsoukalis (1997) points out, the true causes of the ERM crisis probably lie in a combination of the three

[26]For a good review of this debate, see Cobham (1996).

[27]Tsoukalis (1997). An additional factor was the stiffening of the EMS for political reasons in response to the Maastricht negotiation process. (Busch 1994 and Eichengreen and Wyplosz 1993a)

factors. I will focus here on the problem of national economic fundamentals since it is related to domestic structures. When financial markets perceive weaknesses in fundamentals, they see the possibility of member states not being able to adhere to their policy commitment to the EMS. Busch (1994) describes the period between 1987 and 1992 as a time in which the EMS countries behaved "as if monetary union were already in place". (p.86) This made realignment in response to economic divergence virtually impossible. However, because macro-economic convergence was far from complete except for the inflation rate, pressure for realignment was building up. Hence, an economically-necessary realignment was not possible due to political reasons. The financial markets started to cast serious doubts on the realisation of the EMU project after the initial rejection of the Maastricht Treaty by the Danish referendum in June 1992. Furthermore, the criteria of monetary union agreed in the Maastricht Treaty (in particular, the fiscal criteria) were interpreted by the market to be too tough for some countries to achieve relative to their economic fundamentals. These factors fuelled speculative attacks by the financial markets.

There is widespread consensus that fundamental problems were the main cause for the crisis faced by Italy, Spain and Portugal in 1992. (Pons 1993) The high inflation rates of these countries compared with the rest of the ERM countries led to competitiveness problems which put the sustainability of their existing ERM parities in question. Little has been said in the literature about the possible structural causes of the comparatively bad inflationary performance of these countries. In the case of Italy, the desolate state of public finances has been pointed out. (Vaciago 1993) On a more general level, the importance of different labour market behaviour, related to different national wage bargaining arrangements has been emphasised by Flassbeck (1994), and Artis and Ormerod (1994). The latter, in a comparative analysis, assert that not simply inflation differentials as such, but divergent trends in wage levels matter for the sustainability of a peg. Whereas the past record of national wage developments demonstrated to markets that countries like the Netherlands and Belgium implemented labour market reforms which underpinned sustainability of the peg to the DM, Italy's inflationary wage behaviour constituted a chronic problem.[28]

The realignments and the crisis of the ERM in 1992/93 demonstrate that the convergence between diverse national economies was not sufficient to achieve permanent exchange rate stability. Nevertheless, the considerable stability achieved after 1987 suggests that some convergence among the economies of the ERM member states has taken place.

1.7. Has the EMS/ERM facilitated domestic structural reform?

The membership of the EMS can be interpreted as a means to fight inflation for non-German member states by 'tying one's hand' through exchange rate constraint. It meant adoption of German style monetary policy priorities by member states to control inflation. Germany, on the other hand, saw the EMS as an instrument against excessive revaluation of the DM. Furthermore, at a time of a lack of US leadership in international monetary affairs as a result of the collapse of the Bretton Woods system, and of the oil shocks and stagflation, the EMS was established to serve as a forum of economic cooperation aiming to create a zone of monetary stability.

This section examines whether the EMS has promoted structural changes in member states' economies by imposing anti-inflationary discipline. The question how an international monetary system affects domestic structures has theoretically been addressed by two perspectives: structuralist international political economy (IPE) analysis argues from a systemic

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[28] For further details about the Netherlands and Belgium, see in't Veld (1992). This analysis is confirmed with regard to Italy by Micossi and Padoan (1994).

point of view, and looks into the systemic constraints imposed by capital mobility under a fixed exchange rate system[29]. Domestic structure approaches in IPE have investigated the strategic behaviour of policy makers who are involved in a situation characterised by a tension between their international commitments and the demands of their domestic constituency[30].

Arguing from a systemic structural approach, Andrews (1994) provides an analytical framework to interpret the ERM as an agent for structural change as follows. He starts from the capital mobility hypothesis based on the Mundell-Flemming approach, asserting that free mobility of private capital, monetary policy autonomy and fixed exchange rates cannot be achieved simultaneously.[31] Thus, states have to make strategic choices about their exchange rate regimes - floating or fixed. In the case of the EMS, countries opted for the latter. As a consequence, they are constrained by capital mobility more than those which choose a floating regime. In a fixed exchange rate regime states are required to adjust to achieve inflation level similar to the anchor currency through monetary, fiscal policies and structural reforms. Structural reforms are necessary to eradicate structural pressure for inflation. Extending this line of argument, a combination of capital mobility and the membership of the ERM forces non-German member states to adjust so that their inflation performance becomes similar to that of Germany. The effect of the EMS on inflationary expectations, based solely on the strong reputation of the monetary authorities, must in the long run be supplemented by more comprehensive credibility, relying on the long-term sustainability of the exchange rate. (Williamson 1991) To achieve sustainability, inflationary countries have to adjust structurally

[29]For a good review on the debate about the systemic constraints on national monetary autonomy coming with capital mobility, see Pauly (1995).

[30]A good example here is Milner (1997).

[31]Cohen (1993a) put it as the 'unholy trinity'. Padoa-Schioppa (1985, 1987), including free trade, called it the 'inconsistent quartet'.

to eradicate the structural causes of inflation, namely from labour markets and fiscal policies. For EMU, the latter were taken care of by the Maastricht criteria, but the former, the labour markets, were not even mentioned.

The fact that policy makers face, in a fixed exchange rate system, constraints by capital mobility does not mean that they have no option but to implement structural reforms. In the ERM, policy makers still had the option to choose among different policy strategies. They could either implement necessary structural reforms to make the exchange rate peg sustainable, or adjust the peg in response to the economic strains coming from structural divergence. Furthermore, they could attempt to postpone structural reforms and defend fundamentally misaligned exchange rates through monetary policy tightening. Ultimately, policy makers always had the option of abandoning the ERM altogether and floating.

As domestic policy approaches have been pointing out, structural reforms are not an easy option for policy makers, since they involve the adjustment of politically-sensitive domestic institutions[32]. Whether policy makers choose structural reform over other policy options depends on the advantages they see in defending their commitment to the ERM, the domestic political costs of structural adjustments and the capacity of the political system to implement structural reforms. Domestic policy approaches speak here of 'two-level-games'[33]. Two level-games, as Milner (1997) has emphasised, contain a structural dimension. In the case of the ERM, membership may have empowered and legitimised policy makers to push through unpopular

[32]The good systematic description of the interaction between domestic and international pressures on policy makers in the case of exchange rate policy can be found in Milner (1997) and Simmons (1994).

[33]For a definition of 'two-level-games', see Putnam (1988, p.434). How different domestic situations affected the policy choices of policy makers in the ERM crisis has been described by Sandholtz (1996). The interaction between the commitment of international cooperation and domestic structural pressures influencing policy choices in the case of the negotiation of the EMU has been investigated by Sandholtz (1993) and Milner (1997), chapter 8.

structural reforms. On the other hand, the past forms of domestic structures themselves impose constraints on policy makers. As Dyson (1994, p. 177) notes, policy makers are embedded in institutional settings which incorporate and represent the past, and thus provide continuity between past, present and future. The following review of the ERM investigates whether the constraints imposed by the ERM indeed made policy makers choose structural reforms to make national labour markets more compatible with the requirements of fixed exchange rates. First, I review the economic evidence for the implications of the ERM for labour markets. Second, I look at the cases of France and Italy to see whether in these countries' ERM membership facilitated labour market reform. I choose these countries because they combine long-term ERM membership with a strong commitment to European monetary integration. The cases of Britain and Germany, the two countries which I will later investigate together with France in my case study on EMU, have been excluded since Britain only participated in the ERM for a brief two year period, and Germany faced few constraints from ERM membership due to the asymmetric nature of the system. Let us review the empirical studies to see if one can observe a structural impact of ERM membership on labour markets.

1.7.1. Empirical evidence

There are a number of studies which empirically estimate the structural effect of the EMS/ERM on members' economies. Yet there is no consensus among economists regarding: i) whether there were structural effects of ERM membership on the wage behaviour of member states, ii) even if there were some evidence, it is difficult to distinguish the effects resulting from ERM membership or from other factors, such as globalisation and other changes of labour market practices. In addition, it should be noted that most works reviewed here, except for

Bayoumi (1992), examine the changing behaviour in wage equations. Hence, the 'structural' impact on labour markets that these works are concerned with does not go much beyond the change in inflationary expectations of the wage-setters.

Bayoumi (1992) examined the macroeconomic impact of the ERM on member states. He found that ERM members had relatively symmetric supply shocks. The ERM appears to have removed the flexibility of floating exchange rates and have lowered the speed of adjustment. At the same time, however, it has facilitated a more coordinated response among member states. He concluded that "the core ERM members have at least some of the characteristics desirable for a common currency area", regarding their responses to shocks. (p.354)

Giavazzi and Giovannini (1989), Barrell (1990), Anderton and Barrell (1995), Morgan (1996) and Artis and Ormerod (1994, 1996) examined the implications of the ERM for European labour markets. Giavazzi and Giovannini (1989), Barrell (1990) and Artis and Ormerod (1994) found evidence for behavioural changes in wages in France and Italy in the 1980s. They found that the average rate of wage increases was far lower in the post-ERM period than in the period before entry, and a higher correlation of both price and wage inflation rates among ERM members. Giavazzi and Giovannini (1989) found that the EMS became a catalyst for producing a shift in expectations. They observed a shift in inflation expectations of wage- and price-setters in the first quarter of 1985 in Italy, March 1983 in France, and in autumn 1982 in Ireland.[34] Barrell (1990) also found that, amongst the ERM members, wage-setters' behaviour changed most in Italy. The credibility of the government's commitment to anti-inflation through ERM membership and the gradual elimination of the *scala mobile* in the 1980s helped to change wage behaviour. A downward adjustment in European wage inflation processes can be observed in

[34]For more detail about the French and Irish cases, see Sachs and Wyplosz (1986) and Dornbusch (1989).

the 1980s, which was, at least partly, caused by the discipline imposed by ERM membership. In the later study by Anderton and Barrell (1995), however, little evidence for statistically significant structural change among the members was found, except for Italy. Affirming the result by Bayoumi (1992), they noted that "the ERM may have provided some pressure towards more symmetric response to shocks, but the changes have not been great." (p. 60) They found that Britain and Italy, which suspended ERM membership in 1992, displayed sluggish responses in inflation and real wage adjustment. This suggests that ERM membership certainly produced lower wage rises by influencing wage-setters' inflation expectations. However, the pressures of membership may not have gone deep enough to change the dynamism of the adjustment mechanism in labour markets. Whereas some wage effects of the ERM have been observed for member states, Morgan (1996) found that the effect of unemployment on wages and of real wages on employment differed considerably between Italy, Spain and Germany. He states, "these structural differences in labour markets suggest that these countries may respond very differently to economic shocks. For this reason, they should be an important consideration in Spain's and Italy's decision to join any future monetary union with Germany." (p.86) Thus, ERM membership has helped to facilitate changes in wage behaviour by affecting the inflationary expectation of of wage-setters, but it may not have brought about enough structural change to underpin successful monetary union. All studies found that changes in wage behaviour were achieved at the cost of rising unemployment, the key problem that needs to be corrected in future. In other words, the EMS/ERM was purely a monetary agent which acted as a catalyst for some change regarding wage behaviour but only with the side effect of high and persistent unemployment.

These results were contested by Egebo and Englander (1993), who found little evidence of regime shift among the ERM participants, including Italy: the wage equation estimated between the period over 1972-1986 fits reasonably well for post-1986 data. Their evidence implies that the credibility effects stemming from ERM membership were small. Rather than credibility effects, they point to the adherence to tight macroeconomic policies as the key for the changing behaviour in some countries. This point is partly confirmed by the discussion in section 1.7.2, comparing the cases of Italy and France.

In addition, as Artis and Ormerod (1996) put it, it is problematic to explain anti-inflationary pressure in the EU solely because of the ERM. During most of the ERM period overall disinflation could be observed in the whole of the OECD, including non-ERM countries. In addition, they point out that, in trying to detect an EMS effect, it is impossible to distinguish between behavioural change in labour market that happened due to the ERM or other institutional changes in labour markets, including regulatory changes, or changes in working conditions. Hence, it is necessary to examine labour market structures closely, which will be done in Chapters 6 to 8.

1.7.2. The cases of France and Italy

This section analyses more closely the examples of France and Italy regarding the structural impact of the ERM on domestic labour markets. With ERM membership in the beginning in 1979, both countries attempted to adhere to the same external policy constraints. This turned out to be much more difficult for Italy than for France, as demonstrated by Italy's need to operate in the wider fluctuation band until January 1990, and its inability to withstand speculative pressure in 1992. Domestic structures crucially account for this different performance. The question is how these different structures influenced the strategy of policy adjustment chosen by these two countries in response to ERM membership.

1.7.2.1. France

The major policy adjustment in France under the EMS started not with its original membership in 1979, but with the U-turn in its expansionary macroeconomic policy in 1983. The original French EMS strategy to combine external stability with traditional redistributive Keynesianism, which produced consistently higher inflation than in Germany, failed in 1982 due to the pressures of globalisation and capital mobility. Faced with the strategic choice between floating the French franc and implementing a tough strategy of macroeconomic adjustment to stay within the EMS, the Mitterrand administration chose to opt for the Franc Fort strategy. (Walsh 1994, p. 251) It can be interpreted as a specific way chosen by France to respond to the pressures of globalisation: the adherence to German demands for macroeconomic stability by emulating German macroeconomic policy. (McCarthy 1993, pp.82-84) As a consequence, from 1983 onwards, France displayed a remarkable convergence of monetary and fiscal policy and underlying macroeconomic philosophy to the German model of competitive disinflation[35]. This strategy seeks external competitiveness through lower inflation than in competing countries. It attempts to achieve external competitiveness through disinflation rather than devaluation. Real wages have to increase less than productivity in order to maintain external competitiveness. The fall in the rate of increases in wage costs brings about lower inflation rates and/or higher profitability of firms. This promotes export-led growth and investment by firms, thereby eventually creating more employment opportunities.

France's impressive macroeconomic record, based on the coherent combination of tough anti-inflationary monetary policy and fiscal consolidation towards German levels, has been

[35]Leading scholars argue that the Franc Fort policy reached maturity by 1987, after the last realignment inside the EMS. See Fitoussi et al. (1993).

explained by the unwavering commitment of French policy makers to undertake the adjustments necessary under the EMS, despite their short-term domestic costs. (Sandholtz 1993, pp.29-30) The 'strong state' capacity of France is explained by pointing to the specific French political structures, which give the executive a substantial degree of autonomy (Walsh 1994, pp. 246-48). In addition, the fact that major firms were owned or controlled by the state made it possible for government officials and businessmen to be aware of French competitiveness in the international economy. Consequently, the French elites strongly committed themselves to raise French competitiveness through the enforcement of the Franc Fort strategy (Goodman and Pauly 1993, p.74). Thus, the Franc Fort strategy should be interpreted as a pro-active macroeconomic strategy, rather than as a re-active attempt to defend the exchange rate parity within the ERM. It was an ambitious macroeconomic strategy to restore French competitiveness and its global influence by emulating the German economy.

Wage behaviour under the Franc Fort strategy changed substantially, as can be observed in the relationship between real wages and labour productivity. In France until 1982, wages were rising faster than labour productivity, whereas in Germany real wage increases were in line with and lower than rises in productivity. After 1983, the French managed to change wage behaviour and exhibit lower wage increases in line with productivity increases.[36]

Does this successful adjustment in wage behaviour, as a result of the Franc Fort strategy, indicate that France implemented structural changes in industrial relations under the constraints imposed by the ERM? The French system of labour market management went through considerable structural and institutional changes in the 1980s. The French government adopted successive measures to make labour markets more flexible, including wage de-indexation since

[36]For a graphical presentation, see Figures A2 and A3 in Blanchard and Muet (1993, p.49).

1983[37], a slowing down of the minimum wage increases, a setting of strict wage guidelines for the public sector and nationalised firms to initiate wage moderation, a relaxation of job security legislation, and a reduction in welfare and unemployment benefits. In addition, wage bargaining has been decentralised. Since the mid-1980s, many firms applied performance related pay systems to enhance relative wage flexibility. (Boyer 1994, p. 59) As a result, the wage / price spiral in France was stabilised, a major factor contributing to the convergence of French-German inflation rates. (Onofri and Tomasini 1992) The key development here is the gradual wage de-indexation of the 1980s. At the beginning of the 1980s, the impact of wage indexation on domestic inflation was almost instantaneous, but changed throughout the 1980s to become partial and lagged. (Artus and Salomon 1996, p.40)

Although these changes in structure and performance strengthened the sustainability of the French economy within the constraints of the ERM, there is little econometric evidence that they happened in response to ERM membership. As Artus and Salomon (1996) put it: "[i]t is commonly held that the EMS has had an influence on the French labour market, modifying the wage formation schema. We don't find ... evidence of such change." (p.54) With regard to the changes in wage indexation, they specify that it was not systemic factors, but domestic considerations which account for the change: "[d]omestic policy developments... seem to have proved more important in changing the mechanism of wage formation in France than the evolution of the functioning of the EMS." (p. 40) Even if there is no econometric evidence to link French wage performance and the EMS, the question remains whether domestic policy developments stem from strategic political choices influenced by the commitment of policy makers to the ERM. What were these domestic policy developments, how did they affect labour

[37]Though explicit wage indexation was forbidden by law, the majority of wages agreed through collective bargaining were de facto indexed to past inflation.

market structures, and how did they relate to the Franc Fort strategy?

The capacity of French policy makers to push through convergence towards the German system looks less impressive, if one considers wider structural reforms in labour markets beyond changes in wage behaviour. Whereas there is evidence of considerable structural reforms in the industrial and financial sector, evidence of structural changes in the labour markets in response to EMS pressure to converge towards Germany is weak.[38] This does not mean that the government did not initiate labour market reforms. On the contrary, the government attempted to change labour market structure in line with the German practice. However, the structural difference in French labour markets brought about a different outcome than expected.

The major structural changes in French labour markets which underpinned their more disinflationary and more flexible performance have been an unintended consequence of the Loi Auroux passed between 1982-86 at the initiative of the socialists. The Loi Auroux was intended to improve the bargaining position of employees and trade unions at the workplace level, in the face of a fragmented and weak trade union structure at the sectoral and national levels in France. The legislation stipulated the following structural changes: first, management was obliged to negotiate with trade unions at the firm level about wages and working conditions on an annual basis. Second, under narrowly specified conditions, these firm level bargains were allowed to undercut wage settlements agreed at a higher-level. Third, co-determination of the employees at the workplace was legally established, and fourth, the power of trade union representatives at the firm level was enhanced. (Altvater and Mahnkopf 1993, p. 161)

The interesting point about the Loi Auroux is that it was inspired by the German example of industrial democracy, and designed to overcome traditional French authoritarian labour market

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[38] On structural changes in industry see Boltho (1996, p.99) and Walsh (1994). On the reforms undertaken to create a more competitive financial sector based on the German credit-based system, and in response to growing international constraints, see Loriaux (1992).

structures associated with the power of *patronat* by increasing trade union representation and power at the firm level. This law can be interpreted as evidence of the influence of the EMS on political initiatives for labour market restructuring, and the French attempt to achieve structural convergence with the German economy. As Boltho (1996) put it, the switch to practices of German social dialogue was questionable since competitive disinflation requires an acquiescent labour force and weak unions. Emulating German structures for this purpose made little sense as German co-determination would not produce the expected result in the absence of the many other conditions which had shaped Germany's industrial relations. (p.100)

Paradoxically, what allowed the Franc Fort policy to succeed was the failure to emulate German labour market structure, in the face of the resilience of traditional labour market structures. What had not been foreseen by policy makers was the effect of the weak and fragmented nature of French trade unions. On the one hand, the laws eroded the influence of sectoral level wage bargaining, but on the other hand, they failed to strengthen trade union power at the firm level. As a consequence, as Howell (1992a) points out, the law produced greater labour flexibility at the firm level in the interest of employers. Given the more unified position of management against fragmented employee representation, the law resulted in a rapid increase in firm agreements to improve efficiency and undercut sectoral level wage bargaining. In other words, the consequences of the laws were opposite to their intentions. As Altvater and Mahnkopf (1993, p. 160) put it, ultimately, the Loi Auroux restored the power of *patronat* under conditions of greater flexibility. In other words, the French government embarked on the Loi Auroux with the intention of improving French labour market performance by establishing industrial democracy. The former objective was met but at the expense of the latter. France was unsuccessful in emulating German labour market structure and thus was not able to achieve structural convergence with the German labour market regime, which is able to both keep its competitiveness and embrace industrial democracy.

Overall, except for wage behaviour, the success of structural reforms in the labour markets motivated by the EMS constraints was very limited. Traditional French labour market structures asserted themselves against policy makers' determination for change. Strong political leadership which had been able to facilitate adjustment at the macroeconomic policy level was not enough to push through convergence of labour market structures. (Boltho 1996, p. 100) Domestic structure intervened between policy choices and policy outcomes. The French experience thus suggests that the choices of policy makers to implement adjustments in compliance with international monetary commitments face growing domestic constraints, the more domestic social institutions are affected. The importance of traditional social preferences is particularly strong in the highly sensitive and politically-charged area of labour markets.

1.7.2.2. Italy

Italy, even more than France, represents a case of political elites choosing to take advantage of the external constraints imposed by EMS membership (*vincolo esterno*) to push through domestic structural adjustment. (Dyson and Featherstone 1996) Yet, unlike France, Italy did not have a comprehensive macroeconomic strategy to undertake economic reforms pro-actively as it lacked consistent and strong state leadership and ability. The technocratic elites' aspiration for domestic structural reform was confronted by continuous inflationary deficit spending rooted in the nature of Italy as a 'weak state' (*partitocrazia*), and the resilience of Italy's traditional inflationary wage bargaining system. (Walsh 1994) Hence, relative to the French case, Italy's policy actions remain re-active, aiming to defend the exchange rate pegs within the ERM. The expulsion of Italy from the ERM under speculative pressure in 1992 demonstrated that the use of *vincolo esterno* did not bring about a comprehensive enough adjustment in the Italian economic structure to underpin a sustainable position for the Italian Lira in the ERM.

Like France, Italy was a founding member of the EMS, but given the fundamental weaknesses of its economy, it joined the ERM within the broad band of ±6%. The structural weaknesses of the Italian economy which led to persistently higher inflation rates than in Germany, forced Italy to devalue the Lira six times between 1979 and 1990. Nevertheless, in January 1990 the Italian government decided to increase *vincolo esterno* by moving to the narrow ±2.25% fluctuation band, although Italy's inflation rate for 1990 was still 3.4% above the German rate[39]. In September 1992, Italy's membership of the EMS had to be suspended under the pressure of speculative attacks, but the continued commitment of political elites to the ERM and to the project of the EMU allowed Italy to rejoin the ERM with effect from November 1996. Consequently, Italy was able to qualify for original membership of the single currency, demonstrating sufficient inflationary and budgetary convergence in 1997. Overall, Italy only managed in the immediate period before its entry to EMU to bring its fundamentals in line with the requirements of the single currency. The speculative attacks of 1992 bear evidence to the fact that at least until the beginning of the 1990s, *vincolo esterno* had not achieved sufficient convergence of Italian fundamentals to the levels of France and Germany. Attacks have consequently been interpreted in the case of Italy as being caused mainly by competitiveness problems[40].

It has to be noted that the Italian political commitment to the EMS and EMU never

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[39]Table 25 of Statistical Annex of European Economy. European Economy June 1997. For details on the realignment of the Lira within the EMS, see Tsoukalis (1997), table 7.2., p. 147.

[40]E.g. Fratianni and Artis (1996).

weakened, despite the setbacks of 1992. The political strategy underpinning this commitment was the decision by the Italian technocratic elites to use *vincolo esterno* to impose discipline on the state's economic and monetary policies, in the face of *partitocrazia.*

> The '*vincolo esterno*' involved a particular version of a two-level game: here the domestic 'reverberation effects' were of prime importance. EC-level developments and commitments were used by Italian elites to restructure the domestic policy process, thereby revising the balance of power between key actors and opening up new opportunities for policy reform at home. (Dyson and Featherstone 1996, p. 291)

On the agenda of domestic reform brought about by *vincolo esterno,* two structural and institutional changes feature prominently: i.e., the 'divorce' of the Bank of Italy from the Treasury between 1991 and 1994 and the gradual erosion and final abolition of the *scala mobile,* the Italian system of wage indexation, by 1993[41].

In respect to the question of how domestic structure intervened with the strategy of Italian elites taking advantage of external pressure to push through domestic reforms, the long process of removing the *scala mobile* is particularly illustrative. The *scala mobile* was the main labour market related cause for persistently high inflation in Italy throughout the 1980s and into the 1990s[42]. Though wage indexation was dismantled completely in Italy only in 1993, the government tried to reduce its influence earlier. A peculiarity of the three-yearly rounds of wage bargaining in Italy emphasised absolute rather than proportional increases in wages, which defended the purchasing power of workers over the duration of the contract by comprehensive wage indexation. The *scala mobile* was widely believed to be a prime cause of inflation inertia in Italy. The Bank of Italy estimated the proportion of wage changes caused by the *scala mobile,* which was 60% in 1975 and 80% in 1978. (Barrell 1990, p. 68) Not only did backward-looking

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[41]See Walsh (1994), p. 254-56, and Dyson and Featherstone (1996), p.292.

[42]The other main cause being the inability of the Italian state to bring excessive public deficits under control.

wage indexation increase the inertia of wage inflation, it also led to real wage inflexibility, thereby making it difficult for the economy to adjust to real shocks. In other words, the *scala mobile* raised the cost of disinflation, and made it difficult to absorb these shocks by distorting the efficient allocation of resources.[43]

With the joining of EMS, the Bank of Italy slowly managed to gain credibility, which made it possible for the government to address the problem of *scala mobile.* Yet, it was a painstakingly slow process. In 1983, it was modified to reduce the degree of indexation from 1 to 0.85. The government set, by decree, a ceiling to limit wage indexation to one year in 1984. This was a minor change and the measure by itself should not have become significant. Yet, the opposition and militant unions called for a national referendum and were defeated. This defeat, in combination with the display of firmness of the government's policy commitment, began to affect expectations far more than the measure itself. Given the fact that it took six years after the start of the EMS to be able to observe significant changes in labour market behaviour, EMS membership alone was not enough to change the expectations of the price-setters instantaneously. Rather, as Giavazzi and Spaventa (1989) put it, successive Italian governments had to prove the firmness of their policy commitment by being prepared to bear the cost of the unpopularity of a disinflationary strategy. Only then price-setters perceived the new monetary targets as credible and lasting, thereby changing expectations and behaviour in the labour markets. In 1985, the frequency of the adjustment was reduced from quarterly to bi-annually. In addition, the indexation rules were modified so that only those with low wages were compensated fully. The wages above that level were either partially indexed or not indexed at all. In 1986, a new indexation clause, a mild degree of indexation exhibiting wage elasticity of 0.5 lasting until 1991, was agreed. The government tried to abolish the *scala mobile* in summer

[43]For more detail, see OECD (1986a).

1990, but failed due to trade union pressure.

The *scala mobile* was finally abolished in 1992-1993. After long negotiations in July 1992, the government, trade unions and the employers associations reached an agreement, the "Income Policy Agreement". This agreement established the definitive abolition of the indexation mechanism. The agreement also set guidelines for a comprehensive reshaping of wage bargaining processes to improve the coordination of bargaining at different levels. This was a complementary but important measure because, in the past, the lack of coordination exacerbated the inflation inertia caused, predominantly, by the wage indexation mechanism. Furthermore, it represented the beginning of a structural shift in wage bargaining relations, with the six most important employers organisations and the three large trade union confederations agreeing to complement central wage bargaining with regional and sectoral wage bargaining contracts over longer periods, modelled on the example of Germany. (Altvater and Mahnkopf 1993)

The drawn-out processes of adjustment in the labour market regime under the pressure of *vincolo esterno* contrast with the relatively fast and successful divorce of the Bank of Italy from the Treasury. This divorce starting in 1981 increased the autonomy of the bank to determine the money supply independently of the inflationary policies of the Treasury[44]. As Walsh (1994) emphasises, although this divorce allowed the Italian central bank to give priority to the defence of the exchange rate commitment under the EMS, the strategy was undermined throughout the 1980s by the government's inability to control inflation and fiscal deficits. (p.254)

What explains the varying degrees of success of the Italian technocratic elites to push through the strategy of domestic reforms in the financial and labour markets by making use of the ERM constraints? It is here that attention has to be paid to the different fashion in which the

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[44]Goodman (1992) p. 181. For a detailed description of the steps taken to divorce the Bank of Italy from the Treasury, see Walsh (1994), p.255-56.

respective domestic structures intervened: financial and labour market structures imposed different degrees of constraint on the capacity of policy makers to push for change. In the case of the divorce of the Bank of Italy, relatively quick and comprehensive adjustment was possible because the area of central banking was atypical for Italian policy making mechanisms insofar as it was controlled by a small group of senior civil servants in a core executive strongly committed to the ERM. (Dyson and Featherstone 1996). Furthermore, as Helleiner (1995) explained, the technocratic nature of financial reform has low domestic political visibility and thus faces comparatively little domestic resistance (pp.203-05). *Vincolo esterno* was sufficient to push through the divorce. There was consensus among technocratic elites to make the Bank of Italy an efficient political agent for economic soundness in the Italian political system that was inefficient overall. In contrast, the reform of the *scala mobile* touched upon deeply-ingrained institutional patterns of labour market behaviour embedded in civic society, with a high public profile. In addition, it was strongly defended by the militant trade union movement. Consequently, the structural resilience of the wage bargaining pattern was very high. In fact, until 1992, *vincolo esterno* was only able to change the *scala mobile* in a piecemeal fashion. The structure itself stayed essentially intact, and remained a key factor behind the unsustainable inflationary performance of Italy until 1992. *Vincolo esterno* was only able to break up domestic labour market structures with the shift to the EMU project in the early 1990s. As Carli notes, "the Italian *classe politica* did not realize that by agreeing to the (Maastricht) Treaty, it put itself in the position of already accepting a change of such magnitude that it would hardly leave it unscathed[45]." It took three factors to achieve a breakthrough in domestic labour market reform: first, the comprehensive crisis of the Italian political system, second, its consequent transformation by the technocratic elites (silent revolution), and third, an increase in external

[45] Quoted in Dyson and Featherstone (1996, p. 277).

pressure due to Italy's desire to be a first round member of EMU. As Walsh (1994) asserts, the Italian case shows how much the capability of policy makers to use external pressure to facilitate domestic reform is contingent on domestic structures. The weak structure of the political system and the traditional labour market structure in Italy brought about the only mixed success of *vincolo esterno.* Until the mid 1990s, Italy was not able to create a coherent domestic structural framework to sustain exchange rate stability in the ERM: it was solely dependent in its defence of the exchange rate on the central bank. (Walsh 1994, pp. 254, 257) The Italian experience thus underlines the importance of domestic structures and in particular labour market structures as an intervening variable in the strategy of adjustment.

1.7.2.3. Conclusion

The close examination of the French and Italian cases suggests that EMS membership, among other factors, directly or indirectly affected the changes in their domestic economic structures, but policy makers had difficulty in achieving the desired outcome and / or swift results in labour market reforms. These cases demonstrate the importance of domestic structural analysis as the foundation of any assessment of the capability of policy makers to push through economic reform as a consequence of commitments to international monetary cooperation. Following the logic of the two-level games, the policy makers' ability to use external constraints to achieve adjustment of domestic structures was itself constrained by the resilience of the domestic structures themselves. Although, as Walsh (1994) observed, domestic structures are not entirely static but change in response to their environment (p.258), external pressure alone is not a guarantee for a smooth and rapid restructuring. As a comparison of France and Italy shows, if domestic structures featured a substantial level of compatibility with the systemic requirements of the ERM, a policy strategy built around an exchange rate commitment brought about a considerable degree of economic convergence relatively smoothly. Onofri and Tomasini (1992) argue in this respect as follows:

> France, in taking EMS discipline seriously, was able to converge to German performance without the EMS exerting a crucial role, but ... Italy was inconsistent in her attitude to EMS discipline, and reached partial convergence mainly because of the effect exerted by EMS. Of course, having one's hands tied is more useful for undisciplined people than for disciplined ones! (p. 96)

Applied to the EMU project, this means that if countries do not have domestic structures, and in particular, labour market structures supporting domestic price discipline, the constraining effects of the monetary union do not by themselves guarantee full and immediate convergence of domestic structures towards a stability culture. Existing domestic labour market structures have to be taken into account as a crucial intervening variable when it comes to the question of what the capacity of policy makers is to turn monetary union into a success.

In both the cases of Italy and France, policy makers faced substantial constraints in their push for structural reform, particularly in the politically-sensitive area of labour markets. On the other hand, the differences in labour market behaviour in France and Italy, in comparison with Germany, were one of the main causes for the sustainability problems these two countries faced under the ERM. The lesson for EMU is that the greater the structural differences between nations are in their politically-sensitive labour market regimes, the greater the challenge policy makers face. The contribution of this thesis, the investigation of structural differences of present national labour markets, points to the structural policy challenges lying ahead for Eurozone policymakers.

Chapter 2

Review and critique of the literature analysing monetary union

Having pointed out the importance of domestic structural analysis in Chapter 1, this chapter surveys different approaches taken by different disciplines dealing with EMU or being relevant to the analysis of EMU. The chapter aims to identify the strengths and intellectual weaknesses of existing studies. By discussing the advantages and limitations of different view points, I argue for the need to introduce a political economic approach with structural connotations.

EMU is a subject covered exhaustively by social scientists. Irrespective of the convergence criteria set by the Maastricht Treaty, many economists have studied the degree of European economic convergence, resulting from the European Monetary System. Generally, these works deal with quantifiable nominal convergence, namely, inflation and interest rates.[1] These empirical studies often lack political economic perspectives. Most work done by political scientists deal with the political process of European integration, its history and the development of the single market.[2] However, there have been remarkably few studies done by political scientists on EMU that deal with the issue of structural sustainability of EMU as a monetary and economic zone.[3]

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[1]For example, see a number of articles in Barrell ed. (1992), Collinion ed. (1994) Artis and Ormerod (1994), Blass and Foster eds. (1992), Gros and Thygesen (1992), Commission of the European Communities (1989).

[2]Among recent works, see Tsoukalis, L. (1997), Guerrieri, P. and P. Padoan (1989), Moravcsik, A. (1991,1994), Garrett, G. (1992).

[3]Few exceptions which touched upon the structural elements are: Pauly, L. (1991-2), Garrett, G. (1994), Woolley, J. (1994), Martin, L. (1994), Cohen, B. (1994), W. Sandholtz (1993). However, their analyses do not go beyond the monetary structure.

Methodologically, economists tend to quantify thus focus on issues related to quantifiable variables, and political scientists focus on the political process of reaching a certain policy outcome such as the Maastricht Treaty. The majority of economic implications for EMU has been studied using cost benefit analysis based on the theory of optimum currency areas.[4] I shall, furthermore, introduce the approach taken by economic historians, as they make interesting attempts to parallel historical monetary union experiences to today's EMU. Though much of the literature has hinted at the importance of structure, none has provided a constructive and comprehensive theoretical framework to examine the labour market structure in the context of monetary union. After surveying the literature, I shall present an alternative theory in Chapter 3, by using the French regulation school.

2.1. Perspective of political scientists/economists

Studying amicable conditions for monetary union is traditionally not the strong-suit of political scientists or political economists. Indeed, until the 1990s there was a lack of analysis on international monetary affairs by international political economists. They tended to study trade, rather than monetary and financial issues. Only a small number of scholars, notably Strange (1971, 1986, 1988), Calleo and Strange (1984) Cohen (1978, 1993), Frieden (1987), Block (1977), Walter (1991) contributed to the political economic analysis of international money and finance.

However, in the 1990s, as international finance became more pivotal, more works

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[4]One Market, One Money: an Evaluation of the Potential Benefits and Costs of Forming an Economic and Monetary Union, (European Economy no.44, October 1990) the official study by the European Commission, suggests rather marginal direct benefits, although it also suggests potential indirect benefits, such as microeconomic efficiency, and increased leverage in international policy coordination processes.

analysing the issue were published. There are two camps of scholars in international political economy who subscribe in the different level of analysis: those who predominantly take systemic approaches and those with domestic approaches. The most traditional thesis in the former approach is the theory of hegemonic stability (HST), which deals with the management of the international economic system. Though it has not been applied to monetary union, it has been applied to analyse systemic stability of international monetary systems, notably by Kindleberger (1986), Eichengreen (1989) and Walter (1991).

2.1.1. Theories focussed at the systemic level of analysis

The HST was developed by Kindleberger, who argued that a properly functioning world economy requires a leading economic power (a nation state) to provide the public good of international financial stability. He specified the five functions of a hegemon as follows: first, providing a relatively open market for distressed goods, thereby reducing the threat of protectionism in the world economy; second, providing counter-cyclical liquidity to secure stable long-term lending to the rest of the world; third, providing a relatively stable system of exchange rates by prohibiting competitive devaluations; fourth, coordinating macroeconomic policies; and fifth, ensuring political order through military preeminence. Though it is questionable whether hegemons - Britain during the Classical Gold Standard, and America during the Bretton Woods system - satisfied these five criteria[5], the HST leads to the conclusion that a system where power is asymmetrically distributed with the presence of a strong and influential hegemon is more stable than a symmetrically organised system. In other words, a system comprising countries with a clear hierarchy of power functions better than a system with a more symmetric distribution of

[5]For a thorough critique of the HST regarding British and American hegemony, see Eichengreen (1989) and Walter (1991).

power, according to the HST. Indeed, Kindleberger states that the decline of British hegemony accompanied by the lack of leadership by the emerging hegemon (America) in the 1920s and 1930s was the key factor which contributed to the disorder of the world economy in the interwar period. I shall take account of these assertions when I examine historical monetary unions - Latin Monetary Union and Scandinavian Monetary Union - in chapter 4.

The more recent approaches can be summarised as follows: Articles in Corbridge, Thrift, and Martin (1994) approach several issues related to global finance from the geographic structuralist perspective. Cerny (1993), Helleiner (1993), Gill (1993), Underhill (1993) provide a structurationist/structuralist framework to analyse the international finance. Contributors in Bonefeld and Holloway (1995) analyse global private finance from the Marxist point of view. In addition, Epstein (1996) presents a realist analysis of the international credit regime. However, these studies generally touch on the issue of EMU as a response to cope with the globalisation of finance.

2.1.1.1. Integration theories

Regarding Europe, the traditional area of expertise of systemic analyses lies in studies applying integration theories. Since the 1950s, they have analysed the integration process of the European Community. There are two systemic analytical frameworks developed in integration theory: functionalism, and neo-functionalism. Functionalism was developed by Mitrany (1943). He argued that as economies become transnational, the need for the creation of transnational "functional agencies" arises to resolve transnational problems. Such functional agencies "determine its appropriate organs". (p.35) Through such integration processes, nation states would lose their power and meaning of existence. Mitrany speaks of an international civil service which would provide public services, instead of individual governments, as their differences in ideology are the cause of conflict. This extremely idealistic picture of the world ignores the political elements in decision-making on both the national and transnational level. This is, indeed, a serious flaw in the theory.

Haas (1958) criticised Mitrany's framework of functionalism by presenting an alternative, neo-functionalism. Haas provided the framework for *political* integration, that is for an integration process which is not "functional" in Mitrany's sense. Neo-functionalism explains integration processes through spill-over effects. The neo-functionalists define political integration as a process in which political actors are persuaded to shift the focus of their expectations, activities and loyalties towards a new supranational governmental institution. Rather than transferring sovereignty to transnational organisations (as fuctionalism suggests), neo-functionalism believes that integration proceeds by the pooling of state sovereignty. Though neo-functionalism starts from a critique of functionalism, it shares largely the same philosophy. Neo-functionalists suggest that the process of integration is inherently expansive, following a functional logic, thus containing automatic spill-over elements.[6] This theory was popular in the 1960s and the early 1970s among liberal academics. Since then, however, it has lost its popularity in international political economy.[7] Since the development of integration theories were closely connected to the real development of the European Community, its apparent stagnation in the 1970s may be the reason behind the decline of the theory. (Mutimer 1994, p.37) Neo-functionalism would argue that the logical step forward after the completion of the single market is monetary union.

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[6]For more details of the theoretical definition of neo-functionalism, see Haas (1958, 1964) and Lindberg (1963).

[7]Even the prime author of neo-functionalism, Haas, states the obsolescence of the theory in his article published in 1975.

2.1.2. Theories incorporating domestic level of analysis

With the passing of the Single European Act in 1986, the European project moved to a new level in the integration process. Along with this trend, political scientists provide a new approach to theorise integration by focussing on intergovernmental bargains. (Keohane and Hoffmann 1991) Criticising neo-functionalism as an idealistic pre-theory, Moravcsik (1994) endorses a version of positivist neo-realism, called intergovernmentalism. Intergovernmentalism is an attempt to add a domestic level of analysis in the European integration process. It denies that spillover effects in supranational action (such as in the European Community) are a decisive force behind the steps towards integration (such as the Single European Act). Instead, it argues that intergovernmental bargaining is the central driving force for integration. Intergovernmentalism attempts the combination of two levels of seemingly contradictory decision making processes. On one level, domestic preferences are formed in accordance with the liberal theory (focussing on state-society relations, though within a pluralist framework). On another level, interstate negotiations reflect such domestic factors. The study of bargaining among rational governments is the focus of the analysis at this stage, which Moravcsik interprets as an attempt to reach a compromise. His positivist logic shares concepts with game theory (in this case, the two-level game model).[8] As his model identifies only two distinctly different stages of a bargaining game, it is weak in capturing complex reality. Interest coalitions can spread across domestic and international levels. Domestic positions are not always decided prior to intergovernmental negotiation, and, furthermore, they can change over time.[9] Despite the flaws,

[8]The two-level game approach which has gained prominence in rationalist international political economy focusing on the interaction of the domestic and the systemic level has been introduced by Putnum (1988)and elaborated by Evans et al. eds.(1993).

[9]Another example using this theory is Sandholtz, W. (1993).

however, it is definitely the contribution of intergovernmentalism to have introduced the domestic politics of the member states into the study of integration processes and to have attempted to integrate both the systemic and the domestic level of analysis.

Milner (1997) further develops the methodology for the analysis of the interaction between the international and the domestic level and investigates the importance of domestic preferences and institutions in international negotiations. She develops the theoretical concept of two level games, applied by Moravcsik, by looking at specific domestic institutions in a more systematic manner. However, her selection and interpretation of domestic institutions is too narrow and rigid. Her choice of domestic institutions is influenced by her intention to gauge the relative power balance in domestic and international bargaining relationships, rather than to explain broader underlying structural patterns which influence the social preferences of a country.

Indeed, the explanation of a particular bargaining process rather than the rationale of integration became the main interest of empirical studies. Such studies highlight linkage politics, domestic power distribution, and transnational relations as explanatory factors for a particular transnational bargaining outcome. The linkage politics approach is the attempt to explain a particular outcome as a result of bargaining by linking two (or more) unconnected issues. Indeed, this is what Delors called hostage-taking behaviour, and seems to happen frequently in practice. Martin (1994) focuses on the issue of linking within the EU bargaining process as a way for member states to use such linkage "to gain the support of other states on which the latter have no other compelling interest. Since refusal to go along could jeopardize the broad array of benefits provided by the EC, linkages have increased incentives to cooperate"[9] (p.89-90) Garrett (1994) and Woolley (1994) argue that Germany accepted EMU in return for progress in political

[9]For example, Britain used linkage tactics to generate support from reluctant member states for economic sanctions against Argentina in 1982.

matters, in particular a common foreign policy. Linkage politics is a powerful way to explain the political process but is, on the other hand, merely a particular form of bargaining process analysis. It needs more sophistication to be developed fully as a theory.

The domestic power distribution approach is an attempt to explain international phenomena as a result of pressures from certain domestic economic groups. If a country takes a pro-EMU stance, it is because EMU improves the welfare of particular powerful groups within a country. Using this approach, very open economies should be most enthusiastic about EMU. Smaller countries in the European Union, such as the Benelux countries are most open and they are undoubtedly ardent promoters of EMU. Among the relatively less open economies in Europe - Germany, France, Italy and Britain - attitudes towards EMU are very different. The stance of powerful economic groups in the former three countries is generally pro-Emu, but those in Britain are split: whereas the big manufacturing sector is for EMU, the financial sector is very sceptical. This analysis is also fails to take account of public sentiment: British population is traditionally sceptical about the European project, and so are the Danish who live in a very open economy. Hence, with this approach, one can also understand only the partial picture affecting a bargaining outcome. This approach also tends to over-emphasize domestic concerns, ignoring systemic constraints, such as an internationally dominant ideology, or a change in the balance of power between market and state.[10]

Cameron (1995) studies the process leading to the Maastricht Treaty in order to determine whose influence is dominant in shaping the process. He argued that such dominance cannot be imputed to any national government, nor to the supranational institutions of the Community. Instead, it was exercised by a number of what he calls "transnational actors" (p.73), in particular, Karl Otto Pöhl and Hans Tietmeyer of the Bundesbank. He also states that the Community

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[10]For examples of studies using this approach, see Frieden, J. (1994) and Goodman, J. (1992).

institutions helped such transnational actors to facilitate their activities. He attributed the foundation of the strong influence of Pöhl and Tietmeyer to the particular domestic structure of the German polity. Due to its legal independence, the Bundesbank could articulate its unique position, whereas most EU central banks' stances were subordinate to their finance ministries.

Like Cameron, Dyson (1994) emphasises the role of policy actors in the European integration process and in particular EMU. However, unlike the mere bargaining process explanations mentioned above, and like Moravcsik's intergovernmentalism, Dyson made a conscious attempt to theorise the European integration processes. Central to his thesis is the application of "policy learning" (Heclo 1974) to the EMU process:

> Policy is a learning process in the sense that specific policies have their origin in, and derive their character from, specific historical events to which they are a response; and in the second sense that policy makers are continually needing to relate new ideas and information to the accumulated experience of policy and decide what kinds of adjustments to policy are required. Propelling this learning process are the dynamics of structural change in the international political economy; these dynamics are expressed in the historical events and new ideas and information that affect policy development. But the idea of policy as a learning process points to a 'self-reinforcing' dimension in policy change. (p. 92)

Such policy changes are executed through bargaining in accordance with the two-level policy process, as Moravcsik has argued, where the will and capability of policy actors are shaped and constrained by structural power[11], i.e. the embeddedness of decision-making in the structures of the national and international political economy. Structures influence and define the framework of bargaining relations in Europe. By putting policy learning and transfer at the centre of his thesis, Dyson manages to capture the dynamism of the EMU process, as "a process whose policy outcomes and end effects cannot be fully predicted but which is neither random nor chaotic in its development." (1994, p. 17) His encompassing analysis enables him to explain negotiation

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[11]For a definition of the political and economic controls over the international system, which constitute the sources of structural power, see Dyson (1994), p.15-16.

processes, resulting outcomes and structural change *ex-post*. However, it has to be complemented by explanations focussing on where the need for policy adjustments comes from, i.e. by explanations concerned with the question of structural differences.

As Tsoukalis (1997) put it, "EMU is a major political issue, because of its wider economic ramifications and also because it touches the very heart of national sovereignty." (p.163) Thus, the analysis of bargaining and policy processes makes an important contribution to the understanding of the EMS / EMU process and the corresponding structural changes coming with it. This was addressed in Chapter 1, where the influence of the EMS on member states was discussed. However, this literature is inadequate when it comes to questions regarding structural differences in domestic economies, which require for structural change. For example, it cannot answer why certain countries could and others could not manage to transform their economic structures sufficiently through the EMS processes of borrowing credibility and were thus able to defend their ERM peg in the face of exchange rate crises. The reason for the French ability and Italian inability to survive the ERM crisis of 1992-93 can only *fully* be explained by taking into account the structural differences in their economies, in addition to policy commitment and state capacity. Hence, the political literature can be improved by incorporating a more comprehensive structural perspective: it would enable us to gain a better understanding of the dynamic interaction between structure and the need for policy intervention. Looking into structure enables students of International Political Economy to identify *ex-ante*, the area of policy intervention needed to bring about structural changes.

2.2. Perspective from economic historians

Economic historians have certainly studied structure, since history generally provides the opportunity to examine wider areas of activities than is the case for economics or political science/economy. There are a number of works which study historical monetary regimes in an attempt to answer the questions surrounding the EMU project. These works, however, mainly focus on monetary structure, especially monetary management, by examining the working of central banks. Most of them do not study broader socio-economic conditions and structure in relation to the working of monetary unions. Certainly it is difficult to collect statistics for the 19th century, because they are either not available or not compatible with present statistics. Panić's work (1992) is the only solid study which compares the gold standard with the European Monetary System (EMS) in this respect. In Chapter 4, I shall attempt a similar comparison of the EMS/EMU with the Latin Monetary Union and the Scandinavian Monetary Union.

Other economic historians examine monetary unions of the 19th and 18th centuries to find lessons for the current EMU project. They study the Latin Monetary Union, the Scandinavian Monetary Union, the German monetary union, the Italian monetary union, the early American monetary union and so on. Some studied a historical monetary union in detail in the light of its monetary management etc., and some briefly surveyed many monetary unions in history to extract the essence of their success or failure. The latter approach was taken by Cohen (1994), Graboyes (1990), and Bartel (1974). Their works are useful in singling out some common features among historical monetary unions. By doing so, one can determine factors which led to their success or collapse. Examining the New England, Latin and Scandinavian Monetary Unions and the East African Currency Area, Graboyes (1990) argues that the over-issue of money is the catalyst behind the collapse of monetary unions. The money supply of the New England monetary union was restrained by Massachusetts, the Latin and Scandinavian Monetary Unions were restrained by the metallic standards, and the East African Currency Area was restrained by convertibility within the Sterling area. In all these unions eventually the influence of such an external regulating standard, i.e., "the depoliticizing factor, disappeared, leaving the individual political justifications free to determine their own money supplies... Members preyed on their partners by issuing excessive amounts of money, which union members were forced to accept." (p.14)

Perlman (1993), Milward (1996), Lester (1939), Sannucci (1989), Fratianni and Spinelli (1984, 85) Holtfrerich (1989), Miron (1989), Eichengreen (1992), Rolnick, Smith and Weber (1994), and Sheridan (1996) take the former approach, and study the Latin Monetary Union, the Scandinavian Monetary Union, the Italian Monetary Union, the German Monetary Union, and the American Monetary Union in detail. Among these monetary unions, the Latin Monetary Union as well as the Scandinavian Monetary Union attempted monetary union without political union. In this respect they resemble the current European monetary union. Thus, these two monetary unions will be studied further in Chapter 4. Apart from these two unions, the American monetary union and the German monetary unification of the 19th century make for an interesting comparison with EMU. The haphazard development of the American monetary system and its background will be analysed in detail in Chapter 5.

2.2.1. German Monetary union

The case of German monetary union is another interesting case to study due to its unique origins. The economic integration of the German states started with the establishment of the Zollverein, the customs union in 1834. It started with Prussia, the Hesses, Bavaria, Wüttemberg, Saxony, and the Thuringian States, but expanded its membership in 1842, 1854, 1867. Its administration was taken over by the newly established Deutsches Reich in 1871. After 1867, the customs administration for collecting duties was streamlined to give more power to the central Zollverein institution.[12] On the other hand, Prussia reinforced its predominant position in the Zollverein. It held nearly a third of votes in the Customs Council, which gave Prussia the power of veto. It signed commercial treaties with other countries on behalf of the Zollverein. This powerful position of Prussia in the Zollverein was based on its exceptional economic power. According to Henderson (1939), Prussia accounted for nine-tenths of the production of the mining and metal industries, half of the textile factories and two-thirds of the workers employed in Germany's big industry. (p.318)

Such enormous industrial predominance and economic hegemony came hand in hand with an intensification of political hegemony. (p.318) The Seven Weeks War between Austria and Prussia broke out in 1866. This caused the Germanic Confederation (Deutscher Bund)[13], an Austrian-led political confederation established in 1815 among 35 principalities and 4 free cities on German territory to collapse. The rivalry between Prussia and Austria was a persistent problem for the Zollverein, as southern German states tended to follow Austria's lead. The victory of Prussia over Austria decisively established its political hegemony, and heralded a new organisation of German states outside the Austrian Empire. Saxony and the South German states fought with Austria, but did not lose any territory, as Bismarck calculated on their support in case of war with France. Napoleon III's ambition for German territory was well-known by then, which caused the South German States, Saxony and Hess-Darmstadt to enter into a military alliance with Prussia. (Henderson, p.308)

The Zollverein served as a precursor of industrialisation and the political union of 1871. Before then, the Deutsche Bund had removed all restrictions on the migration of citizens in 1815.

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[12] Custom inspectors, who up to then had been civil servants of separate states, then became Zollverein officials in their own right.

[13] The Deutsche Bund was established after the collapse of the Holy Roman Empire during the Napoleonic wars in order to stabilize the restoration of the old order in Germany.

As in the current case, the diversity of monetary conditions such as different denominations, silver-content in coins, and different monetary standards - the Thaler standard in Northern states, and the Gulden standard in the Southern states and Austria, was an obstacle to free trade. Indeed, an article in the Zollverein Treaty specified that member states should standardize their coinage system. (Holtfrerich p.221) Following the treaty, there was the Dresden Coinage Convention in 1838, where fixed exchange rates between the Thaler and the Gulden was established. This could be seen as the equivalent to the EMS in the current situation. Money supply was subject to the silver standard. After the Vienna Coinage Treaty in 1857, Prussia established decisive hegemony in the monetary system of the Zollverein. Austria, though outside the Zollverein, linked its coinage to the Thaler and the Gulden. What was more important was that "the Southern German Gulden states thereafter minted more than 90% of their full-value silver coins in the Thaler Vereinsmünze (union coins) and less than 10% in Gulden state coins." (Holtfrerich, p.224) Thus, one can conclude that the Thaler was steadily building its position before the establishment of the Mark as a single currency. The decisive step towards the single currency was taken after political union in 1871. Monetary union followed political union, with the establishment of the Reichsbank in 1876.

One of the lessons Holtfrerich (1989) draws from the monetary unification process in 19th-century Germany for the present EMU process is that it is problematic to attain considerable monetary unification prior to political unification.[14] It is certainly possible to establish monetary union without political union. There was no political union in the case of the Latin Monetary Union and the Scandinavian Monetary Union. However, these unions were short-lived. Indeed, the lasting large scale monetary unions in history have been accompanied by political unification

[14]The same point was made by Goodhart (1995).

prior to monetary union, as in the case of Germany, Italy and the United States.[15] Following this line of argument, EMU may not be long-lasting without the achievement of a deeper level of integration, in particular, political union. Yet, political union without the presence of legitimacy is also risky as the case of American monetary union reveals in Chapter 5.

What would be very interesting to investigate, but is not clearly analysed by him or other scholars of the German Monetary Union is "the degree of economic integration achieved by the formerly independent German states during this period prior to monetary unification." (Siklos p.13) The same criticism holds for most of the works introduced here, studying other monetary unions. They often focus on monetary structure such as the organisation of banking, the mechanism for the control of the money supply, the degree of 'independence' of the central banks (or how depoliticized they are), in order to draw lessons for the new European central bank. I shall attempt to fill some of the gaps for two 19th century European monetary unions in Chapter 4, and for the American monetary integration before the Civil War in Chapter 5 by trying to incorporate wider socio-economic structural factors.

2.3. Perspective from economists

There exists a vast economic literature on EMU. I will review in this context the main theories which foster an understanding of structural factors. The debate about convergence, an issue with which many economists are concerned, was covered in detail in Chapter 1.

2.3.1. The theories of 'Sound Money'

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[15]The exception would be the CFA Franc Zone in Africa. But this case is unique because of its inheritance of French colonial arrangements.

Both the theoretical debate and the policy process of EMU are centrally concerned with the issue of sound money. Sound money can be described as the priority of maintaining the value of the currency through long-term low inflation. Crucially linked to the concept of sound money is the issue of credibility and time inconsistency: how can a credible and consistent monetary policy framework be established to provide the conditions for sustainable price stability? The theoretical foundation of 'sound money' comes from monetarist ideas represented by the writings of Brunner and Friedman[16]. The debate around how to achieve sound money is centred on macroeconomic fundamentals. Central bank independence is considered the best way to achieve price stability, hence a pre-condition for joining the single currency in the Maastricht process. Furthermore, the problem of inflationary deficit spending has been addressed in the Growth and Stability Pact. In Europe, both the intellectual and practical proponent of the concept is the German Bundesbank, which has comprehensively influenced the constitution of the European Central Bank. (Giordano and Persaud 1998) Economists focus mainly on the immediate implication of the concept, i.e., its monetary and to a lesser extent fiscal implications[17]. They also address supply side measures like the deregulation and flexibility of labour markets, but only in their policy recommendations. What is lacking is the analysis of differences in domestic structures of EMU countries, despite the fact that the sustainability of sound money has structural implications beyond the structure of the ECB. A broader framework is needed for an understanding of these wider structural implications. This can be demonstrated by the issues of credibility and central bank independence.

2.3.1.1. Credibility

[16]See Dyson (1994), p. 233.

[17]Fiscal implications were discussed in detail in Chapter 1 in the debate on the fiscal criteria of the convergence criteria.

The concept of credibility has been widely used since the 1980s. The concept, based on the rational expectations hypothesis, was operationalised in the game theoretic framework of "time inconsistency" (Kydland and Prescott 1977, Barro and Gordon 1983), i.e., the problem that an optimal policy calculated at the beginning of a planning horizon does not continue to be optimal at a later stage. Such inconsistency results from the forward-looking behaviour of private agents and the inability of policy makers to pre-commit themselves *credibly* to announced policies. Consequently, the greater the credibility of the central bank's commitment to an anti-inflation policy stance, the lower the costs of disinflation: credible monetary policies lead private agents to change their expectations and behave on the assumption that they will not be cheated by authorities on the commitment to low inflation. In other words, economic policies are more effective if they are credible to private economic agents.

Following this argument, by becoming an EMS member, an inflationary country can borrow credibility and reputation from the Bundesbank, which makes it easier for it to fight credibly for disinflation. (Giavazzi and Pagano 1988) With the presumed credibility bonus, it can reduce the unemployment costs of disinflation. By successfully sticking to the pre-commitment, the government and central bank can acquire reputation, which makes it easier to fight inflation in future.

Several economists tested the credibility effect empirically by using proxy variables but the evidence generally remains inconclusive.[18] It is difficult to single out the disinflationary effect of ERM membership, as EMS countries and many other non-EMS OECD countries have

[18] C.f. De Grauwe (1992), Weber (1992), and Fratianni and von Hagen (1990), Cohen and Wyplosz (1989). Giavazzi and Giovannini (1989), on the other hand, confirmed the hypothesis in their empirical study. Yet, what is missing is a full and conclusive affirmation of the hypothesis, using the data of the 1990s.

been experiencing disinflation during the 1980s and the 1990s, influenced by the globalisation of finance, free capital mobility, and the new hegemony of neo-orthodox economic thinking.

The credibility hypothesis assumes an asymmetric functioning of the EMS, where the Bundesbank independently chooses its monetary policy while all other EMS members tie their hands on pursuing autonomous monetary policy. With the move towards EMU, two significant changes in the European monetary regime have taken place: first, the system moved to a more symmetric arrangement and second, the ECB, though modelled on the Bundesbank, is a new institution without any historical track record to underpin its reputation and credibility. With the old Bundesbank anchor gone, countries have to find alternative means to deal with potential inflation problems. The Maastricht convergence criteria and the Stability and Growth Pact were designed to deal with the fiscal causes of inflation, but do not address potential inflationary pressures emanating from the wage front as a result of the operation of national labour markets, or from the financial front, for example from asset or property price bubbles. Building on the borrowed credibility bonus of EMS membership, member countries may have changed their economic structures towards a less inflationary national economic regime, but it is beyond the capacity of the credibility hypothesis to analyse the nature of these structural changes.

Borrowed credibility must be used to implement fundamental adjustments in national structures, if it is to be sustainable. It cannot be borrowed forever. In the long-term, credibility has to be based on domestic structures which support price stability. The credibility of German price stability, which acted as an anchor for the EMS, has been based on specific German socio-economic structures. (Posen 1993, 1998, Jochimsen 1993) As to the structural underpinnings of credibility, the ECB is now faced with a completely new situation. Its credibility depends on the consistency of the economic structures of all member states with the goal of price stability. In particular, the difference between national wage-price processes and thus labour market structures poses an immediate challenges for the ECB. (Dornbusch et al. 1998) Without the corresponding structural changes, the policy commitment risks becoming *incredible* over time.

2.3.1.2. Central Bank independence

The hypothesis of central bank independence as a means of dealing with inflation brings a structural-institutional perspective to the credibility hypothesis. What has been debated is whether central bank independence in itself can provide the structural underpinnings for sustainable low inflation[19]. Often these arguments are used here to complement the argument on borrowed credibility: both credibility stemming from EMS membership as an agent facilitating structural change, and the credibility hypothesis based on central bank independence lead us to examine the structures necessary to produce a credible outcome. The leading economists in the field of the credibility effects of central bank independence come from the political economy school, represented by the theory of the political business cycles pioneered by Nordhaus (1975). The Nordhaus hypothesis asserts that elected politicians have an incentive to create inflation prior to elections to stimulate the economy and thereby engineer their re-election. Central bank independence is regarded as an institutional solution to this problem.[20] In other words, the ability of the central bank to conduct monetary policy free from government interference is an institutional requirement to achieve price stability. The Maastricht process has adopted this view and the independence of national central banks thus became a prerequisite for countries to participate in EMU.

[19]For comprehensive survey on the debate about central bank independence, see articles in Forder and Slater eds (1998).

[20]For detail, see Alesina (1989), Alegina and Grilli (1991) and Newmann (1991).

The hypothesis was refuted by Posen (1993, 1998) who studied the case of Germany. He argues that it is the relative power of interest coalitions against inflation in the financial sector, rather than the institutional structure of monetary policy-making, which determines inflation differentials among industrial economies. Similarly, Henning (1994) focuses on the preferences of private sector institutions. Like Zysman (1983, 1994), and Posen (1993, 1998), he believes that the relationship between banks and industry, i.e. the national financial structure, strongly affects the monetary policy stance of the private sector. (p.329) As Dyson (1994) put it, "the issue was not only one of institutional design but also one of the presence of a coalition of interests capable of giving the bank political protection and of a supportive economic culture that prioritizes stability". (p. 238) These studies point to the wider structural requirements for successful central bank independence, and are therefore highly relevant for the future of successful EMU. However, these studies focus on the financial structure in addition to the monetary structure. They leave out another important structure - the labour market structure. Rather than re-examining bank-industry relations, I examine national labour markets, which are a crucial factor in the inflation proneness of an economy[21].

Generally the weakness of the economic approaches surveyed is that they have limited ability to address the relationship between money and the structures in which money is used. An economic theory, which has provided a cost-benefit analysis that addresses this gap, is the theory of optimum currency areas (OCA). It is the only theory which deals *directly* with the issue of what kind of structures are required for "optimal" monetary unions. As my thesis deals with this question, the OCA will be reviewed in detail.

2.3.2. What is the theory of OCA?

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[21]The relations between wage bargaining systems and inflation performance will be elaborated in section 2.3.5.

The OCA theory proposes a number of criteria which are to be considered as the prerequisites of successful monetary unions. The OCA theory focuses on the opportunity costs of introducing a common currency: that is to say, the costs arising from the loss of the traditional means of economic adjustment - the exchange rate. The theory was first developed by Mundell (1961). He studied adjustment processes in response to a demand shift, using a two-region model with sticky nominal wages. McKinnon (1963) and Kenen (1969) added extra dimensions to the theory, by considering the openness of an economy, and the degree of product diversification respectively. Let us now define the theory developed by Mundell, as it is the basic framework of analysis as well as the focus of academic debate. Suppose a negative demand shock, such as a shift in consumer preference from certain goods produced in Britain to those produced in Germany. One strategy Britain may take in order to regain competitiveness is devaluation. This particular tactic has been used widely, with questionable results.

Now suppose Britain and Germany had a common currency. In such a situation, there are the following three ways to deal with the problem. First, instead of exchange rates, one has to manipulate relative prices through other means, such as nominal wages. As the demand shift induces more unemployment in Britain, it leads to lower wages in Britain and to higher wages in Germany. This would make output prices to increase in Germany and fall in Britain. In this way, the external equilibrium would be restored by Britain regaining competitiveness in the international market. Second, unemployed British workers could move to Germany where there are better job opportunities. Given such labour mobility, the British unemployment problem disappears, and the German wage inflation problem is solved as well. The last, a less orthodox means of adjustment involves inter-state transfers. Assuming a central fiscal authority exists along with a common currency, the tax structure would semi-automatically bring about redistribution. German workers would pay more tax because they earn more, and the British unemployed would receive more of central tax income in the form of unemployment benefits. In order to cope with excessive national income differentials, a more direct means, such as inter-state regional transfers can also be used. This has been the case within many nation-states as well as at the EU level. Some states, such as the United States and Germany, practice inter-state fiscal redistribution, with a built-in semi-automatic transfer mechanism from the richer to the poorer states.

In sum, the theory of OCA suggests that countries with economies that are prone to asymmetric real shocks and suffer wage and/or price rigidities should not form a common currency area, for they need the exchange rate as an instrument of adjustment. The exception to this rule applies to cases with a high degree of labour mobility or nominal wage flexibility to correct labour market disequibria, and/or fiscal transfers large enough to stabilize and equalize diverging incomes among member states. Europe has a poor record in all these respects, relative to the United States.[22] There is now academic consensus that Europe as a whole is not an OCA.

2.3.3. Operationalising the theory of OCA

Mundell (1961) and others provided the theoretical framework in the 1960s, but it was only in the 1990s that scholars widely undertook empirical studies to operationalise the OCA theory. These works were obviously encouraged by developments in the real world, particularly the movement towards EMU since 1989 through the publication of the Delors Report.

Most recent works by economists are highly technical because of the introduction of new

[22] For the details of the argument, see Eichengreen, B. (1992b) and De Grauwe, P. and W. Vanhaverbeke (1993).

econometric methods to estimate the degree of symmetry in disturbances.[23] As these technical contributions are not relevant to this thesis, they will not be discussed in detail. However, the results of such exercises are rather inconclusive. The original model by Bayoumi and Eichengreen (1992) shows a clear correlation of disturbances among the core counties, but not for countries in the periphery. The extension of their observations in their later work (1996) suggests that German reunification did not disturb the above result. Yet the extensions of their model by Chamies, Dessrres and Lalonde (1994) and Erkel-Rousse and Melitz (1995) show some results which contradict the original. In addition, the methodology of the original model itself has been heavily criticized by some econometricians. Thus, one can conclude that there are no decisive results arising from new technical developments to measure and predict asymmetric shocks among the current and prospective EMU states.

A more interesting result for my purpose is that empirics cannot prove that the correlation of EU countries' disturbances is considerably lower than in the case of existing monetary unions. For example, Bayoumi and Eichengreen (1992) find the correlation between US states only to be slightly higher than among EU core countries. De Grauwe and Vanhaverbeke (1993) suggest that asymmetric shocks to regions within EU countries are considerable, yet do not hamper the economic management of a single currency zone.[24] Though these results do not necessarily make the correlation indicator irrelevant, they suggest the presence of other factors which play a more important role in the success of monetary union. Let us then examine the empirical

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[23]. The standard model for estimating the correlation of supply and demand shocks was pioneered by Bayoumi and Eichengreen (1992), using an econometric method called a structural vector autoregression (VAR). A VAR is a system of two or more variables where each variable is related to lagged values of all of the variables in the system.

[24]This is because asymmetric shocks are most likely to hit regions within a nation state, which can still be partially dealt with by national fiscal policies with the presence of inter-regional labour mobility.

studies which focus on other indicators of an OCA.

Labour mobility was one of the prime concerns of Mundell, as well as the symmetry of disturbances. Blanchard and Katz (1992) show that rather than capital flows, labour flows among US states play a major role in the adjustment process of the US economy. Eichengreen (1993) and Decressin and Fatas (1995) compare regional labour market performances in European countries and in the US. Both reach the conclusion that interregional migration within European countries are much less responsive to the region-specific shocks than that in the US. The latter arrives at the following alarming results: whereas a region-specific shock in the US immediately induces interregional migration, most of the shocks in Europe are absorbed over years by changing participation rates. Negative real disturbances in Europe would, therefore, induce higher regional unemployment rates, rather than migration. Whether such higher regional unemployment rates persist or not is open to question. Eichengreen (1993), and Decressin and Fatas (1995) are careful in their conclusions. They see other mechanisms such as relative wage adjustment, interregional capital mobility, and government intervention also playing important roles in Europe to offset the limitations of regional labour mobility. These results imply that Europe as a whole and even core countries would be far from being optimum currency areas. Given the sluggish response of regional labour markets to idiosyncratic regional shocks within European countries, the adjustment to asymmetric shocks through labour mobility can be considered to be far from satisfactory. Another form of adjustment in the labour market would be through wage flexibility. This will be examined in detail in Chapter 8 on labour market flexibility.

Fiscal transfers - the last criterion - is another way to correct economic discrepancies caused by asymmetric shocks. The issue is debated widely by economists, but not by practitioners: even after EMU has come into operation, the very small size of the EU budget in terms of the EU wide GDP does not allow it to play a major stabilization or equalization role inside the EU.[25] In order to make this instrument work, there would have to be agreement on major reforms by national governments to increase the power of European institutions, which seems very unlikely. The central issue in the academic debate is whether there is a need for a centralization of fiscal authority to provide for an automatic redistribution and stabilization mechanism. In order to test the need for the centralization of fiscal policy, in other words, for fiscal federalism, scholars study the role of federal governments in federal states such as the US, Switzerland or Germany. Sala-i-Martin and Sachs (1992) show that approximately 35 to 44 per cent of the impact of region-specific shocks is offset by the federal tax and transfer system in the US. They did not, however, differentiate equalization from stabilization properties of fiscal policy. The former property absorbs and lessens persistent income differentials between regions and the latter plays a corrective role to dynamic changes in economic conditions, caused by, for example, idiosyncratic economic disturbances.[26] Bayoumi and Masson (1995) take account of this problem and find that the stabilization effect is, rather than the higher figures mentioned above, 35 to 20 per cent for the US, with the equalisation effect also being slightly smaller. Other estimations by the Commission (1993), Goodhart and Smith (1993), Pisani-Ferry, Italianer, and Lescure (1993) show significant effects on interregional equalization and stabilization. There is no doubt that fiscal transfers play an important role in maintaining monetary union. But it is still unknown whether they are absolutely essential to the working of the system or not. Bayoumi and Eichengreen (1996) argue that "fiscal transfers were likely to be more important the less

[25]Tsoukalis (1997, pp.209-22) makes the same point by looking into the EC's institutional constraints.

[26]One should note that these distinctions are not necessarily applicable to all fiscal and social policy measures. For example, income taxes and unemployment benefits are measures attempting both stabilization and equalization.

responsive was migration to regional wage and unemployment differentials; by implication, the absence of a system of fiscal federalism in Europe could be devastating, given the region's relative low levels of labour mobility." (p.13)

The more politically sensitive debate for Europe today is whether these function should be covered predominantly by federal institutions, or whether they can still effectively be maintained by national authorities. Sala-i-Martin and Sachs (1992), Goodhart (1995) and Krugman (1993) are the proponents of a federal fiscal authority, whereas Bean (1992), De Grauwe (1993), Eichengreen (1996), Kletzer (1995) and Alesina, Perotti and Spolaore (1995) are against it. Krugman (1993) takes the example of the US states, and finds that even in the US state governments do not use their budgets as a means of stabilization, because every state except Vermont has a balanced budget requirement. Thus, their fiscal policies move in a pro-cyclical direction, rather than a counter-cyclical one, as it would be needed for stabilization. The stabilization role in the US is largely through the automatic stabilisers in the federal budget. For this reason, Krugman (1993) deplores the lack of a large-scale centralized fiscal body in Europe. Following Kenen (1969), Goodhart (1995) believes that interaction between the monetary and fiscal policy domains is essential in order for them to operate effectively. He also points out some factors which are relevant with regard to fiscal federalism: first, the externality or spill-over effects of fiscal policy to neighbouring areas should be taken into account. In order to avoid negative overspill, fiscal coordination would be necessary. Here, some kind of centralized fiscal body would be useful. Second, with the deepening of economic integration, it would become difficult to have different national tax regimes. Third, some member countries would have to bear the full cost of asymmetric shocks or regional depression if there is no federal fiscal authority[27]. Fourth, and probably most interesting, centralization should be based on what he

[27]An argument against fiscal federalism is that it allows for financial bailouts of regions by the centre and therefore poses a problem

calls "social union, where people in a particular area agree that all of them should be treated alike." (p.468) However, in the EU, there is so far only minimum agreement on taxes and the provision of public goods. In addition, there is virtually no or very little feeling of common European citizenship and solidarity among European nationals. Unless the current situation changes drastically, there would be no political consensus to push through centralization. Or the central fiscal authority, if established, would remain partial, without the legitimacy needed.

Those scholars arguing against a federal fiscal authority believe that national governments can provide for fiscal transfer better than a central authority, even after EMU. De Grauwe (1993a) takes the view that instead of a federal fiscal body, national governments can continue to play the role of stabilization. He also suggests a role for income policies, in addition to fiscal policy instruments, to induce the stabilization of national economies. In Belgium and the Netherlands, income policies were successfully used as a main stabilization instrument to bring back growth after the economic shocks of the early 1980s. Eichengreen (1996) sees the moral hazard problem in connection with fiscal transfer, and argues that national governments can raise taxes to finance the costs incurred by asymmetric shocks. Indeed, the German government introduced solidarity surcharges in order to finance German reunification. For poorer countries, or countries in recession, however, this would be difficult to implement in practice. Alesina, Perotti and Spolaore (1995), on the other hand, argue against a centralized fiscal authority from a perspective of institutional differences, similar to the fourth point made by Goodhart (1995): "when the social security system is used for political purposes to different degrees, in different regions, or it is administered with different criteria, centralized funding of the system can generate an inefficient outcome." (p.757) Differences in awareness of what they call "social capital" (p.756) i.e., civic-mindedness and concern for the public good among EU countries, are

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of moral hazard.

large and cannot be explained by demographics or economic factors alone. "Social capital" is a key concept which explains differences between countries in their regime of administration, their size and efficiency in managing the welfare state and their social policies. As Boyer (1996) and Esping-Andersen (1996) put it, social regimes still show substantial differences despite the pressure emanating from the unifying force of globalisation.

In sum, the point made by Masson and Taylor (1994) is a very accurate observation of the limitation of the empirical studies using the OCA analysis:

> 1) because the criteria are overlapping, there is no unique decision variable; 2) because currency unions also cause other changes in the economic structure, which are typically not captured in economic models, calculated effects should be regarded as only approximately of the true effect; and 3) because the formation of a currency union has political as well as economic dimensions, it interacts with other policies . . . in complex ways. (p.40)

The following section looks more closely at the criticism of both the theoretical and the empirical side of the OCA analysis.

2.3.4. Criticism on the theory of OCA

A number of prominent economists criticise OCA as erroneous.[28] The most fundamental critique is that the OCA considers exchange rate as a panacea. The impact of devaluation on the real economy is only transitory. The loss of exchange rates as an adjustment mechanism is indeed a cost of forming monetary union. It can be a very useful means if applied wisely with other means of adjustment. Yet, it cannot be used repeatedly. It may invite undesirable consequences such as uncontrollable inflation. Furthermore, they cannot undo the asymmetric supply or demand shocks, unless they are of monetary origin.

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[28] See De Grauwe (1992), Bean (1992)

Taking account of the empirical analyses of European economies, Bean (1992) argues that the usefulness of the exchange rate as a "weapon of macroeconomic management" is overemphasised by the proponents of the OCA. He points out that the core of European countries engages in intra-industry, rather than inter-industry trade. Indeed, according to the calculation of the European Commission (1990), between 57 and 83 per cent of trade between EU countries was intra-industry in 1987, except for Greece and Portugal. The increase in intra-industry trade means that countries increasingly export and import the same kind of goods. This indicates that the asymmetric shocks have become less pronounced than before.

In addition, Bean (1992) raises fundamental doubts about the relevance of the OCA assumption. Empirical studies show that real rather than nominal wage rigidity matters in the case of the European Union.[29] When real rather than nominal wages are rigid, they are not affected by the changes in a nominal variable, such as exchange rates. Thus, "relatively little is lost by giving up the exchange rate as a weapon of adjustment because the effectiveness of independent monetary policy is always limited by the relatively low degree of nominal inertia." (p.11)

Whereas the OCA approach is right to point out some sources of instability under the common currency regime, it is criticised as being biassed towards very small common currency areas. One has to admit that under the criteria, even nation-states are not small enough to qualify for monetary union. However, in reality, they function stably with their own common currencies. Therefore either there is a problem in operationalising the theory, or the theory itself is incomplete. Bofinger (1994) and Frankel and Rose (1996) opt for the former explanation: they suggest that a regime shift brought by the introduction of EMU would produce a structural break.

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[29] For more details, see the excellent survey by Bean (1992a). Buiter (1995) also suggested that real wage flexibility plays a larger role in labour-market adjustment in the US.

This means the existing data under the EMS is weak in predicting what would be the case under EMU. Bofinger (1994) starts by arguing that the common OCA approach to use EMS data to study the plausibility of EMU is problematic. He says, "considering the highly diversified production structure in the EU, the absence of money illusion, an increasing downward flexibility of nominal wages, and the erratic behaviour of fixed but adjustable rates could easily draw the conclusion that completely different criteria are required for a comprehensive assessment of EMU"[30] (p.12) He proposes a monetary approach to improve the theory of the OCA. He argues for EMU because it is beneficial for the credibility of monetary policy and its subsequent impact to the real economy. The common currency would also make asymmetric *monetary* shocks, induced by exchange rate speculation, impossible. Just as the traditional OCA theory overemphasises the virtue of smallness, his 'monetary approach' over-praises the largeness of currency areas. It is true that European money demand function is generally more stable than the national money demand functions, as empirical studies by Kremers and Lane (1990, 1992), Sardelis (1993) indicate. Through the introduction of a single currency, there will be no such exchange rate crises as the Franc problem resulting from a lack of credibility within the enlarged European financial market. On the other hand, it may create exchange rate problems on the external front - the Euro vis-a-vis the dollar or the yen, if the common currency area is too large and participants cannot agree on consistent monetary and fiscal policies.

Revealing the endogenity of the criteria of the OCA, Frankel and Rose (1996) argue that countries may not pass the criteria now, but they could pass after joining monetary union. They examine the two criteria - correlation of income with other countries, and the extent of trade with others, the criteria added by McKinnon (1963). They give econometric evidence that as trade

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[30]The European Commission also takes the same view. "There is no ready-to use theory for assessing the costs and benefits of EMU. Despite its early insights, the theory of optimum currency areas provides a too narrow and somewhat outdated framework of analysis." (1990, p.31)

links between member states strengthen, their national incomes become highly correlated, making their business cycle more synchronized. This is an interesting empirical finding which makes countries more appropriate members of monetary union ex post than ex ante. Both studies by Bofinger and by Frankel and Rose suggest, from different angles, the limitation of statistical analyses. Given these shortcomings of statistical analyses, I will supplement them with qualitative analyses in my empirical studies.

Among politically aware economists, Goodhart (1995) in particular opts for the incompleteness of the OCA, by pointing out the importance of political dimensions of monetary union. The OCA cannot capture the political dimension, which makes him claim that "the theory of optimum currency areas has relatively little predictive power." (p.452) He explains the reason for the politicisation of the currency union with the symbolic character of currencies and seigniorage gains. In most current monetary unions in the world, the boundary of a nation state and a single currency coincides. When ex-communist countries broke down to small nation states after the collapse of communism, all of the newly established states opted to issue their own currencies. Seigniorage is derived from note issuing, but seigniorage revenue is small under non-inflationary monetary regimes. The additional reason for nation states being a viable monetary regime is political legitimacy. People simply accept without any question that nation states hold their own national currencies. This political legitimacy is a key factor which one cannot analyse by economics. It would be interesting to study what would happen in terms of monetary autonomy to regions campaigning for secession, such as Quebec in Canada and the Basque region in Spain. The economic costs of becoming politically independent may be inordinately high. Nevertheless, the desire of movements for autonomy to establish their own currency demonstrates the fact that the legitimacy of a currency is closely connected to political legitimacy. The kind of automatic political legitimacy most nation states enjoy, however, does not exist at the European level. This leads to the hypothesis that the European single currency has to be more stable than the national currencies preceding it, in order to build its legitimacy as foundation for political viability.

With insufficient political support and legitimacy, the success or failure of EMU depends more on its economic and social benefits than it is the case for national currencies. For an assessment of these benefits one can use the criteria laid out by the OCA. Indeed, some scholars extend the analysis of the OCA and argue that a common currency shared by countries which have very different economic structures is undesirable. Empirical studies undertaken look into different preferences towards the (short-term) inflation and unemployment trade-off, growth rate differentials, different fiscal and monetary systems (regarding the importance of seigniorage for national income), and different labour market institutions.[31] De Grauwe (1992), among others questions the relevance of such differences in economic structure to the functioning of monetary union. Except for the last factor - differences in labour market institutions, such differences in economic structure have are either irrelevant or have an ambiguous effect on the working of monetary union.[32] Labour market regime differences may induce different wage / price developments even in reaction to symmetric shocks. It is, however, likely that national differences in labour management would continue after the introduction of a single currency. Thus, De Grauwe (1992) and Magnus and Donovan (1996) suggest that these institutional differences may become a significant source of adjustment problems. This question of labour market institution is the key to my thesis and will be explored further from Chapter six onwards.

In sum, although the validity of the theory has been contested due to its incompleteness, it directs us at the need for examining structural factors to assess the viability of monetary union.

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[31]For an excellent survey of works regarding the issue, see Chapter 1 of De Grauwe (1992).

[32]For details, see Chapter 2 of De Grauwe (1992).

The empirical evidence in its support, on the other hand, is inconclusive. In practice, almost all criteria reviewed here are controversial and difficult to operationalise fully. (Ishiyama 1975) Studies suggest that the core of the European Union is roughly an OCA, but for the EU as a whole this is probably not the case.

Despite this contentious assumption, one cannot say that the criteria for an OCA are irrelevant. If two or more countries sharing a common currency reacted symmetrically upon an external shock, it would be easier for them to adjust. Having similar economic structures and economic policy preferences would go some way in establishing the conditions for such a symmetrical reaction. However, it is unrealistic to assume that any two European countries will have identical economic structures. Thus, the question lies in how similar their socio-economic structures should be to qualify for as an OCA, and what other factors matter to facilitate viable monetary union.

2.3.5. The extension of the OCA framework

In order to study such a question, one would need a broader theoretical framework. The OCA is a cost benefit analysis, which is essentially a partial equilibrium analysis. In order to examine the structural similarity of the economies concerned, a different theory has to be applied to complement the partial nature of the OCA theory. As the *problematic* to examine economic structure is generated by the concept of an OCA , such a theory should be able to extend the OCA theory to compensate for its limitations. Such a theory should be able to bring in the two essential missing-parts in the OCA theory. They are, first, the ability to examine broader structural elements of the economy, and second, the ability to incorporate social and political factors suggested by Goodhart (1995).

It is also necessary to define what kind of structures to examine in this thesis. Although I shall investigate general structural issues in the historical chapters (Chapters 4 and 5), I shall focus on the labour market structure in the empirical section.

2.3.5.1. Why labour markets?

The OCA identified where the adjustment burden lies in EMU, namely, in labour markets and fiscal adjustment. Practically speaking, the possibility of a large fiscal transfer is denied in the current European framework as elaborated in the following paragraph. Hence, with the Maastricht EMU design, it is the labour market which is designed to bear the adjustment cost.

A flexible labour market is a crucial factor for the success of EMU, since that is the main and possibly the only effective adjustment mechanism available. As a result of the introduction of a single currency, domestic monetary policy autonomy, by definition, disappears, because central banks cannot set different interest rates. There will be only one European single (nominal) interest rate. Meanwhile, at the Dublin Summit in December 1996, the Stability and Growth Pact was agreed. This pact further curtailed the fiscal policy autonomy of the member states with very restrictive numerical targets and penalty payments.[33] This, *de facto* eroded the

[33]The concept of a stability and growth pact originated from the idea of a 'stability pact' by Theo Waigel, the German finance minister. The stability pact was concieved by the Germans who saw the need to ensure austere fiscal discipline after the introduction of single currency. The Germans proposed near automatic sanctions against states running deficits in excess of three per cent of gross domestic product, but France was reluctant to accept the German proposal mainly due to the lack of democratic accountability. At the EU summit in Dublin in December 1996, a Franco-German compromise was reached, and the stability pact was officially renamed 'stability and growth pact'. Under the agreement, countries running excessive deficit will be automatically sanctioned unless either of the following applies: First exceptional circumstances, such as the case of a natural disaster. Second a severe recession which causes a fall in gross domestic product of at least 2 per cent. According to the Financial Times, "such a severe recession has occurred only 13 times in any of the 15 EU members in the past 30 years".

possibilities for an effective use of demand management. The use of fiscal policy as an adjustment mechanism in response to a medium-sized idiosyncratic shock would in practice become very difficult.[34] Even if fiscal policy measures were taken, its effect would be minimal due to the restriction set by the Pact.

The only area of effective macroeconomic management to remain, with the current design of EMU, would be supply side measures, including the adjustment of the labour market. What kind of labour market measures could be taken? They can be the lowering of wage and non-wage costs, and the deregulation on restrictive labour legislation. Conventional wisdom believes that these measures should in the long run promote more employment[35]. However they may, at least in the short-run, increase unemployment by making it easier for employers to fire members of their workforce. Such downward adjustments in wages as well as working conditions would be deeply unpopular for the continental workforce and trade unions. In addition, with job insecurity and downward pressure of wages, workers would spend less. Consequently, such suppression of demand may have further depressive effects for the continental economies.

As Solow (1990) put it, the labour market is a social institution, unlike any other market. The economic concept of optimality does not necessarily provide the best solution for persistent unemployment, as "they allow for a variety of motives and interactions that are conspicuously missing from the standard textbook model". (p. 31) Different countries have different ways of

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(p.1) Another would be the case where GDP has fallen between 0.75% and 2%. In such a case, EU finance ministers have discretion to decide whether to impose sanctions or not. For details see, Financial Times 14/15 December 1996, p. 1.

[34] Of course, in the exceptional case of a significant asymmetric shock, countries can still take fiscal measures even within the current framework.

[35] Though the OECD Employment Outlook (1999) has found an inconclusive relationship between employment performance and the degree of rigidity in employment regulations, conventional wisdom still firmly believes in the need for more flexible labour market regulation. For details, see Financial Times 10/11 July 1999, p.6.

tackling social problems within the parameter of their socio-economic preferences. The standard solution of deregulation may be socially sub-optimal in some countries, if they trigger social instability. Europe comprises countries with different degrees of labour market flexibility and institutions. The very act of trying to adjust by imposing flexibility in the labour market, may invite inter-state friction, as one member of EMU may claim another is resorting to the social dumping. From the British perspective, however, the continental labour market is simply uncompetitive due to over-regulation.

Furthermore, it is not clear whether labour market adjustment alone is enough to pull a country or a region out of recession, or an idiosyncratic shock. There is no federal government in Europe, nor substantial and significant direct or indirect fiscal transfers, which help the smooth adjustment of depressed regions or countries. In other words, under EMU, there will be no automatic income redistribution mechanism as in the case of nation-states. These political deficits of the Maastricht road to monetary union have invited serious doubts. Commenting on the agreed stability and growth pact, the Financial Times (14-15 December 1996) editorial comments as follows:

> To constrain it (fiscal policy) as tightly as the stability pact agreed yesterday would seem to imply to throw all adjustment on to the EU's sclerotic labour markets. Worse, imposing substantial fines on elected governments will create direct clashes between the politics of individual members and the EU. It is far from obvious that the latter will always win. (p.6)

Structural differences in European labour market regimes, therefore, have far-reaching implications to the success or failure of future monetary union in Europe. Such implications do not only concern the question of adjustment but the problem of inflationary pressures as well. Magnus and Donovan (1996) summarize their point as follows:

> Different methods of wage negotiation are not, of themselves, a problem for a monetary union if the bargains achieve a broadly similar outcome.

> If different levels of wage deals are struck, in regions of an EMU that can hide behind the skirts of labour immobility, an asymmetric shocks across the monetary union is produced. The potential for this shock is significant, and comes from bargaining methods and welfare priorities.... Forcing a monetary union between countries like the UK and Germany, who have entirely divergent objectives from their respective labour market policies, automatically creates tensions over policy. (p.11-12)

Labour market institutions affect not only the levels of wage deals as mentioned above, but also the equilibrium unemployment rates and the speed of adjustment after transitory shocks. In addition, the propagation mechanism of shocks would be different, as countries' labour market regimes differ. Thus, labour market institutions would provide a crucial point of reference in examining Euro-wide economic management and coordination.

In extending the OCA framework to examine structural factors, the following sections explore some economic studies, which deal with the issue of labour markets and EMU. The purpose of these sections is not to review all conventional labour market theories, as most of them do not link monetary and labour market structures in their analysis, tending to focus instead on microeconomic factors which influence certain economic and social behaviour. Only those which examine the interaction between monetary and labour markets will be introduced in order to assess their relevance for my thesis.

2.3.6. The labour market institutions and economic performance

With the establishment of EMU, countries lose the external anchor, i.e., the exchange rate peg as a means to control inflation. As a result, they need an internal anchor to keep inflation under control. The management of the internal anchor depends very much on the kind of domestic regime countries have.

One source of structural inflation pressures is labour markets. There has already been a number of works by economists on relations between inflation and bargaining structures. This aspect was first put into an academic perspective by Bruno and Sachs (1985), and developed as a theory by Calmfors and Drifill (1988). The basic theoretical argument is as follows: very centralized and very decentralized bargaining systems are likely to produce lower real wage increases. The former institutional arrangement internalises various wage externalities, and the latter is restrained by competition with other market forces. Hence, one can observe a hump shape relation between the degree of centralization of wage bargaining and the aggregate real wage, i.e. unemployment.

The theory has recently been applied by political economists to OECD and European countries. Both findings by Iversen (1998) and Hall, Franzese (1998) have implications for economic management under EMU. Using the pooled time-series data for fifteen OECD countries, Iversen (1998) proved that monetary policies have real employment effects in all but the most decentralised bargaining systems. Hall and Franzese (1998), predicted unemployment rates would be higher under EMU, due to a lack of effective coordination of collective bargaining within the EMU area. European wide coordination of collective bargaining virtually does not exist. In accordance with the theory, this implies that bargainers in Europe as a whole would be less sensitive to the signalling of the European central bank than, for example, the German social partners have been to the signals of the Bundesbank. This suggests that the European Central Bank would be required to have higher interest rates to deter inflation, which in turn should induce higher unemployment rates and other social costs.

The theory has also been criticised as simplistic on several grounds: Soskice (1990) criticized it for not being able to include the variable of economic-wide (union, employer, and sometimes government) coordination. He sees economy-wide wage coordination to be the key to low inflation, as both employers and unions are concerned about low real exchange rates. (p.

58) However, even the improved version of the theory, taking into account Soskice's point, was refuted by an empirical study conducted by the OECD (1997a). It found little significant statistical relation between measures of economic performance and certain indices of bargaining systems.

Other political economists, Garrett and Way (1995) examine domestic labour market institutions more closely and distinguish the behaviour of public and private sector trade unions. The public sector trade unions behave differently from their private sector counterparts, as the former, unlike the latter, do not have any concern for external competitiveness. This lack of market pressure makes public sector trade unions more inflation-prone than the private sector trade unions which are exposed to external pressure. Thus, a country with a stronger public sector trade union movement is structurally more inflation prone than that with a strong private sector trade union movement. Measuring with this indicator, France seems to be more inflation prone than Germany. The investigation of such structural factors is the objective of this thesis, and labour market developments will be further explored from Chapter 6 onwards. The focus of the works surveyed here, however, was on the relationship between inflation and labour market institutions only. I am interested in capturing the broader socio-economic differences which cause different inflation rates and different modes of adjustment, and which ask for different monetary policies. Hence, an alternative theoretical framework is necessary to examine the relationship between labour markets and monetary union more comprehensively.

2.3.7. Keynesian approaches to employment and EMU

Conventional neo-classical economic theories assume the neutrality of money. That is to say, monetary variables, including exchange rates, cannot affect the real economy at all in the long run. Money may have a short-run impact on the real economy, but it does not have any consequence in the long run. Thus, in their thinking, EMU should not have any long-term real effect on European employment or unemployment.

Keynesian economists, however, disagree about this classical dichotomy between the monetary and real economy. The Keynesians argue that money matters both in the long and short run.

> An economy which uses money but uses it merely as a neutral link between transactions in real things and real assets and does not allow it to enter into motivates or decisions, might be called - for want of a better name - a real exchange economy. The theory which I desiderate would deal, in contradiction to this, with an economy in which money plays a part of its own and affects motives and decisions and is, in short, one of the operative factors in the situation, so that the course of events cannot be predicted either in the long period or in the short, without a knowledge of the behaviour of money between the first state and the last. And it is this which we ought to mean when we speak of monetary economy... Booms and depressions are peculiar to an economy in which money is not neutral. (Keynes reprinted 1973, pp. 408-09)

Whereas classical and neo-classical economists take money as another producible commodity like apples, Keynes interprets money as a unique object. He emphasises the role of money in his theory, and argues that the emission of money leads to positive demand creation only if it is related to the payment of wages. Therefore, production is immediately identified as the process of making money real. Rather than supply or needs, he sees that demand is exerted by available income through money-wage earning. In this sense, money is the key to employment, as a decline in demand causes the contraction of production and hence growth in unemployment. At the same time, Keynesian economists see the causes of inflation not just stemming from monetary factors as the neo-classical school does, but being rooted in real factors as well. Weinstraub (1961), the leading Post Keynesian[36], argues that inflation could be

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[36]Davidson (1982) classified different interpretations of Keynes as socialist-radical, neo-Keynesian, Keynesian, Neoclassical synthesis-Keynesian, and called all of them the 'Post Keynesian school'. For details of their interpretations, see table 1.1, p.2.

controlled by the conditioning of money-wage increases with productivity increases.

Flassbeck (1994), a German Keynesian economist, points out the astonishing similarity between the blueprints of EMU and German Economic and Monetary Union (GMU). Both processes hardly touched upon the problem of wage determination and labour markets. He argues that labour markets are of paramount importance for currency unions by emphasising two points: first, the wage regime at the micro level (centralised or decentralised bargaining) decisively influences the competitive dynamism of an economy, and second, the wage regime at the macro level (wage increases in line with productivity rises, and concern for price stability in wage bargaining) is vital for the stability of the currency system. (p.266) He argues that the Maastricht process of EMU is problematic as it does not have any means to sanction wage misconduct (wage increases out of line with productivity increases). The incentive for wage misconduct increases with the transparency of wage levels in the Euro-zone due to the single currency. He warns that the centralisation of wage bargaining at the European level would create a disastrous outcome, as in the case of German unification. Because EMU participants have very different productivity and income levels, as in the case of the two Germanies, a harmonisation of wage setting systems is not recommendable. The Maastricht treaty has successfully set out sanctions on fiscal extravaganza, but "wage policy, by far the more important factor in overall economic terms, is not even mentioned." (p.265)

The problem of the Keynesian approach to monetary theory, however, is that it over-emphasises the importance of money wage rates as the determinant of price stability and economic growth. With the increasing importance of financial markets in the late 1980s and the 1990s, asset price inflation has increasingly become a serious threat for inflation. An example is the case of the bubble economy in Japan. Whereas real wages stay relatively constant[37], asset

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[37]The annual average growth of real compensation per employee during 1981-1990 in Japan was 2%, whereas it was 5% during 1971-1980. For more

price inflation picked up in the latter half of the 1980s, largely caused by land price speculation. Economic growth in the US seems to be sustained despite declining real wages. The high level of consumption of the US population is supported by (real or expected) income from booming financial markets and the growth of employment in the service sector. This has been explained through the "wealth effect" of rising asset prices. Despite falling saving rates, the wealth of Americans has been increasing with the stock market boom. This has facilitated rapid domestic credit growth and increasing consumption. Thus, a more comprehensive theory which can at least capture both the wage and the financial side of inflationary pressure would be desirable.

2.3.8. EMU and unemployment

Two approaches deal with the issue of the labour market effects of EMU directly: one investigates the relations between exchange rate regimes and labour markets, the other looks at labour markets in the light of real convergence. Regarding the former, Alogoskoufis and Smith (1991) and Eichengreen (1993a) find evidence that the responsiveness of wages depends on the exchange rate regime. Van Gompel (1995) examines the relevance of wage-formation characteristics for unemployment under different exchange regimes. He finds that the impact of monetary shocks on unemployment is smaller for a country belonging to EMU compared to the EMS. The relevance of the wage formation process on unemployment was inconclusive, as it depends on the precise type of shock hitting the economy, the structural parameters of the model, as well as the exchange rate regime to which a country belongs. Sibert and Sutherland (1997) take a critical stance towards conventional economic analysis, which takes the state of labour markets as exogenous in studying monetary integration. Although the OCA states certain labour

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details, see table 30 of Statistical Annex of European Economy. June 1997.

market conditions as a requirement for an optimal monetary union (labour mobility and flexibility), it does not offer the means to assess how a monetary union will affect labour market reforms. Using a variant of the Barro-Gordon model, Sibert and Sutherland (1997) simulate the impact of monetary coordination (different exchange rate regimes) on labour market reforms. They show that monetary union produces less impulse for labour market reforms than negotiated monetary policy and non-cooperative monetary policy. This is because having a lower level of labour market distortions improves a country's bargaining position in a non-cooperative regime (floating), but a monetary union (cooperative regime) removes this competitive environment. This finding is interesting as it negates 'monetaristic' intentions behind the Maastricht process regarding the labour market, i.e., the assumption that monetary union would create an impetus for more labour market reforms. However, these models cannot grasp social and political factors which are not quantifiable. For example, Sibert and Sutherland (1997) treat labour market reform merely as a bargaining chip. Yet, labour market reforms involve social processes: they depend on a country's capacity to structurally adjust, including the willingness of political leaders to undertake often politically unpopular reforms, and the willingness of the society to go along with the political leadership and implement reforms in a sustainable fashion. Models can neither adopt such complex reality nor are they intended to do so.

Arguing for the importance of real convergence, Heyden, Poeck, and Van Gompel (1995) represent the latter approach. They assert "real convergence (convergence in real macroeconomic variables such as per capita GDP, economic growth and unemployment), while technically not necessary for EMU, would have great advantages for the working of the Union. Stated differently, the absence of real convergence is likely to put the EMU under considerable stress." (p. 100) They point to the need for changes in labour market policies and institutions for a successful EMU. Because of rigid labour market structures, they argue that the Maastricht fiscal conditions may have a counter-productive effect on the EU economy by creating semi-permanent high and divergent unemployment rates. For real convergence, they believe that some structural convergence in the form of convergence of labour market institutions and policies is necessary. They are not arguing for deregulation of labour markets *per se.* Rather they demand that "the working of the labour market is broadly similar in all countries." (p.115) Though they point to the crucial issue that this thesis explores, their analysis is not deep enough, as it does not present the means necessary to examine labour market structures. Hence, I need to explore this *problematic* by using an alternative theoretical framework, the French Regulation school, in Chapter 3.

Chapter 3

Analytical framework - regime compatibility

This chapter introduces the analytical framework of the thesis, the French regulation school, in detail. The previous chapter looked at the limitations of existing approaches to analyse monetary union. The economist approach introduced in Chapter 1, the approach arguing for the need for certain domestic political and economic conditions for sustainable monetary union, needs to be put into a concrete conceptual framework. The approach denotes that further study of structural elements of economic institutions is necessary. According to North (1981), the main challenge for social scientists is "explaining the institutional structure which underlies and accounts for performance of an economic system, and explaining changes in that structure." (p.ix) Criticising the neo-classical approach in the analysis of economic history, he argues that political organisation and ideology support different modes of economic organisation. They are, therefore, the essential variables for studying economic structures and institutional changes. What underlies the stability of institutions and makes them slow to change is the combination of rules with associated moral and ethical codes of behaviour. (p.205) He defines 'structure' as an institutional framework. One can extend this argument by using the concept of 'regime'.

The role of the Maastricht convergence criteria was to make sure that the single currency is only introduced in an area which is economically sound. In Chapter 1, I have criticised the criteria for their very limited and partial demand side point of view. The ERM has made a certain degree of nominal convergence among member states possible, but not real convergence. It is therefore important to think of ways to establish a more sophisticated framework to examine the monetary, fiscal and social spheres.

The theory of OCA, as introduced in Chapter 2, emphasises the need to look into labour market conditions, in examining the viability of monetary unions. In order to better understand structural factors, however, we need a more comprehensive theory which surpasses the barrier between monetary and real economy. Here, the French regulation school provides a guideline.

3.1. The French regulation school

Theories associated with the French regulation school were developed in the 1970s, as a way to analyse long-term transformation processes in capitalist economies. The regulation school approaches the problematic from the angle of Marxian institutionalism and Kaleckian or Keynesian macroeconomics. This is one of the few dynamic theories which can explain changing phases of economic development in history. It examines "any dynamic process of adaptation of production and social demand resulting from a conjunction of economic adjustments linked to a given configuration of social relations, forms of organization and structures." (Boyer 1988, p.127)

There are several sub-branches in the regulation school: the Grenoble school, the Parisian school, the Amsterdam school, the West German school, the Nordic school, and the North American school. They all share the common radical heritage of the regulation approach, but differ in their priorities of focus and methodology. As it in not the aim of this thesis to seek theoretical refinement, a further investigation on this issue will not be pursued. Suffice to say that my approach is closest to the Parisian school, where scholars have mainly examined the development and working of Fordism, neo- and post-Fordism as regimes of accumulation, and studied modes of regulation to show the heterogeneity of national variants under the same regime of accumulation.

The regulationists examine the mode of socio-economic interaction between capital and labour as a determinant of economic growth. They believe that some institutional preconditions for capital and labour to compromise on issues of growth and welfare are necessary. Concerning such preconditions, the consistency between the mode of regulation, and the regime of accumulation is very important. Boyer (1986) argues that slower economic growth in Britain than other European countries in the 1950s and the 1960s was due to the inconsistency in institutional arrangements - the mode of regulation - and the underlying economic structure - the regime of accumulation. Now, let us turn to the definition of these concepts.

3.1.1. Theoretical framework of the regulation school

The *problematique* of the regulation school is to study "the variability of economic and social dynamics in time and space" (Boyer 1990, p.27). Its main interest is to analyse economic crises. In particular, it examines why a certain pattern of economic management stagnates after a period of steady growth, and why different societies need different configurations of socio-economic interaction within the same mode of production[1]. Furthermore, it tries to clarify why crises take different forms, conditional on differences in the modes of production.

There are two central concepts used by the regulation school. They are 'regime of accumulation' and 'mode of regulation'. Lipietz (1986a) concisely describe the 'regime of accumulation' as "the stabilization over a long period of the allocation of the net product between consumption and accumulation. It implies some correspondence between both the transformation of the conditions of production and the conditions of reproduction of wage earners" (p.19) The regulation school distinguishes two types of regime of accumulation:

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[1]For example, in the post war period, when all OECD countries introduced Fordism, their mode of economic management crystallised in rather diversified forms.

extensive and intensive accumulation. In the former, capital expands by employing growing numbers of workers with the same technology to increase output. In the latter, capital expands by investing in new technology to intensify the use of existing labour, i.e., it increases output by raising productivity. The difference lies in whether the growth of capital disrupts the methods of production. The extensive regime would eventually reach the limitation of growth, as labour supply is limited. Aglietta (1974) categorises France in the first half of the 19th century as an example of extensive accumulation. In general, the dominant regime in the OECD countries during the post-war period is intensive accumulation. Boyer (1990) explains the 'regime of accumulation' in more detail, as a set of regularities or a form of articulation consisting of the following socio-economic patterns. First, the dynamics of the organisation of production which affect capital-labour relations. Second, the time horizon of the valorisation of capital (making profitable use of capital) which affects the type of economic management. In other words, whether capital holds a short-term or long-term perspective matters for regimes. Third, the distribution of income which affects the cohesion of society and relations between different social classes. Fourth, the constitution of social demand which affects a society's productive capacity; and finally, relations with non-capitalist economic forms if they are essential to the functioning of a capitalist society. (p.35) Table 3.1. shows detailed historical examples of different patterns of regimes of accumulation.

The mode of regulation provides specific characters for the regime of accumulation. Different types of mode of regulation can belong to the same regime of accumulation. This is because the regime of accumulation is general, but the mode of regulation can be country- or society- specific. This makes the theory pertinent to analyse variations in capitalist societies.[2]

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[2]The recent works by Boyer (1996a, 1996b) present a comprehensive critique of the convergence thesis, which argues for a converging trend of different cultures and societies.

Boyer (1990) sees institutional organisation - the structures and behavioural patterns constituting the mode of regulation - as "any kind of codification of one or several fundamental social relations." (p.37) Lipietz' (1986) explanation is more precise to the point, by denoting mode of regulation as:

> the ensemble of institutional forms, the networks, the explicit or implicit norms, which assure the compatibility of behaviours in the framework of a regime of accumulation, in community with the states of the social relations, and thereby through the contradictions and the conflictual character of relations between agents and social groups. (p. 16)

In other words, it describes the role of market mechanisms, institutions and of power relationships among different social actors in linking the dynamics of production and consumption. The arena of such structural interaction can be found in monetary relations, the wage-labour nexus, competition policies, state and international relations. In other words, the regulationists focus on the following institutional arrangements: forms of monetary constraints, configurations of wage relations, forms of competition, forms of the state, and positions within the international regime.[3] First, 'forms of monetary constraints' refer to banking and credit systems. They examine the interaction between credit and money creation in a society and its consequences. Second, 'configurations of wage relations', the area that I deal with in detail in forthcoming empirical chapters, is a broader concept than the discipline, "industrial relations", addresses. In fact, there is no proper translation of the French term "*Rapport Salarial*" into English.[4] Boyer (1988a) defines this as "the organization of the means of production, the nature of the social division of labour and work techniques, type of employment and the system of

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[3]Jessop (1992) added another element to the mode of regulation, the concept of social processes promoting the construction of ideology. Such social process would be embedded in education and training, and can also be studied by examining the influence of the media.

[4]Howell (1996) translated '*rapport salarial*' as wage relationship, but the English translation does not convey the holistic picture regulationists lay out in this concept.

Table 3.1. Variety of Regimes of Accumulation in dominant economies

	Extensive accumulation	Intensive accumulation without mass consumption	Intensive accumulation with mass consumption	Extensive accumulation with mass consumption
Production organization	Simple cooperation: low rate of productivity growth	Taylorist restructuring of production; big production; big productivity increases	Fordist deepening of mechanism, even higher productivity gains	Exhaustion of Fordism and previous sources of production gains
Time horizon for capital formation	Short, subject to immediate validation by the market	Slightly longer, due to greater capital intensity	Multi-year, the validation of investments occurring over their expected duration	Shortens, due to economic instability and major uncertainties
Income distribution (wages, profits, deductions)	Governed by the short-run phases of the accumulation process	Attenuation of wage reductions	Contractualization of direct and indirect wages	Institutionalized division challenged
Composition of social demand	Capital formation plays the main role, final consumption a secondary one	Consumption diffused more widely, investment remains preponderant	Simultaneous dynamic linking consumption and investment	Previous tendencies and patterns break down
Articulation with other relations of production	Workers reproduced outside of capitalism (petty production, family etc.)	Slow insertion of workers into wage labour, international relations playing a key role	Workers depend on wage labour for reproduction, modification of needs accompanying internationalization	Restructuring of relations with international and domestic economies
Examples	France (first half of the 19th century)	U.S., France (between wars)	Europe, U.S. (after 1950)	U.S. (since 1960s)

Source: Boyer (1990), Appendix 3, Table 2.

determination of wages, and finally, workers' way of life." (p.127) In other words, the regulationists deal not only with the traditional area of research into industrial relations like collective bargaining processes, but also look into the broader social setting that wages are negotiated in, including the pattern of income distribution and the norm of production and consumption. Third, 'forms of competition' focus on relations among producers. It describes the form of business organisations, the source of profit, the regulation of competition and other forms of inter-firm relations, and relations with finance capital. (Lane 1995, p. 23) Fourth, 'forms of the state' define different configurations of relations between states and the economy. In other words, they are nation-specific institutional arrangements of compromise between capital and labour, characterised by state intervention and welfare provision. Fifth, 'positions within the international regime' deal with a state's relations with internationally-dominant arrangements of trade, investment and monetary regulations. They also clarify the relative power or influence which a state exerts over others within a particular international economic order shaped by a hegemonic economy.

Using regulation theory, one can either study one of the above institutional arrangements, or the interaction of all of them - i.e. analyse the regime of accumulation as a whole. The latter is also called mode of development, which embraces the industrial paradigm by integrating modes of regulation and a regime of accumulation. (Lane 1995, p. 23) With the crisis of a regime of accumulation, the underlying divergence between rules and structure becomes obvious. The mode of regulation increasingly becomes an inadequate framework for a society. After a confusing transitional period, the mode of regulation is re-configured to meet the demand of the new form of the regime of accumulation. Such a process would be a historical co-evolution. As it is a social process, the mode of regulation could again differ considerably from culture to culture. In the empirical chapters of this thesis different labour market regimes will be discussed. I shall focus particularly on the configurations of wage relations, but also, to a lesser extent, take account of the interaction with other modes of regulation - forms of monetary constraints, state, competition and relations with the international regime.

How do modes of regulation interact in a regime of accumulation? It is useful to introduce the concept of Fordism, a well known regime of accumulation, to illustrate the analytical approach of the regulation school.

3.1.1.1. Analysing a regime of accumulation - Fordism

Fordism is one of most important regimes of accumulation of the twentieth century. The word was first used by Antonio Gramsci in an argument that high wages would improve workers' morality and social integration.[5]

The golden age of Fordism lasted from the post-war period until the beginning of the 1970s. It was an intensive regime of accumulation, in which capital intensified the use of the factors of production through a rise in labour productivity and technological innovation. Let us briefly analyse Fordism by focussing on modes of regulation. First, the monetary regime was characterised by an institutionalised pure credit system (as opposed to a metallic standard). Under the Bretton Woods system, by design, finance was regulated heavily. Hence, banks were protected, and financial markets were stable with little leeway for speculation. Second, regarding the relationship between capital and labour, the structural power of labour has increased relative to the previous regime of accumulation in the interwar period, with the emerging structure of institutionalised unions and collective bargaining. Consequently, wage formation was more

[5]For more details, see Gramsci, A. (1971) "Americanism and Fordism." Selections from the Prison Notebooks. New York: International Publishers.

administered than market determined. In addition, a significant part of indirect wages was institutionalised. Fordism was based on a system of rising wages and social security coverage backed by the institutionalisation of labour power. Rising wage levels and social security coverage ensured that workers' demand to consume reached high levels. It was the first regime in history in which workers could mass-consume what they mass-produced. This virtuous circle of mass production and mass consumption, and technological innovation induced by high levels of investment made it possible for the world economy to grow steadily at a fast rate for nearly 30 years.[6] Third, competition among firms in the product market was strong but not as intense as now, and that in the financial market was regulated. Consequently, banking activities were largely concentrated at the national level. Fourth, state intervention in public services were developed in particular for the sectors of education, health, and transportation. The nationalisation of key industries was widely practised in European countries, and social welfare was nationally institutionalised at varying degrees across Europe. Fifth, an international regime on trade through the GATT enforced the progressive liberalisation of trade. Private financial flows were limited due to the design of the Bretton Woods system, though there were some mechanisms of public financial flows for international redistributive purposes through the IMF and the IBRD. The international regime of private capital did not have any institutional framework as above, and was characterised by the significant expansion of American direct investment abroad and to a lesser extent, of the Western European. (Boyer 1996a, p.88)

The key characteristics of Fordism - mass production and mass consumption - was invented in the early interwar period, but did not become fully effective until the post-war period. Such a model could not work if it only took place at the Ford factory in Detroit: it only worked because it became the dominant form of economic management in the United States and later in

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[6]Of course, as in any capitalist regime, there were cyclical downturns.

the OECD countries as a whole. Boyer (1990) argues:

> the effects of collective bargaining were extended by 'connective bargaining', which, starting from the auto industry, propagated increases in incomes to the non unionized private sector, then to the public sector. Such a mechanism is the condition of a simultaneous evolution of the norms of production and consumption. (p.x)

The argument becomes clearer if one compares the experience of Ford and Renault. In order to cope with industrial action, the Renault factory in France introduced the same sort of management structure Ford had in the inter-war period. The company guaranteed the near-indexation of wages to prices for employees and a share of the profits. However, this contract worked against the firm, because Renault was the only factory doing it. It lost its competitive edge due to the constraints of higher wages and lost market share. This shows that a certain mode of regulation and regime of accumulation only works at the macro-level.[7]

In order to understand the working of Fordism better, one also has to take account of other modes of regulation, since the harmony / compatibility among modes of regulation would be indispensable for the success of a regime of accumulation. Fordism was a unique combination of Keynesian macroeconomic management, welfare states, and collective bargaining with the international regime characterised as 'embedded liberalism.'[8] Without the institutional framework of Keynesian demand management and welfare states, the above mentioned wage policy would not have worked relatively smoothly for nearly 30 years, and vice versa. The regulationists examine the economy as a whole in order to assess the working of a certain institution. Thus, the working of monetary union cannot be assessed on monetary factors alone. What is important is whether a monetary regime to come would be compatible and work in

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[7]Economists call this kind of problem a "coordination problem", i.e., something works if everybody does it, but not otherwise.

[8] C.f. Ruggie (1983)

harmony with other existing modes of regulation. In this context, the success of monetary union depends on the performance of the whole economy, including the non-monetary, real economy.

3.1.1.2. The role of money / credit

Having introduced the holistic approach of the regulation school, it is necessary to further expand on their treatment of money. Unlike neo-classical economics, the regulationists take money as an essential element for the working of the real economy - a regime of accumulation. The way money interacts with the real economy, in the regulationists' interpretation, is more structural than that of Keynesian economists. Boyer (1988a) evaluates the key elements which distinguish Fordism from other regimes of accumulation as follows:

> the alteration in wage relations - in particular the transition to Fordism, i.e., synchronization of mass production and wage earners' access to the 'American way of life' - and monetary arrangement, i.e., transition to internally accepted credit money - seems to have played a greater role than change in modes of competition or conjunctural stabilization policies a la Keynes. (p.128)

Like Strange (1986), the regulationists put emphasis on the central role of credit money in an intensive regime of accumulation, such as Fordism. A system of mass production and mass consumption could not work on the scale of the golden age without support from credit money. In the post war period, the demand for credit increased drastically in America. Household's debt-GNP ratio in America in 1921 was 15%, but in 1978, it reached to 52%. It is a surprising development, given the corporate debt-GNP ratio was only 50% in 1978. (Saito, 1989) The development of the credit system through e.g., mortgages and consumer credits, ensured the growth of consumer demand for housing, and expensive household durable goods. Through consumer credit, workers could afford such goods, which in turn urged the diversification of a variety of durable and non-durable goods.

What supported the sustained expansion of consumer credit was the perception of the continuous rise of wage income. This expectation was institutionally supported by the collective bargaining processes and social welfare provided by the welfare states. In other words, regular wage rise by institutionalised collective bargaining and the expansion of indirect wages by the welfare state guaranteed a continuous flow of future income, which in turn increased current spending.

The availability of cheap credit encouraged not only consumption but also investment. Interest rates were lower in the golden age than at present. In the US, for example, the average nominal short-term interest rate during the decade 1961-70 was 4.3%, whereas it was 6.9% in 1971-80, and 8.5% in 1981-90.[9] Large investment in research and development brought about technological innovation. These institutions induced a rise in productivity through technological innovation. Consequently, capital could afford rises in real wages, as it could still keep unit labour costs[10] constant. Thus, such interaction between the credit system, the norm of consumption and the production system was the engine for growth in the post war period.

However, this very factor of growth later caused the stagnation of the intensive regime of accumulation, and a vicious downward circle in the late 1970s. Excess demand for credit became a cause of inflation, destroyed future income, and thus drastically reduced the saving ratio. Inflation increased the cost of energy, of consumption goods and reduced real wages. In addition, the external shock of oil price increases in the 1970s accelerated inflation. Hence, real disposable income decreased, which reduced consumer demand. This led to the lower

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[9]Data are from the European Commission Services.

[10]Unit labour costs are the index of the ratio between wage costs (compensation per worker) and apparent productivity (value added at constant price per worker).

investment, lower productivity rises, and lower wage rises[11]. In order to maintain living standards in the short run, households had to depend further on consumer credit. By doing so, consumer debt mushroomed. Meanwhile, credit industries were mature enough to invest their own credit in real estate etc. for speculation. This, in turn, caused further rises in inflation rates. Hence, as Saito (1989) put it, for an intensive regime of accumulation, consumer credit is the catalyst in creating the virtuous cycle of economic growth as well as the vicious circle of economic crisis. In this context, for regulationists, money and credit take central stage in understanding the working of the real economy.

3.1.2. Advantages and limitations of the regulation school approach

The regulation approach is more sophisticated than the regime theory introduced in Chapter 1 in the following four respects. First, it can examine domestic regimes in addition to international regimes. Second, it can certainly accommodate more variables to analyse the problem. Distributive changes in the power structure, interests, principles and norms are the only variables that regime theorists look at. The regulation school focuses on broader social interactions, which can be seen as a social mode of economic management. Its analysis is truly inter-disciplinary taking into account economics, sociology, history and politics. In this way, it can offer a holistic approach to structures, examining them as structures in an integrated ensemble. Third, the theory can analyse the structural relationship between states and markets in an interactive fashion. It can explain dynamic interactions within a regime. Central to the

[11]In the late 1960s and 1970s, inflation was also accelerated by wage inflation in some European countries, particularly in France, Italy and the UK. The downward movement of wages tends not to be as efficient as it should be (sticky wages), because of institutional factors such as the excessive pressure of trade unions for wage rises and the lack of credibility of central banks in their ability to control inflation.

regulation school is the notion of institutional change and transformation, as a result of the inherently dynamic nature of social relations within a national regime. The key to institutional change is the structural breakup at the moment of regime crisis. Crisis mediates regulatory and institutional changes. (Hübner 1989, pp.197-220) Fourth, as it is interested in the unique configuration of a national regime under pressure from a dominant international ideology, it always sees national economic regimes as integrated parts of the global economy. It shows the emergence of different configurations of domestic regimes when different domestic traditions and institutions are exposed to the same kind of economic pressures and norms. The backbone of regulation analysis is the link between global economic change and the specific reaction of domestic regimes, as accumulation is a social process corresponding to a particular set of social institutions. As Howell (1992) put it, "the importance of the regulation approach is that it directs attention not simply to the strategies of actors, and their capacities for achieving goals - though these are important parts of the story - but also to how successfully these strategies correspond to the pressures and constraints imposed on them from a constantly evolving capitalist economy." (p. 11)

Precisely because the theory covers such a broad area, there are some limitations and drawbacks in the existing empirical studies. First, though the theory is good in detecting and categorising the different domestic regimes, it is weak in explaining why differences in domestic regimes emerge and persist. In technical terms, the interaction between regime of accumulation and mode of regulation is vaguely defined. Lipietz (1986), for example, argues that they co-evolve by stabilising each other. Jessop (1990) agrees with Lipietz's stance and refutes technological functionalism: he argues that specific modes of regulation are historically contingent rather than capitalistically and technologically pre-ordained. Second, though the regulation analyses clearly present the different levels of modes of regulation - in particular, global and national levels - they do not clarify how they influence each other. Lipietz (1986) asserts reciprocal relations between the two levels but gives the national regime priority for the research agenda, whereas Jessop (1990) takes a more flexible stance. Third, although regulationists deal with institutions as modes of regulation, they have largely ignored the issue of "institutional inertia". (Lane 1995, p. 27) Institutional inertia emerges when a regime of accumulation is in crisis. The lack of analysis of the inertia thus makes it impossible to determine whether crisis starts at the national or global level. Finally, regulation analyses are vague when they come to the transition from one regime to another. This is intentional as they respect historical, social and cultural contingency. However, as Lane (1995) put it, it also means the lack of:

> tools to conceptualize current process of transformation and instead fall back on a variety of plausible empirical generalizations... one cannot be sure whether any new trends in industrial paradigm or mode of growth are, indeed, traces of a new order, or whether they are merely transitory phenomena. In the end, the attractive openness and flexibility of the theory is achieved at the expense of conceptual vagueness. (p.27)

The problem here is that the regulation school pays insufficient attention to the interaction between structure and agency[12]. As a structuralist approach with Marxist origin, it tends to emphasise the importance of structure: it is weak in examining the individual (agent) actions which facilitate structural changes. The structuralist approach has been criticised for its inability to explain anything else but behavioural conformity to structural demands (Layder 1979). Wendt (1987) argued that by doing so, it may fail to explain some properties within the structures themselves. Though such reductionist tendencies are evident in systemic theories, such as the structural Marxist theory of Louis Althusser and the world- system theory by Immanuel Wallerstein, the regulation school is able to grasp changing structures. It does so by identifying

[12]For details, see Wendt (1987). For recent debates, see Hay and Wincott (1998) and Hall and Taylor (1998).

domestic structural tensions and agents who implement changes. One should emphasise that the regulation school was created as a criticism of structural statism pioneered by Altusser's structural Marxism, which emphasises the reproduction of structures rather than the transformation. Yet, the regulationists' ability to analyse such dynamic structural change is contingent on the changes being of internal origin. If structural change originates from outside the domestic social relations, the regulation school cannot capture fully the sources of change, but it is capable of explaining the specific structural transformation resulting from this change. For instance, the regulation school cannot explain a global oil price shock, but it is useful in analysing the consequences of such a shock on structural change in Norway as a oil producing country. As regime change associated with EMU is very much contingent on the organizational principle of national economies under the previous EMS regime, the regulation analysis is valid here.

Institutional transformations happen as a consequence of intended or unintended action by social agents. Since the regulation theory does not conceptualise how these processes affect pre-existing structures, it has problems in unambiguously analysing the potential for and direction of future structural change. The potential for re-regulation of inadequate existing institutional structures through policy actions is not systematically understood and remains contingent on future developments. The regulation theory thus contains a historical dimension: it describes the present nature of institutions and regulatory frameworks in retrospect, as a product of path dependent developments driven by social interaction. (Hübner 1989)

As economics has discovered in the Lucas critique, it is impossible to predict the future precisely, based on past variables. The advantage of the structural analysis of the regulation school is that it points out the constraints policy makers face from existing historically-rooted domestic institutional structures. Particularly in the situation of structural crisis, when structural constraints lose legitimacy, policy makers face strategic choices on how to adjust national economic systems. Though the regulationists are aware of social agents facilitating structural changes, they are better in identifying the build-up of structural tensions which interact with agents' intervention. Predicting the options policy makers will choose goes beyond the analytical scope of structural analysis. What is needed here is an understanding of policy processes as has been put forward, for example, by the notion of policy learning. (Dyson 1994)

Regulation theory is not a concrete and rigorous theory. Rather, it sets out general notions, a method of work and a way to examine social interactions of capitalist economies. Teague (1990) argues that the theory may be better understood within the framework of the tradition of French sociological theory. However, the fact that the theory is less rigorous than conventional economic theories may be advantageous in its application to political economic questions. It may not be a theory which is meticulous in detail, but it presents a very useful means of analysing socio-economic questions. The question of this thesis is how domestic structures of labour markets intervene in the process of managing a single currency in Europe. Its purpose is to point out the structural constraints policy makers of the Euro zone countries are currently facing from their traditional domestic labour market institutions. Hence, despite its limitations, the methodology suggested by the regulation school is pertinent here.

3.2. Analysing domestic regimes

The analysis of domestic regimes is at the core of this thesis. They will be explored in detail using the empirical cases of three European countries, Britain, Germany and France from Chapters 6 to 8. The purpose of analysing the domestic regimes of three countries is to determine whether the three countries make good partners in constituting a **sustainable** monetary union. Given there is no clear hierarchy in power among these three countries, monetary union among them would have to rely even more on cohesion in economic and social policies. For that, it is necessary to examine whether the domestic regimes of the three countries are structurally compatible. By 'compatibility', I mean the three countries being able to co-exist without major problems or conflict. One way to assess compatibility of domestic regimes is to examine the historical traditions, institutional structures and the social preferences[13] of different countries. These three factors are the key to clarifying the differences in domestic socio-economic regimes.

3.2.1. Anti-inflation regime and structural compatibility

The Maastricht convergence criteria were envisaged by those in the 'economist' camp to ensure that only non-inflation prone EU member states would participate in monetary union. The main focus by the Bundesbank is to introduce a 'stability culture' (Jochimsen, 1993) through the Maastricht criteria to member states. 'Stability culture' stands for price and economic stability backed by social consensus. Contrary to conventional wisdom, it does not necessarily mean that countries have to have identical structures, i.e., the same democratic corporatist culture, as Germany. The regulationists know that it is impossible for countries with different socio-historical traditions to achieve an identical economic structure. Structural factors do not need to converge totally, but they have to be compatible. Similarity in dominant norms of economic management, in economic and social objectives, and the degree of social consensus,

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[13] I define social preferences as the underlying attitudes and inclinations of society towards a certain issue area like monetary or labour market policies. Social (or societal, socio-economic) preferences are conditioned and shaped by historical traditions and national institutional structures. (Henning p.329) The regulationists also call preferences "social demand". (Noël p.329)

rather than an idiosyncratic institutional structure, is more relevant to assess regime compatibility.

In order to examine whether or not countries have a 'stability culture', one has to consider questions regarding the anchor of price stability. As Henning (1994) put it, "societal preferences ... influence external and domestic monetary policy" (p.246). With EMU, countries lose the external anchor, i.e., the exchange rate peg, as means to control inflation. As a result, they need an internal anchor to keep inflation in control. The management of the internal anchor depends very much on the kind of domestic regime countries have.

Structural inflation pressures come from either labour or credit markets. For the former, it is induced by wage inflation, and for the latter by asset-price inflation. The attempts to theorise structural inflationary pressures from labour markets are discussed in section 2.3.5. of Chapter 2. The regulation approach to labour market regime analysis will be discussed in detail in the next section. Before doing so, however, one should briefly note another structural cause for inflationary pressure, although it will not be elaborated in this thesis.

The credit market is also another important source of inflation. The regulationists' interpretation of the relations between inflation and credit is already surveyed in section 3.1.1.2. In a nutshell, when an intensive regime of accumulation is in crisis, asset-price inflation emerges and is difficult to contain. It could easily get out of control, as Japan experienced in its 'bubble economy' of the second half of the 1980s: institutional investors, financial institutions, and small investors joined the speculation. They expanded credits excessively by, in particular, buying into and selling off real estate. Once the bubble bursts, it is difficult to manage the economy out of stagnation, as the Japanese example shows.

How do we assess the proneness of asset-price inflation? The relations between banks and industry consumers is an indicator. An economy where banks have a higher ratio in creditloan activity would be more sensitive to inflation than one with more securitised financial markets. In this sense, French and German economies are less inflation prone than the British one. Households' equity holding was about 75% of disposable income in Britain, whereas it was less than 20% in both France and Germany in 1997.[14] Another indicator would be the structure of fiscal deficits. A government may be tempted to inflate away its debts if they are excessive. Not to mention, this is why the Maastricht convergence criteria include a section on the size of debts and deficits.

Aside from these structural factors, the historical experience also helps to mould an anti-inflation climate. This, however, may be only ingrained in Germany and not the rest of Europe. This thesis concentrates on the study of structural elements arising from labour market regimes thus ignoring other important issues related to credit market regimes.

In a narrower sense, the issue of regime compatibility seems to be to do with full economic union rather than monetary union. However, monetary union does not work well without a well-functioning economic and social counterpart. For this reason, I interpret the sustainability of monetary union in a broader sense, including the consideration for non-monetary factors. In assessing structural compatibility, I concentrate on the analysis of labour market regimes, as the sustainability of EMU is critically dependent on this crucial mode of regulation.

3.3. Analysing labour market regimes

It is important to define a navigational guideline for further empirical exploration in Chapters 6 to 8. In section 3.1.1., the configuration of wage relations (*Rapport Salarial*) was introduced as one of the modes of regulation. Wage relations cover wide areas related to the

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[14]Statistics are from Economist 19th-25th September, 1998, p.157.

functioning of labour markets including industrial relations, wage formations and welfare payments. In other words, they examine the organisation of labour, wage bargaining processes, and the coverage of social rights. This methodology to deal with wage relations and welfare states as a single interdependent unit is a significant contribution of the regulation school. By doing so, one can classify the different kinds of democracy that different societies belong to.

This point is complex, and may require further elaboration. A French sociologist, Théret (1994) introduces the concept of social debt, i.e. individuals owing society a debt. For him, society is comprised of a set of inter-individual debts and a set of rights-duties that bind together those who make up society. A democratic state is responsible for formulating individuals' reciprocal rights and duties and for guaranteeing the reimbursement of the social debt. By playing such a role, states become socially legitimate. Of course, there are a number of different types of society in different democratic countries. In very practical terms, one can interpret taxation as one of the factors constituting social debt. Anglo-Saxon countries prefer lower taxes, the lower social debt, which results in lower redistribution of income from rich to poor and thus higher income inequality. Nordic countries, on the other hand, tolerate higher taxes and higher social debt, resulting in higher income redistribution, and lower income inequality. In addition, the former can afford lower standards of public services, such as health, education and childcare, than the latter. These differences are nothing but differences in the social preferences of citizens, which are shaped by long historical and cultural traditions. And institutions, including social institutions, are built upon such social preferences and labour market institutions are no exception.

In section 3.1.1.1., I have described the way Keynesianism and Fordism interaction went hand- in-hand to maintain a virtuous cycle of mass production and mass consumption during the golden age of economic growth. Théret (1994) describes such interaction as a combination of the capital accumulation regime guaranteeing sustained individual consumption (Fordism) and the regime of state legislation agreeing to complement wage relations in a framework of welfare states. (p.33) The Keynesian-Fordist regime was based on the generalised principle of compensation. In other words, social security payments by states covered the loss of consumption power due to low wages, loss of work (unemployment), or retirement. In addition, basic social services provided by welfare states, such as health and education, were public and they guaranteed, at least in most Western European countries, quasi-universal access at low cost.

Let us now turn to the practical point of how exactly scholars of the regulation school deal with the labour market regime empirically. It is one of the most important modes of regulation that regulationists deal with. Consequently, there are large number of empirical studies by economists and sociologists. Boyer (1988) above all presents a most comprehensive framework. He studies labour market institutions by breaking them down into the following criteria: first, the trade union movement; second, employers' organisations; third, government intervention; fourth, the type of collective agreement; fifth, the role of wage formation; and sixth, social security. For the fourth criterion, type of collective agreement, he examines levels of negotiation, and the frequency of agreements. For the role of wage formation, he studies the correlation of wages with productivity, cost of living and labour market behaviour in general (such as the level of unemployment, labour supply and demand, the awareness of external competitiveness). For social security, he looks at its extent, the level of benefits and how it is financed.

By examining these elements, I shall investigate whether France, Germany and Britain share similar socio-economic preferences and compatible labour market regimes. In doing so, I examine the concept of labour market flexibility (LMF), which is, as a principal means of adjustment, believed to be essential for a successful and sustainable monetary union. I distinguish between the two types of LMF, internal and external flexibility, proposed by Boyer (1993), to assess whether the labour market regimes of the three countries are compatible.

Scholars agree that LMF is very difficult to define as a generic concept. LMF is a means of evaluating the adaptability of labour market conditions to changing economic conditions. An assessment of LMF is both difficult and controversial. It is difficult because wage setting and legal frameworks in individual countries differ from each other, featuring diverse institutional settings and practices. It is also controversial because it raises major analytical and empirical questions on which no consensus exists. (OECD 1986) More than a decade since the OECD raised the point, there is still no agreement on a standard measurement of LMF. This thesis attempts to differentiate external and internal flexibility which are ideologically and practically difficult to reconcile. These concepts will be elaborated in Chapter 7 in detail.

Before moving to the central focus of the thesis, i.e., the comparison of labour market institutions and flexibility, let us survey the historical cases of monetary union attempts in the next two chapters. The Latin Monetary Union, the Scandinavian Monetary Union, and the early American monetary experiments will be studied, as they share some conditions and environments similar to the current EMU attempt. Does historical experience confirm the importance of the structural factors which I have been emphasising? To find out, an analysis of historical cases is necessary before moving to the specific analysis of labour market regimes in Europe from Chapter 6 onwards.

Chapter 4

Lessons from history: Part I
Latin and Scandinavian Monetary Union

This and the next chapter examine historical attempts to form monetary union. Studying history can be useful to determine the key economic, political and institutional features, which cause the success or failure of monetary unions. In particular, I shall attempt to capture the broader structural factors which may have contributed to the sustainability of historical monetary unions.

In Chapter 2, two types of historical monetary unions were briefly introduced: those with and those without political union. In terms of its procedural development, a past monetary union comparable to the current EMU project is the German monetary union. It started with the initial customs union, the Zollverein, which eventually developed into the United German state, as explained in Chapter 1. However, in the case of the Zollverein, full monetary union came after political union. In this chapter, I shall only deal with monetary unions which were not accompanied by political unions - probably the most imperative feature of the current EMU attempt[1]. Therefore, I shall study the Latin Monetary Union (LMU) and the Scandinavian Monetary Union (SMU), both of which flourished in the latter half of the 19th century without political integration. Both were established within the international framework of metallic monetary standards and free mobility of capital and labour. Both eventually ceased to exist over the political differences leading up to World War I. However, there were already vast differences in the performance of the two monetary unions before this decisive break. They will be clarified in the forthcoming sections. Though the differences between the international monetary regimes

[1]Since the European integration process has been considerably deepened since its creation, some may interpret Europe as having imperfect political union. (Dyson 1994) However, political union is still a highly contested issue in Europe today, and fully-fledged political union would not be likely to materialize in the near future.

then and now should be taken seriously, we should be able to gain fruitful insights by studying history.

4.1. A comparison of the international monetary regime of the 19th century with the present regime

The current international monetary regime shows some distinct differences to the 19th century. First, and most evident, the monetary arrangements in the latter half of the 19^{th} century to the beginning of 20th century were based on metallic standards. Among those the gold standard evolved into the most dominant form, but there were also many countries subscribing to a silver or bimetallic standard. The metallic standards de facto meant a fixed exchange rate regime, whereas the current international system is characterised by **floating exchange rates**. There was a clear hierarchy during the classical gold standard period: the three European capital markets - London, Paris, and Berlin - were de facto running the world of 'haute finance' (Polanyi). The rest of the world - colonies of the British Empire, Latin America, Asia and to a lesser extent, the US - were minor players in terms of outward investment. There was a core-periphery division in the system, with the former being the core and the latter being the periphery. Within the core countries, there again was a clear hierarchy with Britain being on top. Hence, the system was **stable** since the hierarchy was clearly defined and accepted by financial markets. There was a transnational consensus of 'haute finance' lending credibility (Eichengreen 1996), which led to capital flows acting as a stabiliser. In contrast, the present can be characterised as an era of **currency competition** (Cohen 1998). Although the dollar is still regarded as the dominant international currency, there are several other currencies, such as the Deutsche mark and the Japanese yen, which are widely used in international transactions and finance. Second, there was little **national economic policy management** in the time of the gold standard, whereas now the interventionist state is firmly established. Before the first world war, with the limited development of democracy, the concept of nation-based social protection had not yet been recognised. Thus, when there was a severe economic downturn, people were forced to emigrate abroad.[2] (Panić 1992) One can argue that domestic regimes of the present type were foreign to the 19th century.[3] There was no mechanism for the redistribution of wealth or of social welfare provided by states. Thus, the international regime was operated under text-book type liberal principles with virtually no intervention in markets and free movement of capital and labour. This **absence of democratic franchise in most domestic regimes** made it easier for countries to adjust. There was no conflict between external and internal stability, and external stability irrefutably prevailed. The adjustment burden was often shifted to the periphery from the core countries. If the core countries had to adjust considerably, it was helped by the emigration of the domestic population. With the lack of social welfare, and the concept of civil rights unknown, poor people either starved or had to migrate. Unlike then, the contradiction between national economic policy making autonomy and global economic interdependence has become the key problem of the international monetary system. National social cohesion has only become a priority since the 1930s.[4] It became institutionalized in the concept of the welfare state developed after World War II. It is very difficult or even impossible to compromise on internal stability in pursuit of external stability at present. Fiscal policy before World War I was

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[2]The cumulative totals of **net** migration between 1870-1913 for Germany, UK, and Italy were -2,598,000, -6,415,000, and -4,459,000. Besides other factors, the later development of partial social protection reduced the number of emigrants. The figure for the same countries between 1914-49 were -304,000, -1,405,000, and -1,771,000, respectively. (source: Table B.5., Maddison 1991)

[3]e.g. Eichengreen (1996)

[4]For more details, see K. Polanyi (1957).

predominantly concerned with tax collection, but it has since become more complex with the emergence of social and deficit spending. In other words, the **domestic regimes** now and then are totally different. Third, the **nature of capital flows** then was not as much dominated by short-term speculation as it is now. Since the world economy was growing, there were opportunities for lucrative long-term real investment, such as investment to finance railway construction in the Americas. Some parts of the world economy were rapidly growing and needed investment in infrastructure at the same time as some other parts, i.e. the European countries, had already reached a certain level of development and were actively seeking overseas investment opportunities. Thus the long-term nature of investment contributed to making the system less volatile. Today, however, a substantial amount of investment is financial speculation, despite the high level of foreign direct investment, partly due to developments in technology, together with floating exchange rates. Yet, one has to add that, toward the end of the 19th century, investment increasingly became speculative. Finally, the **political structures** the world economy operates in are totally different then and now. During the classical gold standard, key countries could conceal their structural weaknesses and maintain a myth of superiority, in particular, Britain. For instance, the British merchandise trade balance was increasingly in deficit toward the end of the century. Yet, its current account was intact due to its net assets abroad. Because of the structural political factor of ruling over empire, it could limit the size of its trade deficits. In other words, British colonies had a clear bias towards importing British manufacturing goods, rather than German or French, irrespective of quality or price. In spite of the myth of free trade, there was a case of what could be described as 'structural impediments' in terms of the current trade debate. Such an imperial political structure does not exist now. (De Cecco 1974) Thus, the economic weaknesses at the core are more visible at the present than they were in the 19th century, which encourages instability in global finance.

4.2. The rationale behind the study of historical monetary unions

Having examined the differences between international monetary regimes now and then, does it still make sense to study historical monetary unions? The answer is yes, as the LMU and the SMU are some of the few inter-European monetary arrangements in history practised without political union. The experience of their success and failure may enable us to gain some insights into the dos and don'ts of the management of monetary unions. Thus, the working and the institutional structure of two monetary unions will be studied in this chapter: the Latin Monetary Union and the Scandinavian Monetary Union. The LMU case may be more interesting to study, as it is a union among countries with considerably different political and economic systems.

4.3. Historical background

In the 1860s, apart from the bimetallic standard, Europe was divided into two different monometallic standards, one based on gold centred around England and the other based on silver in the Russian and Hapsburg Empires. For about five years after the creation of Latin Monetary Union in 1865, the bimetallic standard, which will be described extensively in the following section, seemed to prevail in Europe as a whole. However, the fluctuation of the relative value of the two metals due to the discovery of new gold or silver mines caused considerable problems in the maintenance of bimetallism. (Eichengreen 1996) Finally, the French defeat at Sedan in the Franco-Prussian War in 1870 decisively contributed to the prevalence of the gold standard in Europe outside the LMU. However, the stability of the gold value was always under threat throughout most of the period of the classical gold standard in those countries which still used silver together with gold, due mainly to the massive inflow of silver from American mines. The

Banque de France, the lender of last resort of the Latin Monetary Union, worked as an important shock absorber to stabilise the fluctuating silver price against the gold price for the first three decades of the classical gold standard. De Cecco (1990) interprets the role of the Latin Monetary Union as positive for the working of the international monetary regime:

> the famed stability of exchange rates which characterised the European currencies in the second half of the nineteenth century would probably not have been achieved had the Latin Union not been there to stabilise silver prices and to prevent silver countries, like the Russian and Hapsburg Empires, from adopting monetary policies even more drastic than the ones they were compelled to take because of the fall in the price of silver." (p.35)

Having introduced the LMU in its international context, I examine the detail of its functioning in the next section.

4.4. The Latin Monetary Union

The Latin Monetary Union (LMU) was formally established in 1865 and ceased to exist in 1927. It was the confirmation of the Franc standard which had already been used by France, Belgium, Switzerland and Italy. The union was not a deliberate attempt at fresh institution building, but a mere formalization of what was already practised. The French Franc had already become legal tender in Belgium in 1832. Switzerland adopted the French monetary system in 1850 and so did Italy in 1862. By 1865, all four countries had more less the same monetary structure based on the French system, and their currencies were freely circulating among them. As Perlman (1993) put it, "the purpose of the (1865) convention (for establishing the LMU) was merely to enshrine an existing system in law". (p.316) At the monetary convention of 1865, the reciprocal obligation to accept each other's currencies without limit was institutionalised. The main objective of the convention, however, was to standardize the fineness of existing silver coinage, because differences in the fineness (in terms of the pureness of silver content) in the countries' 5 franc pieces threatened the displacement of good by bad silver coins.[5] Kindleberger (1993) characterized the motivation for the establishment of the union as follows: "the instinct or reasoning that prompted the decision would be known in the 1960s as the theory of 'optimum currency areas'. Belgium was too small to have an independent currency." (p. 68)

In addition to the aspect of optimum currency areas, the LMU experience can offer another discrete but interesting lesson for the current European project. That has to do with the desire for the standardization of money not only in Europe, but also world-wide. Napoleon III's finance minster, François Nicholas Mollien, believed in the desirability of universal money. Initially, it was conceived that other countries would join in the LMU at a later date. The founders of the LMU, especially France, believed that "they had laid the basis for what might eventually develop into a world wide monetary union based on a bimetallic currency." (p. 596, Nielsen 1933). Like Napoleon I, Napoleon III was ardent to become a lawgiver to foreign countries, and aimed at France eventually becoming a dominant European power politically and economically through monetary influences.[6] Some authors assert that this intention may be similar to that of Germany or France in the present context of the EMU project.[7] Indeed, some countries considered joining the LMU, but this never materialised, except for Greece, which

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[5]This problem confirms Gresham's law, proposed by Sir Thomas Gresham in the 16th century. The argument is that in the case of two monetary media circulating simultaneously, if their intrinsic relative values determined by market forces diverge from their legally determined values, the money with the higher intrinsic value will be driven out from circulation, since it will be hoarded. Thus, Gresham's law means that bad money drives out good money.

[6]See Willis (1901) p.56, and Bartel (1974) p.696, quoting Henry B, Russell (1898) International Monetary Conference. New York: Harper and Brothers.

[7]For example, see Connolly, B. (1995). He calls the French vision of Europe "imperialist" and German "missionary-colonialist". (p.388)

joined in 1868.[8] The main reason lies with the institution at its core - the bimetallic standard.

Ironically, the fact that France insisted upon bimetallism against all odds resulted in a fatal blow to its dream of becoming the provider of universal money, both technically and economically. Technically, to maintain a fixed relative price of gold and silver, and to maintain both as effective currencies, financial markets had to be convinced that the system was completely credible. Otherwise the market had to be managed. As we know, the international monetary regime of the 19th century was based on the free movement of capital. Any major changes in relative metal prices had a disastrous effect on such a system. (Perlman p.314) In addition, it was already widely believed that keeping the bimetallic standard did not make sense economically. Gold currencies had already become the money of commerce, because gold was the wholesale money of mercantile nations.[9] As most countries tended toward the gold standard, the bimetallic anachronism was "likely to hinder the extension of the Latin Union". (Willis, p.57) At the monetary convention in 1865, Belgian, Swiss and Italian delegates strongly favoured adopting the gold standard, rather than the existing bimetallic standard. Interestingly enough, French delegates also were personally in favour of the gold standard.[10] Yet, the minister of Finance "demanded the maintenance of the status quo" (Willis p.57) This official French position can be interpreted in two ways. First, the French government was heavily influenced by the interest of the Banque de France and haute finance, which were reluctant to forsake the

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[8] Spain and Romania formally applied for the union but were rejected, due to political reasons. Austria considered joining the union in 1867 only for gold currencies, and Austrian gold coins were made legal tender in Italy and Belgium. Willis (1901) argued that "it was a severe defeat for the bimetallic policy". (p.83) The Papal States, the Balkan countries, the Grand Duchy of Finland and some countries in Central America introduced the franc standard and contemplated joining the LMU, but never did.

[9] Willis (1901) argues that France was already dependent on the new gold currency which was adopted in 1848, by the time of the 1865 monetary convention.

[10] For details, see Willis p.78-79.

existing system. The system had operated for well over half a century since 1803, and more importantly, bimetallism provided an opportunity for lucrative arbitrage operations. Those arguing for bimetallism also pointed out the advantage of the system in trading with the East, where most countries were on a silver standard. Second, France possessed considerable amounts of silver. The redemption of the outstanding silver coinage would have been a great loss to France.

The design of the union reflected French interests completely. It was an asymmetric arrangement with the Banque de France as the lender of last resort. The Banque de France provided liquidity by supplying the other member states with gold against their silver. As mentioned above, the fundamental feature of the union - bimetallism - was determined solely by the interests of France, and ignored the opinion of other member states.

The French government, however, reviewed the LMU thoroughly between 1867 and 1870. The results of the investigations were in favour of the gold standard.[11] Willis (1901) argues that "at the opening of 1870, everything was ready for the introduction of measures definitely committing France to the gold standard." (p.108)

In the same year, the Franco-Prussian War broke out, and at the battle of Sedan, Napoleon III was captured. The war ended the following year with a German victory. The fact that Germany opted for the gold standard, according to Willis (1901), was reason enough for France to reverse the decision to go for the gold standard. (p.112) France had to pay a large part of the indemnity to Germany in gold.[12] Furthermore, the institutional structure of the gold standard applied by Germany was totally incompatible to the French monetary system. This made it

[11]For detail about the development of French public opinion, see Willis (1901), pp.94-107.

[12]For the breakdown of the indemnity and the amount paid, see footnote I of p.110 by Willis. (1901)

impossible for the union, even if based on gold, to continue to flourish.

In sum, with the French defeat in the Franco-Prussian War in 1871, and the newly established German Reich adopting the Gold standard, bimetallism lost its significance. As silver lost its importance as a unit of account, Germany sold its silver holdings. France had to pay considerable parts of its indemnity in French gold coins, which weakened the French ability to serve as the lender of last resort in the LMU.

A number of new silver mines were discovered between 1869 and 1872 in the United States as well as in Latin America, which exacerbated the problem of over-supply of silver relative to gold. From 1860 to 1885, the production of gold decreased and that of silver increased, which caused the relative value of silver to fall. In 1872 and notably 1873, the value of silver sharply declined, which made it clear that the bimetallic standard was unsustainable: it became increasingly difficult for the LMU countries to maintain stability of the gold-silver exchange rates. Growing speculation induced a massive flow of silver to France and Belgium, the main countries practising the system. In return, gold from these countries went abroad. Belgium pushed hard for the adoption of a single gold standard. The coinage of silver five-franc pieces was suspended during 1873 to 1875. The free movement of currencies among the member states was hampered by the French reluctance to receive Belgian and Italian coins in late 1873. In order to avoid developments as predicted by Gresham's law, coinage of silver was limited and consequently stopped in 1878. From this point onwards, the bimetallic standard de facto became "a limping gold standard". (Nielsen 1933, p.597) The member states, France in particular, suffered from a massive overhang of silver coins, which slowly undermined the already crumbling system. As Perlman (1993) put it, "the basic element of a monetary union, the uniformity of coinage, and their free circulation had by now been so circumscribed by detailed regulation that except on paper the union was finished." (p.329) For the rest of the period until the legal demise of the LMU in 1927, member states were muddling through just to keep the LMU in existence: there was not much substance left to the LMU. It was a French creation and died with the French inability to act as a political and economic hegemon.

4.4.1. Evaluation of the LMU

What can we learn from the historical experience of the LMU? This question is best looked at by, first, analysing the causes which led to the failure of the union.

4.4.1.1. Why did the LMU fail?

The direct economic cause of the collapse of the system was the changing price of silver vis-a-vis gold. The political cause was the defeat of France in the Franco-Prussian war. These elements can be categorized as external factors which caused the failure. However, these external factors were not alone in causing the union to collapse. Rather, there are a number of more fundamental problems regarding internal arrangements, which deserve attention.

First of all, the **institutional structure** of the LMU was not adequate. The fundamental feature of the union, bimetallism, was inherently unstable, as any change in the price of either metal attracted speculation.[13] As explained above, from as early as 1865, LMU member states, excluding France, advocated the application of the gold standard. The fact that the system only reflected the narrow interests of the French finance ministry and haute finance, resulted in the

[13]In the words of Bagehot, bimetallism is described as follows: "we regard that scheme (bimetallism) as so entirely beyond the boundaries of practical finance that we did not think it worth discussing, and we only discuss it now because we continued to receive ingenious pamphlets . . . they (universal bimetallism) seem to us fit only for theoretical books, because the plan is only a theory on paper, and will never be in practice tried." (St. John-Stevas p.215-17)

breakdown of the system as a whole.

Secondly, institutional weaknesses to control inflationary tendencies could be considered as the most crucial cause of the demise of the LMU. Svindland (1990) blames the failure of the LMU on the lack of regulation of the total money supply. As a result, countries took advantage of this flaw to solve problems in their public finances. Despite the fact that France was the dominant power (hegemon) in the system, it was an irresponsible manager and was not enforcing proper management of the system. There were some mechanisms to control the domestic money supply within some member states, but there were none to monitor the total money supply of the LMU. For example, there was no limitation for the notes issued by the Banque de France, but the notes in circulation within France were limited by law, which changed from time to time. The National Bank of Belgium was constrained in its note issue by law, which required the coverage by securities readily convertible, and also a certain amount of metallic reserves in return for new notes. Due to its unique political structure, Switzerland had several banks which were authorised to issue notes, but the Federal Assembly reserved the right at all times to fix the total issue of the Republic and determined the quota for each bank. In addition, banks were regulated in their procedure to issue notes, as in the case of the National Bank of Belgium. Italy also had several banks but their banking affairs were not managed properly. Six banks were authorized to issue notes, with a legal limit to maximum issuance, but they quite often did not follow such regulations. (Rothwell 1893, p.24) Italy was given special treatment in the LMU, and was allowed to issue large amounts of paper money. (Perlman p.329) Unfortunately, the money supply of the system was largely determined by Italy. The union decreed a common monetary policy, but left it to each central bank to ensure compliance. As the global depreciation of silver began in the late 1860s, several members increased the amount of circulation for additional seigniorage gains.(Cohen 1994, p.158) Although the system allowed free circulation of national currencies, there was no institution to monitor how much money was actually circulating. This **lack of control over the total money supply** made the system inflationary, which eventually led to its collapse.

Thirdly, the fundamental cause of the breakdown of the LMU can be put down to a standard economic problem: that is to say, the collapse was the result of **asymmetric shocks,** a problem addressed in modern economics by the theory of optimum currency areas. The external shocks derived from the fluctuation of the metallic values which had different effects on different member states. Such shocks were exacerbated by structural differences in their economies. As Perlman (1993) put it, "the specific changes in the economic environment that will affect the system and the specific intervention required will vary according to the type of monetary and other economic structures present." (p.331) The external shocks brought about different kinds of internal disturbances, depending on the monetary or economic structures of the members. With the LMU, their monetary structure was unified. However, their economic structures were diverse, since the LMU brought together nation states in different stages of economic and political development and with different cultural traditions. France was a traditionally centralized state and Switzerland was a traditionally decentralized federal state. Belgium was newly independent[14] and had not established a firm domestic regime yet. The same could be said for Italy which was only united in 1870. As table 4.1. indicates, the employment structures of member states were diverse. We can infer that Italy had by far the most agrarian economy relative to other LMU member

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[14]Belgium declared independence from the Netherlands in 1830, which was acknowledged in the London Protocol in 1831. However, the settlement of the border problem was not achieved until 1839.

Table 4.1. Structure of employment in 1870 in selected LMU countries (% of total employment)			
	Agriculture	Industry	Services
Belgium	43.0	37.6	19.4
France	49.2	27.8	23.0
Italy	62.0	23.0	15.0
Switzerland	49.8	n.a.	n.a.

Source: Maddison (1991), p.248.

states, and the least developed among the 4 member states. The fact that the least developed economy was de facto determining the money supply illustrates gross negligence in LMU governance. This internal diversity often led to the issuance of paper money. Internal disturbances in one country were then echoed by and transmitted to other member states, and developed into Union-wide problems.

4.4.1.2. Lessons to be learnt from the LMU experience

The problem of lack of control over the system was caused by the absence of international institutions devoted to the functioning of the LMU. There was no secretariat nor any other permanent coordination body among member states in the LMU. The absence of such machinery to promote consultation and coordination hampered the union from taking any decisive action. This is a pertinent message for the current EMU attempt, since it justifies the establishment of the independent European Central Bank (ECB).

Another relevant message for the current monetary union project would concern the order of integration. France wanted to have currency union first, with the intention that it would become a stimulant for further integration. Clearly France was aiming for political dominance in Europe. However, with the lack of corresponding consistency in any other area of the economy as well as the political system, the union did not take off. In parallel to the present monetary union attempt, some in Germany (notably Bundesbank officials) argue that there has to be a clear commitment to political union in order to achieve successful monetary union.[15]

The motivation for the LMU, which is to use the currency to expand French political influence, was also not appropriate as a foundation for monetary cooperation. Though LMU operated in the international (or continental European) dimension, the institutional arrangements only reflected French interests. This is also a relevant lesson for the current project of EMU. The Maastricht criteria as well as the stability pact proposed by the Germans to strengthen the fiscal criteria seem to reflect mostly German interests rather than system wide interests. European economies at the start of EMU are just emerging from recession. In order to promote growth in the long run, it may be useful to have room to allow some coordinated fiscal stimulation for some time. Seeking fiscal soundness is good for the system, but imposing fiscal stringency to the level of the Maastricht fiscal criteria could be counterproductive to system wide socio-economic stability. Most European countries have unemployment rates of more than 10%. The economy may benefit from a carefully designed demand management policy to promote economic growth. It is, thus, important that the system is not organized in the interests of the dominant member alone.

The LMU was only a monetary union which was not backed up by institutionalised cooperation among member states in other areas of economic policies than monetary policy. The EU, as was the case for Germany before unification in the 19th century, has built up other areas of economic policy coordination through a customs union. Therefore, the EMU project, after considerable economic integration and institutionalised coordination, may be more sustainable than the ill-fated LMU.

Last but not least, the diverse political and economic conditions of member states caused

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[15] e.g. Tietmeyer (1994), Jochimsen (1993, 1994).

asymmetric shocks, which led directly to the collapse of the LMU. Would external shocks also make EMU fail? This is the standard OCA argument surveyed in Chapter 1. Due to lack of data, it is almost impossible to make a comprehensive assessment of the degree of divergence in domestic regimes in LMU and EMU countries. A crude measurement is attempted in section 4.6. Rather than comparing past and present monetary unions, it may be more pertinent to compare the records of success of the LMU and the Scandinavian Monetary Union (SMU), as they took place during the same period of time. This assessment will be done after the introduction of the SMU.

4.5. Scandinavian Monetary Union

In conjunction with the discontinuation of the silver standard, Scandinavian Monetary Union (SMU) was established at the end of 1872, and ceased to exist in 1931. A common system of coins and money of account among Denmark, Norway and Sweden was introduced after the Scandinavian mint convention in 1875. It was a monometallic gold standard, and set the Krone as a uniform monetary unit. It was established with the aim of standardising existing coinage. In 1885, the participating states agreed to accept one another's bank notes and drafts. The SMU established the total disappearance of exchange rate quotations among the three monies. By the turn of the century, the SMU had come to function, in effect, as a single currency for all payment purposes.

Unlike the LMU, the SMU worked very well due to close central bank coordination. The three central banks opened credit lines to each other and balanced mutual drawings regularly. In other words, the central banks were pooling reserves, as is practised in modern central banking.

The SMU broke up because of the malfunction of the currency system, owing to political developments. In 1905, Sweden cancelled its membership in response to the separation of Norway from Sweden. Yet Sweden continued the arrangement with Denmark. The SMU finally collapsed during World War I due to inflation in Denmark and Norway. Danish and Norwegian bills were quoted at discounts in 1915. Their exchange rates were continuously discounted in the markets against the Swedish Krone from 1916 onwards. In order to cope with the problem, the union managed to agree on the suspension of gold coinage and an embargo on gold imports from outside the union. However, Sweden continued to be exposed to the inflow of Danish and Norwegian gold coins. In 1917, the three countries agreed on a gold exclusion policy (the prohibition of gold imports), which de facto forfeited the SMU. (Bartel, p.702) As a consequence, the rates of exchange among the three currencies fluctuated heavily. Formally, however, monetary union was not abolished until 1924. Then, the last form of payment still convertible among the three countries - token money[16] - was abolished. Due to the differences in exchange rates after 1916, the Swedish Krone was considerably stronger than the Danish and Norwegian Krones. Yet the token money of one Swedish Krone still had the same nominal value as one Danish or Norwegian Krone. As a result large amounts of Danish and Norwegian Krones were smuggled to Sweden. As Gresham's Law indicates, people hoarded Swedish Krone and used Danish and Norwegian counterparts.[17] In 1924, the parliament of all three countries ratified the law to make the old convention money ineffective as legal tender. (Hecksher et al. 1930)

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[16]Token money stands for a legal tender which bears no relation to its intrinsic commodity value.

[17]According to Hecksher et al. (1930), "the sums sent back by Sweden in the course of the year 1923 and 1924 amounted in Norwegian money to Kr. 19,300,300, and in Danish to almost exactly the same sum, or Kr. 19,500,000. . . By comparing this with the total amount minted during the fifty years of the Monetary Union, it will be found that exactly 40 per cent of what had been minted in Denmark since 1873 had gone to Sweden during the few years of the depreciation of the currency. . . The corresponding figures for Norway appear to be lacking." (p.265)

Outside the formal agreement, the public offices of the border towns continued to accept token money and banknotes of other member states of the SMU in smaller amounts. The SMU was never formally invalidated. At the end of 1931, however, the three countries left the gold standard, and introduced paper currency, which practically terminated the SMU.

4.5.1. The LMU versus the SMU

Though the LMU de facto failed in 1878, the SMU was relatively successful until 1905. This means that the LMU functioned for about 13 years, but the SMU worked for 33 years. What made the SMU more sustainable than the LMU?

The LMU and the SMU took place at the same time, but they had very different characteristics. First, as the SMU was a monometallic standard, it was not as vulnerable to the relative price changes between gold and silver as was the LMU under bimetallism.

Second, unlike the LMU, the SMU successfully managed to control union level money supply through central bank coordination.

Third, one of the distinct differences between the two monetary unions is that there was a high degree of cultural uniformity among SMU member states. In the 1830s, a movement called Scandinavianism emerged to promote fraternity among Denmark, Sweden and Norway. Its objective was to join the Scandinavian countries into a political, economic and cultural entity. This liberal movement of Scandinavian brotherhood faced a setback when Norway and Sweden failed to aid Denmark in its war with Prussia in 1863-64. However, the spirit of unity continued, and was embodied in the Scandinavian labour and social democrats movements in the 1890s.

Fourth, this cultural similarity made it easier for the SMU countries to proceed with economic and quasi political integration in other areas. Political and economic integration took place at various levels during the 19th century. The Scandinavian Inter-Parliamentary Union, comprising Sweden, Norway and Denmark, was formed in 1907[18]. It worked as an advisory body for political ends. A secretariat of the Inter-Parliamentary Union was established, which enabled it to publish its proceedings. (Lindgren, p.235) The Scandinavian Administrative Union was established in 1918, and played a complementary role. The Union was dominated by social democrats. What is most different from the current situation is that the labour movement was also more international then: national labour organizations initiated their Nordic meetings. The movement for a Scandinavian labour congress developed in the 1890s. During 1898-99, national trade unions started to unite as a Scandinavian federation, which "served as an administrative clearing organ during industrial conflicts and collected funds to assist colleagues in other countries." (p.236)

The forces behind such regional integration were Social Democratic Parties and labour groups. This internationalisation of the labour movement in the Scandinavian countries was, of course, influenced by the "internationalist" movement on the continent. Yet, such institutions were never built among the LMU countries, nor was there any further integration attempt beyond the monetary sphere. Though each Scandinavian nation pursued its own national policies "their natural similarity caused a growth of identification with each other." (p.236) The participants of the SMU were, though only for a short period of time, engaged in even deeper integration than the current EU countries.

Fifth, According to Vanthoor (1996), the SMU was "successful in the sense that its participants were equal economic partners, who had already put their economies in order before the monetary treaty was concluded, thus giving their national currencies an equal status." (P. 41) Sweden was not the absolute hegemon of the SMU, to the extent France was in the LMU.

[18] The Inter-Parliamentary Union was similar to the current European Parliament, including its ineffectiveness as a law maker.

Sweden was the largest economy and politically the most powerful of the Scandinavian countries, as was France in the LMU. Yet the institutional arrangements of the SMU were more symmetrically organised than those of the LMU. Such symmetry was induced by the similarities among the member states.

Table 4.2 below compares the employment structure of the SMU member states. The three countries had similar economic structures: they were predominantly agrarian economies with efficient agricultural systems, and increasingly industrialised in the latter half of the 19th century.

Table 4.2. Structure of Employment in 1870 (% of total employment) in the SMU countries

	Agriculture	Industry	Services
Denmark	51.7	n.a.	n.a.
Norway	53.0	20.0	27.0
Sweden	54.0	21.0	25.0

Source: Maddison (1991)

A comparison between tables 4.1 and 4.2 indicates that the SMU was a union of much more homogeneous countries than the LMU. This similarity between countries seems to have contributed to the sustainability of the SMU compared to the LMU.

Lindgren (1959) clarifies the drive behind Scandinavian integration as follows:

> It seems apparent that common systems of social thought and similar reactions to social change are basic to integration. Thus Scandinavian political reforms and social progress displayed domestic trends and effected a growth of identification with each other, since, basically, these impulses sprang from identical or similar pattern of social thought.... Some **common social values** seem to be necessary also, even though these might not always be in complete agreement. **Social equality** must be recognized fully... without mutual respect for the opinions of another country's representatives, any framework of amalgamation could not but fail. (emphasis added)(p.278-79)

He also points out that social welfare, democracy, and political participation are the key variables of social values in peaceful times. If countries have similar social values, "the political responses of leaders and peoples will be more certain to coincide and to be much less erratic." (p.282) He argues that economic motives - desire to preserve trade, commerce, a high standard of living, and other economic and social demands - were the engine for Scandinavian integration.

In accordance with the second criterion of Panić (1992), introduced in Chapter two, the socio-economic preferences of the member states were alike, which seems to have made the SMU more durable than the LMU.

4.6. Lessons from historical monetary unions

This section summarises the finding in this chapter to extract the lessons for the current EMU project. The first part attempts to objectify the differences between the LMU and the SMU by using statistical methods.

Generally speaking, the LMU was very loosely integrated and affected the monetary sphere alone, uniting member states of a variety of economic, political and cultural backgrounds. As table 4.3 suggests, the member states of the LMU had very different levels of per capita industrialisation[19], as well as per capita GNP. Such differences were less prominent in the case of the SMU, but there were still considerable differences in terms of per capita levels of industrialisation. What is interesting in studying such statistics is that the economically most wealthy countries - Denmark in the SMU, and Switzerland in the LMU - were not hegemons of their respective monetary regimes. The hegemons of both monetary unions were certainly the

[19]The level of industrialisation stands for the per capita volume of industrial production. The particular method of calculation is explained in Bairoch (1982), pp.311 - 329. This is the only comparable set of statistics indicating the patterns of economic activities, available from the mid 18th century to the present.

biggest countries, and perhaps more importantly, the politically most dominant ones in their regions. Thus we can infer that the operation of monetary unions in the 19th century were rooted more in political ambition than in economic rationale.

Table 4.3. Per capita levels of GNP and industrialisation

Per capita levels of industrialisation (UK 1900 =100)				Per capita GNP levels (1960 US $ and prices)	
	year	1880	1913	1880	1913
LMU	France	28.00	59.00	483.00	670.00
	Switzerland	39.00	87.00	584.00	895.00
	Belgium	43.00	88.00	481.00	815.00
	Italy	12.00	26.00	289.00	445.00
SMU	Sweden	24.00	67.00	404.00	705.00
	Norway	16.00	31.00	376.00	615.00
	Denmark	12.00	33.00	431.00	885.00
LMU	mean	30.50	65.00	459.25	706.25
	variability	577.00	2,570.00	45,584.75	117,018.75
	variation	0.79	0.78	0.46	0.48
SMU	mean	17.33	43.67	403.67	735.00
	variability	74.67	818.67	1,512.67	37,800.00
	variation	0.50	0.66	0.10	0.26

Note: Variability is a measure of the variability of the data set, and technically, measures the sum of squares of deviations of data points from their sample mean.
Variation is the square root of variability divided by the mean.
Unlike variability, variation is independent of units of measurement.
Source: Calculated from table 1.1 in M. Panić (1992)
European Monetary Union: Lesson from the Classical Gold Standard.

Table 4.4. Per capita levels of GDP and industrialisation in EMS countries

		Per capita levels of industrialisation (UK 1900=100)	Per capita GDP levels (Thousands of ECUs at current market prices)	
year		1980	1980	1995
EMU core	Germany	395.00	9,472.76	22,919.03
	France	277.00	8,880.85	20,282.14
	Netherlands	245.00	8,711.56	19,543.11
	Belgium	316.00	8,632.07	20,644.14
	Austria	342.00	7,333.86	22,628.74
	Luxembourg	n.a.	9,060.96	25,444.66
EU rest	Portugal	130.00	2,210.96	8,624.54
	Finland	n.a.	7,742.21	19,059.75
	Italy	231.00	5,776.66	14,226.87
	Spain	159.00	4,068.37	10,780.30
	Ireland	147.00	4,204.65	13,251.33
	Greece	114.00	3,588.47	8,082.55
	UK	325.00	6,859.58	14,601.45
	Sweden	409.00	10,866.43	19,112.12
	Denmark	356.00	9,330.47	25,818.81
EMU core	mean	315.00	8,682.01	21,910.30
	variability	13,474.00	2,629,301.64	23,883,047.48
	variation	0.26	0.19	0.22
EU all	mean	257.50	6,957.81	17,085.77
	variability	116,977.00	87,577,644.06	392,999,890.74
	variation	1.33	1.35	1.16
EMU 11	mean	249.11	6,917.72	17,945.87
	variability	68,242.89	60,920,552.49	293,526,419.27
	variation	1.05	1.13	0.95
F, G, UK	mean	332.33	4,368.37	13,835.97
	variability	7,042.67	3,754,866.52	36,135,188.27
	variation	0.25	0.44	0.43

Note: The industrialisation figure for Austria is the weighted average of Austria, Hungary and Czechoslovakia.
1980 is the last year available on the comparable calculations on industrialisation.
The GDP per capita figures of Germany refer to West Germany in 1980 and the united Germany in 1995.
Naturally, the same figure of West Germany only in 1995 is much higher.

Source: Panić (1992) and P. Bairoch (1982), European Economy: Annual Economic Report 1995 no.59, World Population Projections 1984, 1994-1995 by World Bank Data Base, EU Data Base.

Table 4.3 compares the economic conditions of the member states of the LMU and the SMU in the years 1880 and 1913. Now, let us compare tables 4.3 and 4.4. As both tables indicate, in terms of the similarity of member states' level of economic development, the LMU is much more similar to the current EU as a whole than the SMU. Even after discounting the size of the absolute numbers for the current situation[20] and using the variation index, the variation of the EU countries is much larger in the case of both factors. Though slightly smaller, the same picture emerges in the case of the eleven countries participating in EMU from 1999.[21] As the economic conditions of the EU countries or EMU participants are more diverse than those of the LMU countries, an asymmetric shock in future may well, as it did for the LMU, destroy EMU comprising all EU member states or even only the current eleven EMU states. However, table 4.4. indicates that the variation of both variables for EMU core countries is considerably smaller than for all EU countries. In addition, their performance is much better than that of the SMU countries.[22] Such a finding clearly indicates that an EMU comprising all 15 EU member states would be economically irrational, but comprising core countries alone would be close to the conditions desired by the subscribers to the theory of optimum currency areas.

What do these findings tell us for the hypothesized case of a monetary union between Germany, France and the UK? Certainly the statistical results are better for a monetary union among these three countries than they are for the EMU 11 or a union including all EU countries. Furthermore, the variation of the industrialisation indicator of these three countries is even lower than for the SMU. However, for per capita income the variation is for both years higher than it is for the SMU or the EMU core. This suggests that monetary union among the three would be less desirable than EMU for the core countries or the SMU, as far as economic similarities among the member states are concerned.

Before ending the discussion regarding the two tables, one has to note the weakness of

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[20]One has to discount the fact that a particular index of variability chosen tends to overemphasize the deviations from the mean, as the absolute numbers being compared become bigger. The variation index, however, can rectify this drawback.

[21]These countries are Germany, France, the Netherlands, Belgium, Austria, Luxembourg, Portugal, Finland, Italy, Spain and Ireland.

[22] Except for the variation of per capita GDP levels in 1980.

these indices. The index of industrialisation only includes the manufacturing industry, excluding mining, construction, electricity, gas, water and sanitary services. (Bairoch 1982, p.322) Those manufacturing sectors excluded weigh relatively highly as a percentage of GDP at the present. In addition, the index does not include the service sector, which is an even bigger contributor to GDP now. Due to statistical incompatibility and the limited availability of historical statistics, Bairoch (1982) could not incorporate such variables in the index.[23] Therefore, one should note that this index portrays only a partial picture of economic conditions. Having examined the crude statistical analysis, let us move to a comparison of the institutional arrangements within the monetary unions. As for its institutional structure, the SMU may be closer to the current monetary union project than the LMU, since EMU like the SMU is built upon other areas of economic integration among member states. However, it is clear that even the core EMS countries do not share the similarities in social preferences to the degree Scandinavian countries did. Nevertheless, the similarities among the Scandinavian nations, which made their monetary union smooth and more successful than the LMU, strengthens the argument for the importance of similarities in domestic regimes as a precondition for a successful EMU, as introduced in the previous chapter. Taking account of the LMU experience, EMU with all member states, or the current eleven member states, can be expected to face difficulties brought about by diverging economic and monetary policy interests.

The historical examples give us two crucial factors to watch out for in the analysis of the current EMU attempt. First, the union has to be careful in its design of an institutional structure for controlling the total money supply. The EU countries have already agreed to set a clear institutional framework for the ECB. Therefore, this point seems to be well covered in the case

[23]See pp.280 - 81 of Bairoch (1982) for details of other indices he would have liked to attempt, such as productivity or labour productivity indices, but was prohibited from developing by a lack of historical statistics.

of the future EMU. Second, integration in other economic and political areas in addition to monetary union strengthens the working of monetary union. Having similar economic structures and social preferences helped Scandinavian countries to build wider socio-economic institutions in addition to monetary union. This seems to have contributed to make the SMU more sustainable than the LMU. According to Vanthoor (1996), "besides the problems surrounding bimetallism, the real reason why monetary integration failed (in the LMU) was that the participants insufficiently observed one of the most important rules of the game - the harmonization of their economies." (p.46) The integration achieved at the EU level is far deeper and wider than that achieved in both the LMU and the SMU. However, it is doubtful whether the current EU has achieved the level of social coherence of the Scandinavian countries in the 19th century. These issues will be explored in Chapters 7 and 8 by examining the labour market regimes of France, Germany and Britain.

Chapter 5

Lessons from history: Part II
American monetary experience and sectional conflicts

In the previous chapter, I examined two European monetary unions in the 19th century. Here, the development of American monetary union (AMU) against the general background of America's economic structure is examined in order to draw lessons for the current EMU project. The interesting thing about the United States is that it only managed to de facto introduce a uniform currency in the 1860s, nearly a hundred years after its independence. The persistent conflicts between federalists and anti-federalists over the management of the US economy and irreconcilable socio-economic structures and preferences among the different sections of the economy contributed to the difficulty in agreeing on the form of a national banking system and the use of a single currency. These problems in 19th century America are similar to those the current EMU project faces. There are persistent conflicts between the federalist and anti-federalist forces over the mode of European level economic and social management. Such disagreements over how the European economy as a whole should be managed are undoubtedly influenced by the different national traditions and diverse national structures and regimes of economic management. This chapter elaborates the historical conflicts in 19th century America, which finally exploded in the Civil War, in order to extract some lessons for the current EMU project.

5.1. Banking in America from independence to the outbreak of Civil War

The history of banking in early America is characterised by its lack of a consistent regime. The different kinds of banking systems or non-system served America for more than 100 years after independence. From 1781 to 1811, the First Bank of the United States served as the national bank. From 1816 to 1836, the Second Bank of the United States was the national bank. Though they did not perform all the tasks of a modern central bank, their sheer size made them function as an equivalent of a central bank. From 1837 to 1863, free banking dominated the banking system in America. In other words, anyone who could raise the capital could obtain a state charter which granted the necessary powers to do the business of banking, i.e., "free" entry into the banking businesses. Free banking acts were passed in most states between 1837 and 1860.[1] The requirements of a charter differed from state to state. In general, however, the only requirement of the charter was for the bank to hold against its notes the full amount in collateral security in the form of mortgages or state bonds, in addition to 12 to 33 % of specie reserves.

Consequently, the development of the banking system in America was disruptive, as the pros and cons of a national banking system and regulation were constantly debated and tried out. Disagreement over the institutional framework of central banking was rooted in the following different but interrelated factors. First, there was persistent conflict in Washington between those favouring a centralised strong federal government and those supporting a loose configuration of decentralised states. Second, the above ideological differences were exacerbated by diverging economic structures and interests between different sections of the economy, roughly equivalent to the divide between the industrial North and the agrarian South. Such conflicts of interests worsened as America's territory expanded westward: what kind of economic structure the West would eventually adopt became the focal point, one of the many factors which ultimately culminated in the Civil War. The following section examines the former aspect in more detail by studying the development of banking systems. The subsequent section explores the latter

[1]For a list of states and exact dates for the establishment of laws, see Atack and Passell (1994), p.105.

aspect mentioned above, the diverging economic structure and corresponding interests between the North and the South.

5.2. The federalists vs. anti-federalists

5.2.1. The First Bank of the United States (1791-1811)

Ideological rifts regarding federal economic policy-making had been constantly present from the very beginning of the United States: the founding fathers had two opposing views about the way the federal government should work and interact with state governments: this was the conflict between Jeffersonian 'anti-federalists' and Hamiltonian 'federalists' since right after American independence. The former, led by Thomas Jefferson, believed in minimum regulation and control at the federal level, i.e., weak federal government, the protection of states' rights, and an agrarian economy as the basis for the United States' economic structure. The latter, led by Alexander Hamilton, instead, promoted strong state control, a federal government and nation building through industrialisation and commerce. As for international trade, the former view endorsed free trade, whereas the latter was inclined to mercantilism to provide room for the development of America's infant industry. The federalist stance was supported by the commercial classes, whereas the anti-federalist stance was endorsed by the land owners. The latter were particularly against the establishment of a central government, which they identified as "the replacement of the British yoke with a Hamiltonian one." (Hammond p.119) The gulf between the two positions was considerable: Alexander Hamilton, predicted already during the

War of Independence (1775-1783) that the near future would bring his fellow Americans all the leisure and opportunity they wished to cut each other's throats.[2]

Naturally, Hamilton and Jefferson took different stances over the new structure of banking systems in the USA. Hamilton, the first treasury secretary, urged the establishment of a federal central bank, modelled on the Bank of England. He saw the need for such an institution as the fiscal agent of the government, as the provider of stability for a paper currency, and for the expansion of commercial credits. A national bank would, Hamilton insisted, also promote lower interest rates by increasing the supply of money. Thomas Jefferson, the first secretary of state and the third president of the United States, was against the creation of a strong national banking system. He and fellow anti-federalists argued that such a Bank would be unconstitutional, as the power to create the bank was not among the powers delegated by the Constitution to Congress. Furthermore, they were against the Bank as it would further enhance federal powers. Generally, they opposed the development of a national banking system, because in their view, banks increased usury and speculation, led to the drain of specie due to the competition from paper money, and diverted capital from agriculture. (Studenski and Krooss, p. 60)

During the first two administrations of Presidents Washington and Adams (1789-1801), the federalists were more influential than the anti-federalists. Thus, despite opposition from anti-federalists, the Act to charter the Bank became law in 1791 effective for 20 years. The role of central banking in the 18th century was not as established as it is now. Indeed, the First Bank of the United States was very much organised like a private bank, run by the board of directors.[3] Its operation was similar to a private bank: printing notes and lending them with interest. Unlike

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[2] Alexander Hamilton (1904) Works I (Edited by H. C. Lodge), p. 217. cited by Hammond (1957), p.89.

[3] Foreigners could also buy shares in the Bank, but they did not have any voting power. Indeed, almost 3/4 of shareholders were foreigners. Later, opposition to the Bank arose due to this high proportion of foreign ownership, as the Bank was perceived as the agent of foreign interests.

other commercial banks, however, it had the federal government as its primary customer: 20% of the Bank's capital of $10 billion was owned by the federal government. The Bank became fiscal agent for the federal government, holding federal tax receipts, and paying government bills. The federal government kept its cash as deposits with the Bank, thereby providing a massive financial base. Due to its federal charter, it could open branches in different states, which was not allowed for other state-chartered banks.

Due to this competitive edge, the First Bank of the United States gradually evolved into a banker's bank, thereby playing the role of a central bank. However, in 1811, its application for the renewal of the charter was rejected by a narrow margin. It was due to the effective campaign of the opposing anti-federalists (notably Jefferson) and state-chartered banks. They argued that the First Bank of the United States was controlled by foreigners and was unconstitutionally created a monopoly, and was far less efficient than the state banks. The administration was no longer dominated by federalists, and the Act to renew the Bank charter was defeated when Vice-President George Clinton voted negative after a 17-to-17 vote in the Senate.

The failure to re-charter the Bank eliminated the only institution which could have provided a uniform currency. This was convenient to states' banks as they had the monopoly of loans within their states. Between 1811 to 1816 the number of state chartered banks rose from 88 to 246. Most state banking practices were far from sound, and they were worse in newly created communities. Besides, bank charters were obtained by special acts of the state legislature, often by bribery. Thus, banking activities were filled with loose fiscal adventures. For example, the share of the Union Bank of Florida was owned by a small group of people who raised their subscription by mortgaging land to the bank. The more inflationary and the greater the depreciation of its notes, the easier it became for them to repay their loans. The only exception to such loose practices was the state of Massachusetts, where banking laws are made to improve bank operations. (Studenski and Krooss, pp.72 -74)

The war of 1812 (1812-1814) and the loose credit system for selling public lands in the West along with poor banking practices led to inflation. Consequently, all specie payments by banking institutions except in New England were suspended in 1814, and the government accepted state bank notes in payment of public debts, which further exacerbated inflation.[4] According to Dewey (1931), the direct loss to the government from poor or worthless bank-notes received during 1814-1817 was over $5,000,000. (p.145) Post-war currency mainly consisted of a mass of states' bank notes and a small number of Treasury notes, all of them with fluctuating values. Out of this chaos grew support among national leaders to re-establish some form of national banking system.

5.2.2. The Second Bank of the United States (1816-1832)

By 1815, restoring order in the banking and currency system by returning to specie payments became pressing. State banks and debtors were against the resumption of specie payments as the former enjoyed their power to issue vast amounts of notes, and the latter hoped that depreciation of state bank notes would lessen their debt burdens. As Congress did not have any Constitutional power to regulate state banks, the only way to influence state banks was to establish its own competing note-issuing and specie-paying national bank. In 1816, Congress chartered the Second Bank of the United States along the same line as the First Bank. The Bank

[4] The large amount of specie outflow from America was initiated by the dissolution of the First Bank of the United States, as payments for its foreign shareholders.

Act guaranteed it a twenty year charter and capital of $35 million of which 20% was to be subscribed by the government.

In the beginning, the Bank was badly managed. Not only was it not able to redress the banking crisis, it became a victim of speculation.[5] In addition, state banks were very hostile to the newly chartered federal bank, and several state governments followed the lead of Maryland in 1817 to impose taxes on the branches of the federal Bank. In 1819, the Maryland branch of the Bank refused to pay stamp duty, which developed into the federal Supreme Court case and it was ruled in favour of the federal Bank *(McCulloch vs. Maryland)*. After Nicholas Biddle took over the presidency in 1823, he re-established the special position of the Bank of the United States within the banking community through sound monetary policies, together with the necessary injection of liquidity and the increase of specie reserves.[6] Under his leadership, the Bank developed into a central bank with control over the national money market by building credibility of their own paper money or drafts:

> At all times, the $5 notes and drafts were receivable everywhere at par, and while notes of higher denomination circulated at slight discounts, it was actually cheaper to settle exchanges with them than by shipping specie. The circulation of the United States Bank (notes) varied from section to section, being greatest in the West and South, of lesser importance in Middle Atlantic states, and unimportant in New England, where capital funds were more plentiful. (Studenski and Krooss pp. 87-88)

In 1832, four years before the Bank charter needed renewal, Biddle allowed the Bank's existence to become a key political issue in the Presidential election campaign. Andrew Jackson, a populist who was opposed to anti-democratic, anti-frontier centrist forces in the nation was elected. He took his election victory as popular support for his anti-Bank policy. He withdrew

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[5]Its Baltimore branch collapsed in 1818 as a result of overexpansion of credits.

[6]For this reason, a school of monetary historians, the soundness school, saw the Second Bank as a precursor of modern central banks.

government deposits from the Second Bank and put them in various state-chartered banks. Instead, twenty three pet banks were selected to serve as federal depositories, many of which supported Jackson's election and gained from the weakening of the Second Bank's influence. Consequently, the number of commercial banks operating in America mushroomed from 330 in 1830 to 704 by 1835. (Atack and Passell p.95)

What was at the core of the opposition to the National Banking system was the distrust against concentrated federal power over the US economy. American capitalism was still in its infancy. The newly created country was still in the process of expanding its territory westward, and was not politically, let alone economically, integrated enough. Facilitating interstate commerce was not big enough a reason to push for a nationally regulated monetary and banking system. Thus, the debate between federalists and anti-federalists re-surged over and over again, and the Federal Bank repeatedly ended up being the focal point of their power struggle.

5.2.3. Free Banking (1832-1863)

The demise of the Second Bank of the United States left the American banking system without any coordinating agency, which resulted in financial instability in American banking until the establishment of the National Banking Act of 1863. Free banking after 1837 brought about the disintegration of the national money market and uneven development of states' banking systems. The free banking system facilitated great success and profits in the banking business in some states like New York, whereas it also caused misery in other states such as Minnesota. For example, the expected value of $1 in New York has never fallen below 99 cents since 1855, but that in Minnesota, fell to less than 55 cents in 1859. (Atack and Passell, p.105)

Free banking, on the one hand, reduced the cost of capital through competition, thereby lowering interest rates, increasing loans and facilitating investment. In New York, where the free banking system was highly successful, loans per capita rose sharply during the 1840s and 1850s, whereas in Philadelphia where free banking legislation was not passed until 1860, loans outstanding per capita declined during the same period. On the other hand, in other states, many banks went out of business at the cost of note-holders. The cumulative losses for note holders in Michigan reached $1 million during 1837-60, and even in New York, the most successful free banking state, it reached $395,000. (Atack and Passell, P.150)

Another important cost of free banking was increased transaction costs for inter-states commerce. Due to the presence of numerous notes issued by different state banks, counterfeiting was a big problem, and the lack of federal authority made it impossible to control. As a result, the use of specie increased as a reliable means of interstate business. During the heyday of the Second Bank of the United States (1823-37), the proportion of money held in specie was 15% or less. It increased to more than 23% during the free banking period. The lack of convertibility of bank money at full face value beyond the immediate vicinity of the issuing bank increased transactions of specie. It was the major problem caused by the lack of a centralised banking system. (Atack and Passell, p. 108)

5.2.4. Civil War and the dawn of a national currency: the introduction of legal tender and the National Banking Act

Before the Civil War, America did not have a national currency nor a national banking system after the demise of the Second Bank of the United States. The first issue of fiat money by the government was out of necessity rather than choice, as it was the only viable solution for the Union to finance the Civil War. Accordingly, the Legal Tender Act was passed in Congress in 1862. The new government notes, called 'greenbacks' as they are printed in green ink, were non-interest bearing Treasury notes. These notes were legal tender but not redeemable in specie. They were welcomed in the West, as Westerners suffered from their volatile state bank notes and instable state banking systems. Easterners were against the greenbacks, since they saw the Act as a threat to a prosperous Eastern state banking by replacing state bank notes for greenbacks. Growing Western support for this relatively stable money outweighed the East's opposition to it, thereby making the issue of government currency part of regular Republican financial policy. (Richardson p.82)

Yet, the treasury was not happy with the greenbacks as they feared potential instability in a currency system based on both greenbacks and state bank notes. Indeed, immediately after the introduction, greenbacks and other paper notes began to depreciate relative to specie. For, speculators and those who required specie for business transactions bought up gold and hoarded it. At the same time, greenbacks and paper currencies depreciated in terms of goods. Price inflation hit the working classes most severely, as they were paid in paper currencies, and increases in the wage level lagged far behind the price level. State banks were blamed for the general disorder of currency circulation. Treasury secretary Chase, supported by mass opinion, perceived state bank notes rather than government notes as redundant. Although government restricted the issue of greenbacks, there was no practical limit in issuing state bank notes, which made state banks guilty of causing inflation.

In order to cope with this financial crisis, in 1863 the National Banking Act was introduced to create a national banking system. The national currency was based on private capital invested in government bonds, redeemable in gold. This legislation, along with its amendment in 1864 established the principle of national government control over the Union's financial system. The bill aimed at the gradual abolition of state bank notes, and imposed taxes on state bank notes. At the same time, it encouraged state banks to convert themselves by adapting national banking charters. Another important aim for the Treasury, besides the need for a national currency, was the need to create a market for federal bonds. The national banking system, however, did not develop fully until after the Civil War. By October 1863 only 66 banks, mostly in the Middle West had taken national charters, and the total national note circulation was less than $4 million. By October 1866, however, there were 1,644 national banks with a circulation of $280.4 million. The opposition Democrat party supported state banks to lobby against the bill, which made the ruling Republican party accuse them of Southern sympathy. By 1864, state banks were accused of being disloyal to the Union.

American monetary politics had been, from the very birth of the nation, characterised by a power struggle between those in favour and against strong federal government intervention. It is important to examine the reason why it was possible in the 1860s to achieve unprecedented centralisation of the financial system. Republican politicians used nationalist sentiment during the war by associating centralisation of monetary policy with the national power of America. Senator Sherman, introducing the bill which became the National Banking Act, was particularly eloquent in this matter. According to Richardson (1997):

> Hamilton's concept of a strong national government spoke directly to the wartime Republicans, and Sherman tapped into that idea, arguing that states' rights theory, which elevated local above national government was behind the Southern effort to overthrow the government. He told his colleagues that the best policy was to nationalize as much as possible. This would make men love their country before their states. (p.87)

In other words, Sherman vision for a uniform national currency was identified with strong government and the glory of America as a nation. Interestingly, already during the Civil War, "the Republicans envisioned a dominant international role for a unified American nation, and

Sherman promised that the bank bill, with its implicit strengthening of the national government, would advance that goal." (Richardson, p.88)

Republicans cleverly used the Westerners' hatred against Eastern bankers to promote the national currency, and discredited state banks as destabilisers and enemy sympathisers. Indeed, nationalism made it possible for the national government to establish Gramscian hegemony[7] and secure mass support for the national currency. What was needed, along with or even more than the economic rationale, was firm unequivocal political support for a centralised monetary management, which was probably only possible under the extreme conditions brought about by the turmoil of war. With the victory of the North, Union policies gained the upper-hand and established legitimacy for the whole United States, thereby creating federalist hegemony after a century-long power struggle.

As Faulkner (1960) put it, the Civil War marked "a definite break midway in the development of the nation." (p.327) Although the inevitability of the war is widely debated among the different schools of historians, there is no doubt about the underlying tensions existing between the North and the South due to divergent economic policy objectives. Such disagreements were fundamental, as they were rooted in their completely different socio-economic regimes.

5.3. The diversity of American states and the Civil War

[7]Antonio Gramsci introduced the concept of hegemonic class, whose power and ideology is perceived as legitimate by most members of society. A regime where Gramscian hegemony exists is believed to be stable and sustainable relative to that without such hegemony. This is because "a hegemonic class is able to transcend its immediate, narrowly conceived, economic interests and present itself, with a reasonable degree of plausibility, as acting in the general interest." (Ashworth p.51)

The American Civil War is one historical event which has been studied and evaluated throughly. It is not the intention here to reinterpret this wide-ranging debate. Rather, some underlying socio-economic factors behind the outbreak of the Civil War, which may be relevant for current attempts of EMU, will be discussed.

The popular myth often too easily identifies slavery as the sole cause of the Civil War. There is no doubt that slavery was an important focal point in this conflict, as it symbolised the economic and social differences between the two opponents. Indeed, "the institution of slavery was central to the sense of cultural divergence between North and South." (Reid p.397) However, one should not forget that the whole set of socio-economic objectives and structures in the South and the North were not only different but incompatible, and that their divergence had grown during the first half of the 19th century as the North industrialised. Eventually in the mid- 19th century, the different outlook of the two sections became irreconcilable economically and socially, and tension grew and peaked with the secession of seven Southern states and the creation of the Confederate States of America in 1861. Before going into the details of the disagreements between the North and the South, let us examine the structural differences between the two regions.

5.3.1. Statistical observations of sectional differences

Before the declaration of independence in 1776, the American economy was predominantly agricultural, and regional economic differences between the North and the South were minute. However, as tables 5.1 and 5.2 suggest, economic indicators diverged considerably from the mid-19th century.

Table 5.1. Per Capita Wealth in the 13 colonies in 1774

in pounds sterling

	North	South
Land	26.0	25.1
Livestock	3.8	4.8
Other producer goods	4.3	3.3
Consumer goods	4.2	3.1
Total	38.3	36.4

Source: Jones (1980) , p.310

Table 5.2. Regional per Capita Income as percentage of National average (in percentages)

	New England	Middle Atlantic	East North Central	West North Central	North Average	South Atlantic	East South Central	West South Central	South Average
1840	132	136	67	75	103	70	73	144	96
1880	141	141	102	90	119	45	51	60	52
1900	134	139	106	97	118	45	49	61	52

Source: Easterlin (1960), p. 137.

N.B: New England: Maine, N.H., Vt., Mass., R.I., Conn.
Mid Atlantic: N.Y., N.J., Pa., Del., Md.
East North Central: Ohio, Ind. Ill., Mich., Wis.
West North Central: Iowa, Mo. (and Minn. Dak. Neb. Kan. except for 1840)
South Atlantic: Va., N.C., S.C., Ga., Fla.,
East South Central: Ky. Tenn., Ala., Miss.
West South Central: Ark. La. (and Tex. except for the data for 1840, Okla. Except for 1840, 1880)

As table 5.2 indicates, in 1840, before the outbreak of the Civil War, the differences in average regional per capita income between the North and the South were still trivial. However, after the Civil War, from 1880 to 1900, the Southern economy stagnated while the Northern economy grew. Such differences in regional per capita income are rooted in the uneven industrialisation of the American economy. Table 5.3 shows the rapid growth in the share of non-agricultural income in the Northern regions. Such changes in the South were slow, and the growth of agricultural income stagnated.

Table 5.3. Income originating from sectors by regions
as percentage of total income

	Agricultural income	Non-agricultural income
New England		
1840	38.7	61.3
1880	18.5	81.5
1900	11.3	88.7
Mid Atlantic		
1840	50.8	49.2
1880	29.1	70.9
1900	14.5	85.5
East North Central		
1840	65.9	34.1
1880	55.5	44.5
1900	35.9	64.1
West North Central		
1840	68.2	31.8
1880	60.6	39.3
1900	57.1	42.9
South Atlantic		
1840	79.1	20.9
1880	72.4	27.6
1900	54.6	45.4
East South Central		
1840	82.4	16.9
1880	76.0	24.0
1900	58.6	41.4
West South Central		
1840	61.7	38.3
1880	72.5	27.5
1900	64.4	35.6

Source: Calculated from Easterlin (1960) pp.97 - 104

Elements underlying economic divergence after the Civil War was already present before the outbreak of war. They are apparent in differences in social and economic orientations in the North and the South, which led to conflict and eventually developed into the Civil War.

5.3.2. Socio-economic regimes of the North and the South

Beard and Beard (1927), Hacker (1940) and McPherson (1982) argue that the prime cause of the Civil War as the irrepressible conflict between the static agrarian staple-producing South and the dynamic commercialised, industrialised North. McPherson (1982) simply put that "slavery and modernizing capitalism were irreconcilable." (P.44)

5.3.2.1. The Northern economic structure

During the first half of the 19th century in the North and middle Atlantic states the economic focus and the pattern of economic activity shifted from trade and commerce to manufacturing. There were two main kinds of manufacturing sectors developing: first, resource-oriented manufacturing consisting of simple processing of raw materials such as lumber and meat processing, and second, manufacturing in which capital requirements were relatively modest, such as textile, leather goods industry etc. The former was the major kind of manufacturing in the West, and the latter was the major one in the East. According to North (1961), the Northeast regions accounted for 75% of US manufacturing employment in 1850, among which 71% were engaged in the latter kind of production in 1860. (p.159) Textiles was the most important industry in the North, producing cotton goods, clothing and woollen goods. According to Gibb (1950), between 1813-53, "the manufacturing of textile machinery appears to have been

America's greatest heavy goods industry." (p.179) Such machines were necessary to produce standardized products on a large scale.

American industrialisation was well underway before the Civil War, and the growth of manufacturing was aided by the growth and the size of the domestic market. Indeed, the North was the production centre of consumer goods, providing goods to the national market, including the South and the West. With the decline of transportation costs due to the fall in ocean, river and canal freight rates and the development of railroads, interregional trade flourished, and induced the further expansion of specialisation, hence, manufacturing in the Northeast. The abundance of banks in New York and New England provided capital needed for a rapid expansion of manufacturing. Quality and availability of labour and entrepreneurial talents were supported by a free education system in the Northeast and the inflow of both skilled and unskilled European immigrants[8], which provided the rich layer of workforce necessary for a rapidly industrialising society.

5.3.2.2. The Southern economic structure

Whereas the Northern and the Western economic regimes were increasingly diversified through industrialisation, the Southern economy stayed with its traditional production of agricultural stables (such as cotton, tobacco, rice and sugar) by making use of slave labour. Except for cotton manufacturing and iron founding, there was virtually no industrialisation in the Southern economy. As table 5.4 below shows, the scale of cotton manufacturing in the whole of the Southern states was far behind that of New England, let alone the North as a whole.

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[8] Generally, English and German immigrants were relatively skilled, whereas Irish immigrants were relatively unskilled.

Table 5.4. Cotton manufacturing in New England and the South in 1850

	Plants	Capital
Southern states	166	$ 7,256,056
New England	564	$ 53,832,430

Source: Faulkner (1960) p.310

Such one-sided economic orientation cost the Southerners dearly. The South was completely dependent upon Northern goods and services. Northern ships carried the cargo of imports and manufacturing goods to Southern ports and returned with Southern cotton for shipment to Europe.[9] Furthermore, production of staples was financed by British and Northern banks.

Staple productions required large scale organisation leading to the development of the plantation system. Faulkner (p. 321) describes the Southern economy as follows:

> The characteristic tendency of commercial planting regions to stress maximum current money income, to expand recklessly, and to live extravagantly when income was high had prevented the accumulation of liquid capital and kept the South in an inferior economic position. "That the South in general," says Lewis C. Gray, "and particularly the lower South, as compared with the North, was largely the result of a system of rural economy characterized by extravagance both in production and consumption, a system which concentrated a large proportion of money income in the hands of a relatively small proportion of the population." (P.321)

The profitability of cotton production under the plantation system, however, was declining by the first half of the 19th century. The price of slaves went up, and that of cotton went down significantly in the 1840s and fluctuated in the world market. The Constitution outlawed the overseas slave traffic in 1808, which limited the increase in the supply of slaves to the natural growth of the slave population, except for small illegal traffic. The demand for slave labour was intensified by 1850 not only by Southwestern plantations but also by the border states

[9] Generally, imports from Europe came to New York and not directly to Southern ports. This is because the Northeast had better transport connections with the West. Thus, New York became a central port for European imports, from which imports were diverted to the South and the West.

for tobacco cultivation, railroad construction and ironworks. Consequently, the price of slaves shot up, and by the 1850s, prices received for southern staples were out of line with costs of production. Cotton production required a constant supply of fresh land, because planters bought rich land, used it up and travelled to new land. For that reason, securing slaveholding territories in the West was very important for the Southern economy.

Another characteristic of the Southern economy was income disparity. The large plantation owners who controlled politics and the economy in the South were a minority. The majority of the Southern population were small farmers who held no slaves at all, and many of them lived in destitute conditions. Indeed, only 24.2% of the whole white population in the South held slaves in 1860, yet their voice represented the whole of the South.[10]

Investment in human capital in the South was much lower than in the North or the West. According to North (1961), the ratio of pupils to the white population in 1840 was 5.72% in slaveholding states, whereas it was 18.41% in the non-slave holding states and illiteracy among the white population was much higher in slaveholding states. (p.133) This lack of investment in human capital reflected the attitude of the dominant planter class, who saw no return in, thus showed no interest in, educating white Southerners outside their plantation system. The oligarchy of plantation lords dominated the political, economic and social life of the South. From the election of Jackson in 1829 until Lincoln was inaugurated as President in 1861, the Southern oligarchy managed to dominate the federal government as well.

5.3.3. Emerging disputes between the two regions

[10] Figures are from Hacker (1940), p. 288.

In the first half of the 19th century, the clash of economic interests reflected on disputes regarding the disposal of public lands, tariffs, the US bank, and federal internal development. Western interests brought a new dimension to the struggle between the two sections - the North and the South.

Until around 1830, the North was generally in favour of high priced public land because of the fear of labour shortages caused by an exodus of Eastern labour to the West. Western settlers insisted on a cheap or free land policy, and the South maintained a neutral position. After around 1830, however, the South was against a cheap land policy as that would encourage settlement in the West by small farmers, in other words, by non-slaveholders. The North also changed its attitude, and supported Western land policies in order to obtain the West's support on tariffs.

The dispute between agrarian and industrial states was most pronounced on the tariff issue. Tariffs had been used extensively from the time of independence as a revenue device for the federal government. In 1816, the Congress passed the tariff for protective purposes to promote the growth of the nation's infant industries - particularly cotton textile manufacturing - by imposing tariffs for imports mainly from Britain. Obviously, tariffs benefited Northern industrialists and workers, whereas Southern plantationists and farmers paid the cost. The minimum rates of the tariff reached an historical high in 1828, dubbed by the Southerners 'The tariff of abominations'. The Southern states protested against its supposed unfairness and illegality and South Carolina threatened secession over the tariff acts.

The disputes about the banking system have already been discussed in section in 5.1, and as mentioned, the sectional conflict was not as clear in this case as it was on the tariff issue. However, the South in general, and in particular the lower South, was continuously in debt partly due to the requirements for new capital for expansion. Though Eastern banks disliked the federal central bank as a competitor, it was generally the case that the Northeast as a creditor area favoured a centralized monetary system with a central bank which kept inflation under control, whereas the South opposed the idea as a debtor region.

The issue of internal improvements and developments is perhaps the most critical regarding sectional conflict. It had to do with the construction of a national infrastructure such as roads and canals at the expense of national revenues. During the 1830s, with the rapid development of the West, the need for internal developments had grown tremendously. The opening of the Erie Canal, the Ohio Canal and the railway connecting the Northeast with the West replaced the old river link with the South and became the main route for transportation and trade. From 1836 to 1860, East-West trade increased drastically.[11]

Before around 1830, the alliance between the West and the South was dominant. The South favoured a cheap land policy in return for Western support for low tariffs. The North tended to be isolated, with its demands for high tariffs and expensive land, and without interest in internal improvements. After around 1830, however, this coalition of interests broke down with the changing attitude of the North regarding internal improvements. The North showed a growing eagerness to promote internal improvements and, to a lesser extent, for a cheap land policy. In return, the North gained Western support for higher tariffs. As the West did not show much interest in the tariff issue, it backed whichever side supported the cheap land policy. By then, the South was opposed to further internal improvements and also began to be at odds with the West regarding public land policy. Thus, the interests between the West and the South began to diverge, whereas those of the Northeast and the West converged. It was the alliance between the Northeast and the West which defeated the South in the Presidential election of 1860 and

[11]For detailed statistics on the changing flow of trade, see North (1961), pp.106-111.

caused the subsequent Civil War. (Jones p.88) Thus, the West was the catalyst in bringing about the hegemony of the North in the United States.

5.3.4. Conflict of the Southern and Northern economic structure and the causes of the Civil War

As Beard and Beard (1927) and Stampp (1980) put it, the differences between the two economic regimes rested on the labour system - slavery vs. free labour. The South's determination to keep its economic regime based on the slave labour system led to the Civil War. There were inherent contradictions in the economic system of the South, as the Southern economy itself could not reproduce and expand without Northern help. An undiversified economic structure and the lack of a free population were obstacles for developing an infrastructure such as roads, schools and commercial centres. This hampered the development of local centres and markets. Hence, commercial agriculture was located where convenient for exportation. The interior regions was occupied largely by a free population whose livelihood was limited by a self-sufficient economy little advanced from the pioneer stage. The slow accumulation of local capital was the bottleneck problem of the Southern economy. Scarcity of capital impeded the adoption of labour-saving measures, which escalated the scarcity of labour in the later period. (Gray 1941) Survival of the economic system in the planting South was largely dependent upon the ample supply of cheap slave labour and land. When the former became scarce and expensive, and with the prospect of the latter becoming scarce without the expansion of slaveholding territories, the Southern economic regime did not have any choice but to decline.

Hacker (1940) argues that the Civil War was the catalyst for the industrial growth of the North.

> ...where did the capital fund come from that made possible such extraordinary industrial advances during the Civil War, exactly at a time when the Union was engaging in a life-and-death struggle on the battlefield? The answer here is plain: the fund came out of the war itself. The federal government, through bond issues and greenbacks, added fully three billions of dollars to basic credit resources of the nation; and the speed of turnover, due to wartime purchases, and the high profits made possible great accumulation. Government expenditure, war contracts and wartime profiteering are the key to this puzzle. (P.324)

In other words, he argues that the Civil War was the catalyst which transformed America from a principally agrarian economy to industrial capitalism. There is no doubt that industrialisation had already been in progress in the North, and in the short-run, the war set back this industrialisation (Cochran 1967). However, as the Beards and Hacker put it, the Civil War brought the triumph of capitalism, as opposed to the Southern mode of production. Before the Civil War, the Southern economy belonged to the English economic zone, and aimed at economic growth through exports of agricultural staples. The development of a national economy, through industrialisation, without dependency on English exports became possible by the defeat of the South in the Civil War. The foundation of American industrial and economic strength in the 20th century would not have been possible without the Northern mode of production gaining hegemony in America.

Foner (1980) reaches a similar conclusion by analysing the ideological background. He believed that the Civil War consolidated an American civilization and the 'American way of life'. In other words, he suggests that anti-slavery promoted the hegemony of Northern middle-class values:

> It was not the wage system, but the expansion of slavery, which threatened to destroy the independence of the northern worker, his opportunity to escape from the wage-earning class and own a small farm or shop. For if slavery were allowed to expand into the western territories, the safety-valve of free land for the northern-worker and farmer would be eliminated, and northern social conditions would soon come to resemble those of Europe. The Republicans therefore identified themselves with the aspirations of northern labor in a way abolitionists never did, but at the same time, helped turn those aspirations into the critique of South, not an attack on the northern social order. (P.74)

Thus, first, the anti-slavery slogan was associated with the American dream of climbing the social ladder, or the upward mobile 'American way of life'. Second, by isolating slavery as an unacceptable form of labour exploitation, abolition implicitly diverted attention from the exploitation of labour taking place within the factory system. By doing so, the anti-slavery movement helped to promote and legitimise the needs and value of emerging American capitalism. "The anti-slavery was a central terminus, from which tracks ran leading to every significant attempt to reform American society after the Civil War." (p.73) The direct cause of the Civil War was the secession of the South, but underlying was the socio-economic incompatibility of interests, policies and ideology between the South and the North, largely represented in the different economic structures. Slavery and what it was perceived to represent[12] was by no means the only cause but one of the most encompassing and inevitable causes of the conflict.

5.4. Lessons for Europe

What lessons can be learnt from the history of the early American experience? One obvious difference between the US case of a single currency and the current attempts at EMU is that the former was established after political union, whereas the latter is being undertaken without even the firm prospect of political union. However, with persistent westward expansion, the frontiers of US territory had been changing constantly until 1853.[13] This suggests that political union in the US before the Civil War was still relatively unsettled, and due to its sheer

[12]Just as anti-slavery was associated with the 'American way of life' in the North, Southern elites identified abolition of slavery as Federalism in disguise. (Ashworth p.50)

[13]For a graphical presentation of territorial growth of the United States, see Jones (1964) p.5.

size, and geographical and structural diversity, states preserved their distinct local characteristics very well even after political union. Despite the presence of political union, the nation was de facto nothing more than a loose constellation of states, which justifies the comparison of the American monetary experience with the current EMU project.

Jones (1964) summarises the ultimate core of the problem:

> In 1787, for the first time in modern history, a political nation was 'made' by one single written act, or rather one body of acts - the American Constitution. But the State must always rest on society, and a definite degree of social cohesion must precede political association. This necessity is tragically illustrated by the history of the United States between the end of the War of Independence (1783) and the end of the Civil War (1865). (p. 3)

In other words, America after independence and before the Civil War was a nation without social cohesion. As in the artificially-made states in Africa, such states are politically unstable and socio-economically diverse. Such states are prone to civil wars, without citizens having a sense of belonging to a single society. This suggests that Europe should not rush into political union, but should build social cohesion and a common European identity before jumping for any political commitment.

The history behind the uniform currency in America cannot be properly examined without studying developments in the real economy and of diverging socio-economic structures. The lack of national cohesion culminated in the outbreak of Civil War in 1861. Lack of cohesion in the mode of production, or "the clash of social systems" (Rozwenc p. 211) was rooted in the socio-economic incompatibility of two different regimes of economic management - emerging capitalism and defensive proto-capitalism - which led to an irreconcilable conflict over hegemony.

There are a number of lessons from the American experience which are very relevant to EMU: first, irreconcilable socio-economic structures and policies without the clear presence of hegemony proved to be unstable. America managed to take off politically and economically because hegemony of Northern norms after the Civil War enabled the country to be reborn as a nation state with greater socio-economic consistency. The differences in structure and the economic orientation of the potential participants of EMU are not as distinct as in the case of the American South and North. However, it is for the forthcoming chapters to assess the different structures of EMU member states as to their similarity and divergence.

Second, both the historical US and current European structural differences stem from different kinds of labour management. Again, the case of America was extreme: the differences among the European countries have never been as pronounced as the contrast between free and slave labour. However, it is interesting to note that conflicting socio-economic regimes have their roots in the labour market. In this sense, it is important to study labour market regimes to assess the viability of EMU.

Third, the lack of clear direction and leadership in the European project seems to be rooted in similar conditions as those suffered by the early US: there has been a continuous dispute between the idea of a federal Europe and of 'a Europe of nation states', similar to the early American dispute between federalists and anti-federalists. As the American case proved, such conflicts cannot be solved over time. Even with political union, such disagreements eventually led to the Civil War.

In the case of present-day Europe, there is no concrete plan for political union yet. Clearly, however, there are some who see monetary union as a step towards a political union.[14] Such federalist forces would push the integration agenda further after monetary union

[14] For example, some in the Bundesbank and German Christian Democratic party (CDU-CSU) share such a view. For more details, see Tietmeyer (1994), Jochimsen (1993, 1994); and a discussion paper written by Wolfgang Schäuble, CDU/CSU (1994) Überlegungen zur Deutschen Politik. Discussion document by the Christian Democratic Union and Christian Social Union in the Bundestag. in Deutsche Bundesbank: Auszüge aus Presseartikeln. Frankfurt, No. 64/1994.

materialises. This would in all likelihood bring about a fierce reaction by anti-federalists who want to preserve the sovereignty of nation states as much as possible. Hence, as monetary union proceeds, the persistent power struggle between federalist and anti-federalist forces is likely to intensify. Germany and France are likely to be on the side of the federalists, whereas Britain belongs to the anti-federalist camp. The question regarding the pertinent turf for European regulation in relation to the national level might be brought up again and again, as in the early American case has shown. Connolly (1995) and Feldstein (1997) mention the possibility of war if such differences are left unsolved. Although these arguments are perceived as extreme, differences in economic and social policy orientations may break up monetary union once it is launched. This leads us to the lesson that 1) there has to be agreement on the level of influence and *régulation* of Europe; and 2) it is better not to have monetary union with countries with too diverse and different economic and social objectives and structure.

Fourth, it was impossible for the United States to turn the dollar into a fully fledged national currency before the Civil War. There were divergent interests for and against the single currency, with one side seizing power at one point of history only to let the other side take over, leading to a backlash. There was no **ideological hegemony** until the Civil war. During the Civil War, the Republican party cleverly brought in the single currency with the National Banking Act, and used it as a symbol of unity. Under the current Maastricht framework, could the Euro become a symbol of unity for Europe? There is also a possibility for it to become a symbol of economic hardship. Without careful management, 'sound' monetary policy itself may cause the breakdown of post-EMU monetary management.

In this context, Sheridan (1996) comes to the following conclusion: first, he predicts that, given the disinflationary tendency of the EMU project, there will be political discontent from less competitive regions within EMU after its introduction. Second, and more interestingly, he argues:

> A Common currency can likewise become a symbol of unity for Europe. But this symbol must represent a unity that is in the process of formation, both economically and politically, as it was in nineteenth century America. If European Union does achieve EMU, building a common political economic identity among its citizens will be its principal challenge in the twenty-first century. (p.1157)

In other words, whether the EMU countries can achieve a common identity and a cohesive socio-economic regime will be the key to its success and sustainability. The following chapters ask these questions by examining labour market institutions and structures closely.

Chapter 6

Labour market regimes in Europe 1: Background analysis

This short chapter provides brief information regarding French, German and British labour markets. The objective is to review recent behaviour of labour markets as background for Chapters 7 and 8. Chapter 7 compares institutional arrangements of labour market regimes among the three countries. Chapter 8 performs a more analytical comparison by making use of basic statistical methods. In typifying the different European labour market regimes, I shall use the concept of labour market flexibility (LMF), which will be elaborated in detail in Chapter 7. The concept itself is partly quantifiable, but mostly interpretation requires a careful qualitative analysis. Such a qualitative analysis has to take account of the idiosyncratic institutional structure embedded in different socio-cultural traditions, which is to be examined in Chapter 7. The economic and employment performances are the result of, or are conditioned by, such institutional uniqueness, which, in turn, exert pressure for changes in the institutional framework. Hence, this overview of labour market performances is necessary to prepare the ground for the empirical analyses in the next two chapters.

6.1. Overview of labour market performances

The three countries that are to be examined, France, Germany and Britain, have very different labour market regimes. The clarification of differences is important prior to the analysis of the institutional framework and of LMF since structural differences and institutional idiosyncrasy are decisive factors, shaping the different conditions and needs for a particular form of LMF.

This section briefly examines the current labour market conditions by looking at several statistics. The purpose is to contrast labour market performances, and show the structural differences between labour market regimes.

6.1.1. Employment and unemployment

The labour force participation rates of the prime age workforce (25 to 54) are more less the same for the three countries examined. According to the OECD (1996a), they are: 86%, 83.3%, and 83.4%, in France, Germany and Britain respectively in 1995. The overall employment/population rates are 59.5%, 65.1%, and 67.8%, in France, Germany and Britain in the same year. The lower rates in France are reflected by the lower participation rates for young workers (aged between 15 to 24) as well as women, and higher rates in Britain are reflected in higher participation rates for young as well as old workers (aged between 55 to 64). This reflects national differences in social organisations and conditions. First, the British youth enters labour markets earlier than the Continental equivalent, as a smaller share of the population continues upper secondary and higher education. According to Eurostat (1996a), the percentage of the population aged 25-59, having completed at least upper secondary education is 84% in Germany, 61% in France, and 52% in Britain. The education participation rates (the proportion of persons of a given age, enrolled in secondary education) for 17 year olds in 1992 were 92.8% in Germany, 87.2% in France, and 55.3% in Britain.[1] Second, the duration of the educational system in France and Britain differs from Germany. Due to the different national taxonomy for education, French and British students enter the labour market earlier than the German equivalent. The usual age for completion of a university degree (bachelor's degree) in Britain and France is 21, whereas it is 26 in Germany. (OECD 95a) However, France has higher rates in youth unemployment, as will be shown in table 6.2, which pushes down the overall participation rates. Third, early retirement is encouraged in France and Germany as work-sharing[2], but not in Britain. Indeed,

[1]Data are from OECD Education at a Glance, 1995.

[2]Work-sharing is based on the idea that labour input is fixed. Thus, if each worker works fewer hours or retires early, the work can be spread over more workers and employment will rise.

according to the European Commission (1995), the proportion of men aged 60-64 retired in 1994 is over 80% in France and 50% in Germany, but under 20% in Britain. This is partly due to the less generous nature of the British public pension relative to continental economies. According to the OECD (1996c), the public old age cash benefits as a percentage of GDP are the lowest in Britain: Germany spent 8.2%, France 9.7% and Britain 5.88% of GDP in 1993. In absolute terms, public expenditure on old-age pensions per person in 1993 were 11,170 ECU in Germany, 11,324 ECU in France, and 7,908 ECU in Britain.[3] Lower public pensions in Britain are reflected by the fact that private pension funds are well developed: pension funds assets (of which about two-thirds are private funds) in Britain were more than 1 trillion dollars, whereas they were less than 0.2 trillion dollars in Germany and France in 1996.[4]

Tables 6.1 to 6.3 show different categories of unemployment. Table 6.1 shows total unemployment rates in the three countries. As the business cycle in Britain differs considerably from the other two countries, the average unemployment rates over a certain period would serve as better indicators for comparative purposes. Tables 6.2 and 6.3 also examine those components of unemployment which indicate structural unemployment: youth and long-term unemployment.

The average unemployment rates in France are the highest among the three, and up to 1996, were lowest in Germany. Yet, due to prolonged recession and structural crisis, unemployment rates, in former East Germany in particular, have been increasing. High and persistent youth unemployment rates are, again, the biggest problem in France, but also persistent in Britain. On the other hand, Germany suffers from the highest long-term unemployment among the three, although all three countries have very high ratios of long-term unemployed.

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[3]Author's calculation from table 4 (p. 72) of Social Protection in Europe 1995 and the Statistical Annex of European Economy June 1997.

[4]Figures are taken from the Economist September 6th-12th 1997, p.127.

Table 6.1: Total unemployment rate (Percentage of civilian labour force)

	Germany	France	Britain
Average 1961-70	0.7	1.8	1.7
Average 1971-80	2.2	4.1	3.8
Average 1981-90	6	9.2	9.8
Average 1991-96	7.6	11.3	9.3

N.B. For Germany, 1961-1990 for West Germany, and 1991- for united Germany.

Source: Eurostat (several issues)

Table 6.2: Youth unemployment

Unemployment rate of young persons under 25

(as percentage of civilian labour force in the relevant age group)

	Germany	France	Britain
1990	4.5	19.3	10.8
1991	5.9	21.5	14.3
1992	6.4	23.3	16.7
1993	7.9	27.3	17.9
1994	8.7	29	17
1995	8.8	27.5	15.9
1996	9.6	28.9	15.5

N.B. Data until 1991 refers only to West Germany.

Source: Eurostat (1996a)

Table 6.3: Long-term unemployment as a percentage of total unemployed

	Germany	France	Britain
1990	45.9	39.7	33.5
1991	30.8	38.7	28.1
1992	33.5	34.6	35.7
1993	40.3	33.3	43
1994	44.3	37.5	45.4
1995	48.7	40.2	43.6
1996	47.8	38.2	39.8

N.B. Long-term unemployment refer to those continuously unemployed for one year or more.

Data until 1993 refers only to West Germany.
Source: Eurostat (1996a, 1997)

The three countries have different strategies to deal with high unemployment. In Germany the dominant labour market policy is the reduction of working time regulated at sectoral and company level, based on the idea of work-sharing. A phased reduction of working hours in the metal industry is being implemented, and other company level negotiations are also taking place. The introduction of more flexible working time and part-time work is also encouraged. In the spirit of work sharing, the metal industry in the south-west of Germany also reached an early retirement deal in September 1997 aiming at cutting youth unemployment. This deal had national implications for the sector with other sectors following suit. (Financial Times 29/9/97) Other policies include labour cost subsidies, with up to the value of unemployment benefits for 1 year being paid to the employer of a previously unemployed person; the establishment of labour promotion and training companies (especially for the East) to absorb the long-term unemployed and other problem groups who often cannot be easily integrated, and to provide practical training in preparation for a job in the primary labour market; the Contract Labour Act, providing unlimited labour contracts between the unemployed and the START Contract Labour Co. Ltd., a non-profit placing agency. It also trains employees when they are not contracted out. In the beginning of 1996, the "employment alliance" (Bündnis für Arbeit) was proposed by Klaus Zwickel, the president of the IG Metall. The proposal was to curtail wage increases in return for the guarantee of employment maintenance and creation. In January, trade unions, employers' associations and the government supported the idea and agreed on the central target of halving unemployment by 2000. However, the agreement failed in March 1996 when the government announced its "programme for further growth and unemployment", which proposed cuts in social benefits, including sick pay, and the deregulation of dismissal legislation.

Work-sharing is also a dominant labour market policy in France. As a part of work-sharing policy measures, there are solidarity agreements[5] on early retirement,

[5]Solidarity agreements are measures agreed by collective agreements.

and the encouragement of a shorter working week and part-time work. The EDF-GDF state electricity and gas utilities companies signed a three-year deal on the reduction of weekly working hours to 32 hours at the end of January 1997, with the aim of creating 15,000 new jobs by 2000. (EIRR 281, p.28) Like Germany, France has "Employment Initiative Contracts", which offer employers taking on an unemployed person a bonus per month and complete waiver from social contributions on the part of the salary over the minimum wage. Due to its high rates, the measure in France targets in particular youth unemployment. Vocational training forms an important part of French unemployment policy. Couseil National du Patronat Français (CNPF), an employers' association, has started a campaign for jobs for young people. The proposal includes increasing the number of fixed-term traineeships[6], such as apprenticeship contracts, qualification contracts, and orientation contracts. The CNPF also proposes to bring the workplace and higher education closer together, by offering vocational training to students before they complete higher education. The government supported the proposal with the financial incentive paid to employers to set up qualification contract schemes. In France a social plan was introduced as a law in 1993. The plan is meant to develop social responsibility in the business world. In companies with over fifty employees, any plan to lay off ten or more workers would be declared invalid unless details of opportunities for retraining for jobs elsewhere are submitted beforehand to workplace representatives (Milner and Mourizux 1997). The law embraces the new trend in French industrial relations where government promotes a consensual approach between trade unions and employers' associations.

In Britain since 1979, the deregulation of employment law has been the prime vehicle against unemployment. A number of legislative measures were initiated by

[6]As this is not a permanent form of employment, these traineeships are paid below minimum wages. The pay is between 25% and 75% of minimum wages, depending on entry and skill level. Trade unions are cautious to welcome the campaign as they fear that new training opportunities may be used to exploit young people by employing them at lower rates of pay. (EIRR 281, p. 28)

secretaries of state for employment, including the removal of wage rigidities, and lowering or abolition of employment protection. As in Germany and France, there are employer subsidies and direct payments to employers recruiting the young and long-term unemployed. Since 1994, by employing a person unemployed for more than two years, employers can claim back national insurance payments for the first year. Training schemes are another important employment policy in Britain. Programmes such as work training schemes and work experience schemes are run by Training and Enterprise Councils (TECs). As Tonge (1997) mentions, the establishment of TECs, local employer-led networks, is an attempt to privatise and decentralise the unemployment problem in Britain. TECs, however, possess no compulsory powers over employers, which is a serious limitation for any governmental initiative concerning employers. The Department of Education and Employment runs job finder grants and work trials. Under the latter programme, employers can try out those unemployed for more than six months free for a trial period of up to three weeks. The unemployed continue to receive their benefit during this period and may quit the job without benefit suspension. (Tonge p.90) In addition, the new Labour government has introduced a welfare-to-work programme aimed particularly at the young unemployed, by making use of a one-off windfall tax on excessive corporate profits to finance the programme.

Prime differences in unemployment policies in the three countries are those regarding work-sharing and deregulation. Work-sharing is the central strategy of unemployment policies in Germany and France, but is non-existent in Britain. Deregulation of employment protection has already been undertaken to a considerable extent in Britain, especially by curtailing trade union influence, but is still, to a large extent, a taboo in Germany and France. Deregulation is still very much limited in the flexibility of working hours and organisational flexibility in both countries. Such differences in unemployment policies are rooted in differences in institutional structure and social preferences. They will be elaborated in the next chapter.

6.1.2. Economic and employment structure

Sectoral differences are another factor which characterise different kinds of labour market regimes.

Table 6.4: Share of GVA at current prices and factor costs by branch in total GVA in 1994

In percentages

	Germany	France	Britain
Agriculture, forestry and fishery products	1.3	3.4	1.9
Fuel and power products	2.8	2.8	4.6
Manufactured products	27.1	20.9	19.3
Building and construction	5.7	5.6	5.3
Services	63	67.2	68.9
Market services	48.9	50.2	55.4
Non-market services	14.1	17	13.5
Total	100	100	100

Source: Eurostat (1995a)

As table 6.4 shows, in all three countries, the largest part of national income is produced by the service sector. Eurostat uses the concept of the gross value added (GVA) rather than the gross domestic product (GDP). The GVA constitutes GDP minus intermediate consumption, i.e., value added tax on products and net taxes linked to imports. The contribution to the GVA by the manufacturing sector differs considerably. As expected, Germany has the highest whereas Britain has the lowest share in manufacturing. Likewise, Britain has the highest overall and market services and Germany has the lowest share in both categories. These differences are reflected in the distribution of employment over different sectors.

Table 6.5: Structure of employment

In percentages

	Agriculture			Industry			Services		
	Germany	France	Britain	Germany	France	Britain	Germany	France	Britain
1966	10.6	17	3.7	48.9	39.1	46.4	40.5	43.9	50
1976	6.7	9.9	2.8	44.9	38	39.6	48.4	52.1	57.6
1986	5.3	7.3	2.5	40.9	31.3	30.9	53.7	61.3	66.6
1996	3.3	4.6	1.9	37.5	25.9	27.2	59.1	69.5	70.4

Source: OECD Labour Force Statistics 1966-86, Quarterly Labour Force Statistics 1997 no.2

N.B: Definition:

Agriculture: Agriculture, hunting, forestry and fishing.

Industry: Mining and quarrying, manufacturing, electricity, gas and water, construction.

Services: Wholesale and retail trade, restaurants and hotels, transport, storage, communication, financing, insurance, real estate and business services, activities not adequately defined.

Table 6.5 shows the changing share of employment over the last three decades. The share for agriculture and industry has been decreasing since the 1960s, whereas that for services has been steadily increasing. As table 6.5.1 indicates, the decline of employment in agriculture is particularly serious in France with its traditionally larger share in the agricultural sector.

Table 6.5.1. Growth rate of employment share 1966-1996

In percentages

	Germany	France	Britain
Agriculture	-68.9	-73	-48.6
Industry	-23.3	-33.8	-41.4
Services	45.9	58.3	40.8

Source: Table 6.5.

The growth of employment in service is also fastest in France. De-industrialisation is most significant in Britain and least in Germany. Assuming the above trend continues, the French economy will become similar to the British, whereas the gulf between the German and British economy can be expected to remain prominent. Table 6.6 shows the distribution of employment in different sectors in greater detail.

Table 6.6. Persons in employment by economic activity
The result of Labour Force Survey 1995

	Males and Females in Percentage		
	Germany	France	Britain
Agriculture (A,B)	3.2	4.9	2.1
Mining and quarrying (C)	0.7	0.2	0.4
Manufacturing (D)	25	18.9	19
Electricity, gas and water supply (E)	1	0.9	0.9
Construction (F)	9.3	6.9	7.1
Total Industry (C-F)	36	27	27.4
Wholesale and retail trade, repairs (G)	14.4	13.6	15.7
Hotels and restaurants (H)	2.9	3.3	4.5
Transport and communication (I)	5.8	6.3	6.4
Financial intermediation (J)	3.7	3.3	4.5
Real Estate and Business Activities (K)	6.2	8.4	9.4
Public Administration (L)	8.8	9.4	6
Other services (M,N,O,P,Q)	19.9	23.9	24
Total services (G-Q)	60.8	68.1	70.5
Total	100	100	100

Source: Eurostat (1996) Labour Force Survey

Regarding the detailed sectoral breakdown, Britain has the highest employment in all service sub-sectors except for public administration. The opposite extreme is Germany. Among the three countries its ratio of employment in industry is highest, due to the high employment in construction and manufacturing sectors. The distribution of employment in France is somewhat in-between that of Germany and Britain, though it is closer to Britain in terms of the employment created by industry as a whole, and services. It has the lowest proportion of employment in financial intermediation among the three countries. This is probably because the financial sector in France is even less developed than in Germany. For example, turnover of domestic and foreign equity on the stock exchange in 1996 was around $170 billion in Germany, while it was around $70 billion in France.[7] Two distinct characteristics of French employment are the higher ratio of employment in agriculture and in public administration. In the 1980s during the Mitterrand administration, France nationalised key industries. As a result, employment in the public sector remains very high. In contrast, Britain privatised industries in the same period under Prime Minister Thatcher. Consequently, the proportion of employment in the public sector in Britain is the lowest among the three countries.

[7]Data are from Bank of England Quarterly Bulletin. February 1997.

Chapter 7

Labour market regimes in Europe 2: labour market institutions and the concept of flexibility

In Chapters 2 and 3, I made the case for studying the functioning of labour markets in order to assess the sustainability of monetary union. To reiterate, under monetary union, given that the exchange rates cease to be the main adjustment mechanism among different economies, smooth labour market adjustment become the key to a well-functioning European economy. Major disagreements among the EMU participants on how labour market adjustments should take place may jeopardise successful economic cooperation among EMU participants, thus threaten the sustainability of EMU.

According to the French regulationist framework, the way labour markets are organised and function is a reflection of social characteristics and preferences. Economic management under EMU requires close coordination of economic policies among the participants. Without the presence of a dominant leader, as is the case in Europe, and without the presence of social coherence, the joint management of monetary and economic affairs would be difficult. The examination of labour markets contributes to our understanding of the consistency of the Euro zone as a single monetary and economic unit, and on the degree of difficulty which joint management may pose.

Chapters 7 and 8 consider different types of labour market regimes in Germany, France and Britain. In doing so, I shall focus on the issue of labour market institutions and flexibility (LMF). This chapter examines the concept of LMF within the context of monetary union. Having established the framework of analysis, I compare labour market institutions. This is necessary because the understanding of the regime of industrial relations is a prerequisite for a deeper understanding of the debate about labour market flexibility. In Chapter 8, the flexibility of labour markets will be investigated in an empirical study which compares the three countries, in order to determine the degree of labour market regime compatibility among them. By closely examining the kind of LMF the three countries under investigation apply, I shall contrast fundamental differences in labour market management.

Before going into the details, let us review the definition of different concepts concerning LMF.

7.1. Labour market flexibility - concept

The objective of this section is to define the concept of the LMF, and provide a clear framework to assess different ideologies and attitudes in labour market management. It is important to define LMF since different scholars has introduced or applied different typologies. There are two different ways to classify LMF: one by issue and the other by disposition. For the latter, Streeck (1987), Sengenberger (1990), and Auer (1991) differentiate between external and internal LMF. External flexibility means flexibility external to a person's employment, such as the easiness of firing and hiring etc. Internal flexibility stands for organisational flexibility within the premises of employment. For the former, Atkinson (1987), Wood (1989) and Lagos (1994) distinguish between labour cost flexibility, numerical flexibility and functional flexibility. The following sections introduce the concepts of these three commonly-used definitions of labour market flexibility. Though I use the former definition as the basis, I shall incorporate elements of the latter definition into the framework.

7.1.1. Labour cost flexibility

Labour cost deals with macro- and microeconomic aspects of wage and non-wage costs flexibility. Wage cost is defined as the gross remuneration paid to wage earners. In plain terms, this is the gross salaries employees receive. Non-wage costs are also known as indirect costs. They are mandatory costs and charges that are paid by employers and employees. In other words, they include fringe benefits, payroll taxes, workers' compensation insurance, contributions to social security and health and pension schemes. Some of the typical institutional rigidities affecting labour cost flexibility would be wageindexing systems, guaranteed minimum wages, the high level of replacement incomes (such as unemployment benefits or income support) and various charges related to the use of the workforce. (Meulders and Wilkin, p. 7) Obviously, employers want downward labour cost flexibility, whereas employees prefer upward flexibility, or at least, downward labour cost rigidity regarding their salaries. Klau and Mittelstädt (1986) distinguish between real and relative labour cost flexibility. The former is a macroeconomic concept, measuring the degree of adjustment of aggregate real-product wages and related non-wage labour costs to changing productivity levels or terms of trade. (p.10) In contrast, the latter, relative labour cost flexibility, measures the adaptability of wage differentials. If there is scarce labour supply relative to demand in a certain skill category, a worker who holds such a skill should be paid more relative to other workers. In the empirical observation, however, I shall only *estimate* real wage flexibility, due to the lack of comparable data on relative wage flexibility. However, the benchmark for relative wage flexibility is examined by using data on earning dispersion.

Minimum wage legislation, for example, would prevent labour market demand and supply being reflected fully in the wage level. For this reason, opponents of minimum wages argue that they destroy jobs. However, the empirical study on European countries by Dolado et al. (1996) finds that the theoretical argument of minimum wages destroying jobs is an exaggeration. They point out the fact that in Europe there has been little change in minimum wages relative to average earnings over the past 30 years. This indicates that minimum wage legislation has little to do with the recent rise in unemployment in Europe. Yet, they also find that it may still be a contributory factor in rising unemployment of young unskilled labour, especially in France. Klau and Mittelstädt (1986) made a similar point by arguing that "the spectrum of total labour costs tends to be narrowed by employers' contributions to social security which, in most countries, contain ceiling provisions. This makes low-paid persons particularly vulnerable to lay-offs in time of economic slack." (p.12) Thus, it seems to be the case that labour cost inflexibility destroys at least some jobs.

Furthermore, there is a social dimension to the question of wage levels. Solow (1990) points to the problem of the reservation wage, i.e., the lowest wage at which people would be indifferent as to working at that wage and not having a job at all. In order to have a balanced labour market policy, one has to take account of both labour market efficiency and social acceptability. The degree of social acceptability is different from country to country, and is reflected by the level of replacement incomes (such as unemployment benefits) available. Thus, one can assume that reservation wages in France and Germany would be higher than in Britain. Due to the qualitative nature of the issue, it is difficult to argue decisively for or against labour cost flexibility.

7.1.2. Numerical flexibility

Numerical flexibility refers to the adjustment to the volume of work in response to cyclical or structural variations in demand or technological changes, or both. In practice, this would take place either through the adjustment to the number of employees or the adjustment to working hours and work schedules. One can also classify the former as external flexibility and the latter as internal flexibility, to use Streeck's terminology. For example, in a recession, employers fire employees or shorten their working schedules in order to keep their business running. The former is reflected in job, labour turnover and enterprise tenure, and the latter can be examined in changes and in the flexibility of working hours.

Such flexibility of employment would be difficult to achieve if there were restrictive employment protection regulations. Such legal restrictions governing employment contracts apply in particular to methods of dismissal, such as advance notice, amounts of compensation, prior agreement with various bodies etc. (Meulders and Wilkin, p.7) By increasing external numerical flexibility, employers can hire and fire depending on the level of market demand. This would, on the one hand, create job insecurity. On the other hand, a less costly arrangement for dismissal should give employers the incentive to hire more workers in times of growth. The empirical findings regarding the cost and benefit of numerical flexibility are still contested, but a number of studies have revealed a positive correlation between unemployment and rigid labour markets.[1]

As for internal numerical flexibility, the setting of maximum working hours is one example which has been widely debated. Employers support either the expansion of maximum working hours or the abolition of such regulations completely. The following three reasons for the employers' stance are mentioned in the report by the OECD (1995). First, the extension of maximum working hours is useful for the better use of existing capital stock. Second, it is useful for the improved adjustment of working time to fluctuations in orders. Third, it may induce the replacement of expensive full-time workers by cheaper part-time workers. (pp. 18-22) Although the last point may not directly relate to the questions on working time, it would be relevant too as far as labour costs are concerned. Trade unions welcome the reduction in maximum working hours, which fits in with the concepts of fair work-sharing and a healthy working environment. Due to the rise in unemployment, the concept of work-sharing has gained support in the continental economies, notably in France and in Germany. As part of work-sharing, early retirement is encouraged in both countries. This, however, is rather problematic, because it increases the burden of pension payments. Pension payments are already beginning to emerge as a very serious problem for the future working generations in the continental economies: on the one hand, the post-war structures of the welfare states need overhauling. This means states cannot keep accumulating deficits to finance pensions. On the other hand, the proportion of the younger generation relative to the older generation is decreasing steadily. Unfortunately, most continental economies suffer from vast unfunded pension liabilities, which strains public spending. This means either a cut in pension payments or the imposition of heavy tax burdens on the young working generation to finance the vast number of pensioners. Either way, it is not a popular policy to be implemented by any government facing the problem.

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[1] The most comprehensive survey of such studies is by Grubb and Wells (1993).

The question of working time cannot be totally separated from that of wage levels. For example, the wages of unskilled labour in Britain are lower than they are for Britain's continental counterparts. Thus, many unskilled workers in Britain depend on their overall pay including overtime. On the one hand, without an increase in wage levels, it is difficult for this part of the workforce to maintain a decent living standard. On the other hand, if wage levels increase without adequate increases in productivity, Britain would lose competitiveness. It is an example of the difficulty of applying European-wide legislation without real or structural convergence in Europe.

7.1.3. Functional flexibility

The last but equally important element of the LMF is functional flexibility. Meulders and Wilkin (1987) call it technical-organisational flexibility, and Lorenz (1992) organisational flexibility. Functional flexibility refers to the ability of employers to adopt and manage the function of labour, as market and technological conditions change. It is to do with the efficiency of the internal allocation of labour, in response to changes in demand and supply, technological developments, or simply company strategies. Like numerical flexibility, this flexibility also has external and internal elements. Internal functional flexibility has to do with the reorganisation of the workforce within the firm. In other words, it is the adaptation of the workforce to a variety of tasks at varying levels of complexity, such as multi-skilling, job rotation, work units, changes in the functional division of labour, retraining, and upgrading. For employees in general, it is considered that internal functional flexibility is more desirable than labour cost or numerical flexibility. This method has been widely used in Japan, where traditionally employees stay with the same company for a much longer time than in the US or Europe. Employees are required to show versatility and willingness to learn new skills, but this enables them to get more involved with the production process, play a more active role and share responsibility in the workplace. The OECD (1990) sees it as both a way of responding to workers' aspirations and a tool for making labour markets respond to the reorganisation of productive systems. (p.24) For this particular flexibility to work, employees have to be relatively skilled or educated, and employers are expected to provide training programmes for their workforce. Other conditions which nurture internal functional flexibility would be the less hierarchical organisational structure, such as the promotion of industrial democracy and the direct participation of employees and the elimination of job demarcation barriers. Industrial democracy and direct participation promote reciprocal cooperation between management and employees through consultation or the delegation of decision-making powers. These measures may seem not to relate directly to functional flexibility, but surely encourage a regime where employees take initiatives and can undertake multiple tasks. Job demarcations - the rigidity of explicit or implicit requirements on deploying labour and of occupational restrictions (types of work that a workforce categorised under a particular occupational classification can or cannot undertake) - would hamper functional flexibility. In other words, countries with active occupational unionism have a structural impediment against promoting functional flexibility. Among the three countries that I study here, Britain fits into this category.

Trade unions are often sceptical about the reduction in demarcation barriers because this could make it easier for employers to push through an intensification of the pace and/or volume of work. They also fear that the flexible deployment of labour will increase internal labour market segmentation between skilled and unskilled workers. (Lagos, p.89) In this context, whether industrial relations are cooperative or conflicting is an important factor in facilitating functional flexibility. Rainbird (1991) argues that educating unions on the benefits of training and the inclusion of the workforce in the decision making process (industrial democracy) in the workplace will be a prerequisite for the active pursuit of a skill-oriented functional flexibility.

External functional flexibility deals with outsourcing labour supply, such as subcontracting, etc. The dispute regarding the outsourcing of the catering section of British Airways in July 1997 is an illustrative example. Outsourcing would create similar effects as external numerical flexibility would bring about, regarding the workforce in main and subcontracted companies. For employers, subcontracting is a cheap and flexible alternative to expanding or downsizing the operation in main companies. Thus, I will only deal with the internal functional flexibility in the empirical section in Chapter 8.

7.2. Diverse paths to LMF

Boyer (1987, 88) presents a different approach and classifies the LMF in accordance with issue areas. He defines five areas as follows: first, the adaptability of productive organisation, second, the propensity of workers to change jobs within a given type of organisation, third, the strength or weakness of legal constraints on contracts of employment, in particular, on dismissals, fourth, the sensitivity of wages (nominal and real) to the economic situation of each firms or general labour market conditions, and fifth, the possibility for enterprises to avoid some of the social and fiscal contributions or other rules or regulations restricting their freedom on labour management. Clearly, both the classifications by Boyer (1987) and Atkinson (1987) etc. introduced above cover the same area, but differently. The first classification of Boyer corresponds to both functional and internal numerical flexibility, the second to largely internal functional flexibility, the third relates to external numerical flexibility, and both the fourth and the fifth correspond to labour cost flexibility. Whereas Boyer tends to classify through causes of inflexibility, Atkinson and others do so through the consequences of flexibility. As there are many different forms of labour market flexibility, there are different paths to achieve different and sometimes conflicting patterns of LMF. In this context, Boyer (1987, 1993) suggests that some notions of flexibility are not reconcilable, and are thus, counterproductive in terms of operating in combination with each other. He argues that the third and fourth types of flexibility are not necessarily compatible with the first two. In other words, internal numerical and functional flexibilities are not compatible with external numerical flexibility as well as labour cost flexibility. The rationale for this argument is clear and justifiable from both the employees' and employers' point of view. Making it easier to hire or fire workers by relaxing regulations on dismissal or lowering nominal and/or real wages, he says, may inhibit employees' morale, loyalty and performances. Employers would not be willing to give enterprise-based skill training in order to make employees functionally flexible, if it is cheaper for them to hire new employees and dismiss the ones with outdated skills. Besides, if employers provide training, employees may simply acquire the skill and leave the company. This free-rider problem is an additional factor in discouraging employers from providing substantive training schemes. Thus, external numerical, external functional and labour cost flexibility may prevent workers from being highly adaptable in work time and functions, and multi-skilled within their companies or organisations. (Boyer 1993, p.110) **This incompatibility between external and cost, and internal flexibility is crucial for classifying labour market regimes in this and the next chapter: if a country emphasises internal flexibility, then its labour market regime would not coexist well with that of a country which emphasises external flexibility.**

Boyer's point was supported both by the OECD and the European Commission. The OECD (1990) makes a similar argument, saying "in future, therefore, a reasonable balance will have to be found between internal and external flexibility". (P.77) In particular, to maintain the balance between two extremes is the real challenge. They are:

> i) that too high a degree of external labour market flexibility adversely affects the up-skilling, job redesign and redeployment of workers within the enterprise; and
> ii) that too strong an 'internalisation' of the labour market impinges on the economy-wide reallocation of labour and segments the labour force between those with secure, career jobs and those with casual, dead-end jobs. (p.86)

A similar *problematique* was raised by the Commission in their green paper (1997). They endorse the achievement of the right balance between flexibility and security. In other words, they argue that with the changing organisation of the workplace, new industrial relations arrangements to promote the partnership between employers and employees are necessary.

7.2.1. Two distinctly different regimes of labour market adjustment

One can thus say that there is an intellectual consensus that a strategy of flexibility has to be pursued with caution. By extending the argument, one can construct at least two different ways of achieving LMF: first, through a regime dominated by internal numerically and functionally flexible workers, second, through a regime dominated by pay and external numerical flexibility. Without losing the meaning, one can characterise the former as a labour market regime predominantly internally flexible and the latter regime as predominantly externally flexible. Under the first regime, employers provide workers with relative job security, but require them to be multi-skilled or to work flexible hours. Under the second regime, workers may be paid higher wages in economic booms, but risk being easily laid off temporarily or indefinitely in recessions. The regulations on dismissal, labour mobility and skill levels are some of the factors which can be used to determine the types of a specific regime. Germany and Japan, for example, fit into the first model, whereas Britain and the US can be classified as belonging to the second camp. This corresponds with the finding of the OECD (1986) that functional flexibility has been, at least up to the 1980s, higher in Germany and Japan, and unlike other indicators of LMF, lower in Britain.

Indeed, comparative studies by economists, notably by Houseman and Abraham (1993a, 1993b), Buttler et. al. (1994) highlight the cases for different employment adjustments due to the institutional differences between the US and Continental European countries. They find that in continental Europe, employment adjustment takes place through working time, whereas in the US, it is done by changing the numbers employed, i.e., by hiring and firing. In other words, in an economic slump or boom, Europe adjusts with internal numerical flexibility and the US adjusts with external numerical flexibility. This is due to the rigid regulation on dismissal as well as high non-wage costs in most European countries. On the one hand, it creates the condition of relative job security even in times of recession. On the other hand, it causes slow employment growth in times of economic growth. By examining labour demand functions, Houseman and Abraham (1993a) find that employment adjustment generally is significantly slower in the German than the US manufacturing industries studied, but also find that total hours adjustment was more similar, implying that average hours adjustment was generally greater in Germany.

The question is whether it is possible to achieve a 'reasonable balance' between the two different ways to organise the labour market, and whether it is realistic for labour market regimes with different priorities (internal or external flexibility) to coexist within a single economic zone sharing the same currency. The LMF regime reflects broader differences in social preferences. The debate on flexibility is about what kind of society people wish to create and live in, because "ultimately, social and economic goals cannot be treated as alternatives; they have to be treated as complementary". (ETUI P.5) Looking back historically, in any single economic or monetary unit, there has always been a single dominant regime of economic and labour market management. The only exception was the case of America in the 19th century, where dominance was resolved by the Civil War between South and North. Therefore, it is important to study the different types of LMF that countries subscribe to, and clarify some underlying socio-economic inconsistency which may cause serious frictions as European integration proceeds. To reflect on the differences in the underlying socio-economic structure, it is necessary to study labour market institutions.

7.3. Labour market institutions

Differences in labour market adjustment are the result of the unique nature of national labour market regimes. Different labour market institutions are the bases for the uniqueness of labour market regimes which bring about the differences in labour market adjustments. This section aims to clarify the different characteristics of labour market institutions in three European countries by using the regulationists' approach introduced in Chapter 3.

I shall examine i) the mode of industrial relations and employment management, ii) the regulatory framework as a principal determinant of the adjustment mechanism and iii) the social security regime to take account of different welfare systems. These aspects comprise the *regulation* concept of *Rapport Salarial* (wage / labour relations). This chapter aims to identify whether the domestic regimes of the three countries are geared towards labour market adjustment of an internal or external nature. For the former, one would expect the system of industrial relations to be relatively cooperative with employment security backed up by regulation. For the latter type of regime, industrial relations may be either confrontational or without much coordination, accompanied by very little regulation on employment security. In addition, it is useful to analyse social security regimes as they interact with labour market regimes. A low level of social protection brings about employment flexibility. Although it is contested to which degree the strictness of regulation determines the level of unemployment[2], there is no debate that the level and extent of social benefits affect labour supply and mobility. For example, the higher participation of women in Nordic countries was achieved through a comprehensive development of state-supported collective services in education, health, and social welfare services such as child care. This is an example which suggests "the cross national differences in labour market behaviour to be attributable to the nature of welfare-state regimes." (Esping-Andersen, p. 144) Higher non wage labour costs would reduce labour mobility as they promote less hiring and firing and longer job tenures than otherwise. Generous unemployment benefits may reduce labour mobility as the unemployed can afford to stay unemployed. In addition, portability of pension schemes may facilitate higher labour mobility. Generally speaking, the countries with lower coverage of social security and lower taxation would make labour less expensive, thereby making labour markets more flexible externally. A country with higher social security coverage should be more internally oriented in its labour market adjustment, as it is less costly. In the following sections, I shall elaborate on these two different paths of internally- or externally-oriented labour market and social regimes by examining the industrial relations, regulations and social security regimes in detail.

[2] For a recent survey of the argument, see Siebert (1997), OECD (1993); notable academics arguing against the argument are Saint-Paul (1996) and Manning (1996), Nickell (1997).

7.3.1. Mode of industrial relations and employment management

It is not the purpose here to explain in detail the trade union movements or employers' organisations of a particular country. Rather, I shall examine the mode of interaction among government, employers and trade unions within the context of collective bargaining processes in France, Germany and Britain, in order to define different types of labour market regimes.

7.3.1.1. Trade union and employer representation

The unionisation and employer density rates presented in table 7.1 reflect the degree of their representation by their respective organisations.

Table 7.1. Union and Employer Representations in the Mid-1990s (in Percentages)

	Union density (market sector)	Employer density (market sector)
Germany	25	70 - 80
Britain	21	50 - 60
France	5	60 - 70

N.B.: Density stands for percentages of union members out of employed wage and salary earners for unions, and percentages of private sector firms registered for employers organisations for employers.

Source: Visser (1998)

The membership of both trade unions and employers' organisations have declined over the last decades, thereby reducing the influence they used to have in the past. However, the effectiveness of their representation in collective bargaining processes differs considerably among the three countries.

Both trade union and employer representation is high in collective bargaining processes in Germany. Organisation is mainly sectoral. A sectoral trade union bargains with a sectoral employers' organisation on wages and working conditions. This representation by a single union rather than by multiple unions makes trade unions in Germany more influential than in other European countries, as will be explained later. The majority (81.1% of trade unions in 1990[3]) of sectoral unions are affiliated to a predominant trade union confederation, and a majority of private sector firms are members of the confederation of employers' organisations.[4] Neither the confederations of employers' organisations nor trade unions take part in collective bargaining but they do play an important and effective role by coordinating member policies.

In France and Britain, trade union and employer representation are not as well organised as in Germany. Trade unions in France are politically and religiously fragmented, with little coordination among them. Furthermore, there are several trade union confederations co-existing, organised along political, religious and professional lines.[5] French trade union federations are ideologically oriented with strong antagonisms and rivalry among themselves. There is no coordination whatsoever among them, and few, if any attempts are made to improve this situation.[6] In contrast to their fragmented trade union counterparts, the confederation of employers' associations in France is much more united, and covers the majority of employers[7]. Despite the high rate of representation, it is fairly ineffective in coordinating members, as employers are deeply divided by personal conflicts and ideological factions.

As in Germany, Britain has a main trade union confederation[8] which represents the majority of trade unions (89% in 1990[9]), organised by sectors or professions. However, it is highly ineffective in coordinating members. As in the case of France, British trade unions are pluralistic and fragmented. Rather than politically or religiously, they are divided by craft

[3] Source: Van Ruysseveldt, Huiskamp and van Hoof (1995), p. 45.

[4] The former is Deutscher Gewerkshaftsbund (DGB) and the latter is Bundesvereinigung der Deutschen Albeitgeberverbände (BDA).

[5] There are five major trade union confederations: the Confédération générale de travail (CGT), Confédération française démocratique de travail (CFDT), Force ouvriére (FO), Confédération française des travailleurs chrétiens (CFTC), and Confédération française de l'encadrement - Confédération générale des cadres (CFE-CGC).

[6] This statement was confirmed by Jean-Pierre Yonnet, the European Representative of Force Ouvriére Post & Telecom Branch Union in a personal interview on 17 June 1997.

[7] Counseil national du patronat français (CNPF).

[8] Trade Union Congress (TUC).

[9] Source: Van Ruysseveldt, Huiskamp and van Hoof (1995), p.45.

and occupation and, to a lesser extent, by industrial affiliation. Such multi-unionism (the presence of more than one trade union at the bargaining table with an employer) makes trade unions in Britain and France ineffective in putting forward their demands, as they do not speak with one voice at the collective bargaining table. The ideological rift among trade unions diminishes union influence, as management can take advantage of infighting. One can probably say that employers' organisations in Britain have the lowest profile among most EU countries, since the members are, like trade unions, pluralistic and fragmented. There is only one main confederation of employers' association[10], but it does not coordinate wage and employment policies among members, nor has it any mandate on collective bargaining. The organised representation by trade unions and employers' organisations is much more effective and constructive in Germany than in France or Britain.

7.3.1.2. The role of the State

The government in some countries is the third actor in industrial relations. The degree of state interference varies greatly in the three countries. In plain terms, one can say that government in Germany, through indirect intervention, plays a supporting role through consultation with its social partners. However, independence from state intervention (Tarifautonomie) is firmly established under the Basic Law in Germany (Article 9, section 3). The French government, on the other hand, plays a pro-active role by direct intervention. Scholars argue that the British government plays a passive role.[11] However, the British government in the past played a decisive role in altering the overall environment of industrial relations. Unlike France and Germany, where the basic infrastructure of industrial relations is enshrined in the constitution, British industrial relations are not underpinned by any basic laws. The political system allows changes in any basic tenet of labour relations as long as laws are passed by the majority in parliament. In the 1980s, government interventions in

[10] Confederation of British Industry (CBI).
[11] For example, see van Waarden (1995), Van Ruyssefeldt and Visser eds. (1996), Schmid ed. (1994), Bamber and Lansbury eds. (1993), Streeck (1993).

industrial relations increased both in France and Britain. However, the nature of interventions by the two governments is almost as different as chalk and cheese. During conservative governments Britain abolished a number of regulations stipulating trade union rights, and established the rules of the game for neo-liberal industrial relations: since 1979, it passed eight employment acts to progressively curtail trade union power and increase greater freedom for employers regarding employment regulations. The state played a vital role in creating a pertinent institutional structure for a pro-business environment regarding the conduct of the labour market and industrial relations. In the case of France, on the other hand, the socialist government introduced the Auroux reform in 1982, with the intention of strengthening trade union powers at the workplace level. It exercises a more traditional form of state intervention by dictating the terms of employment and working conditions, such as minimum wages, working hours, social security, workplace safety, etc.

In a nutshell, in France the law gives a mandate to the government to take an active role, in Germany the law regulates and conditions government intervention, and in Britain the government sets the law. This suggests that the state in Britain may hold potentially the strongest **structural** power in industrial relations.

7.3.1.3. Collective bargaining

7.3.1.3.1. Level and coverage of collective bargaining

Collective bargaining in Europe is in transition. In the past, the dominant level of collective bargaining in all three countries was the sectoral level. Collective agreements on wages and working conditions in France and Germany are legally binding, but not in Britain. In France, collective agreements are defined under the Labour Code as agreements relating to conditions of work and social codes between employers and trade unions. In Germany, there exists a thorough legal framework for the conduct of collective bargaining as well as the protection and enforcement provisions accompanying it. The right to bargain collectively and to resort to industrial action was stipulated in the Basic Law, the constitution of the Federal Republic of Germany in 1949. Collective agreements are not legally binding in Britain, unless explicitly stated otherwise. Such cases are extremely rare. This means that unlike in France or Germany, there is no systemic mechanism of administrative extension[12] in Britain. In addition, there is no statutory form of employee representation, nor is there any obligation for employers to recognise trade unions or any other representatives for collective bargaining.[13] There is a growing number of multinational corporations, such as Shell or ICI, which have de-recognised trade unions. According to Millward et al. (1992), 56% of manufacturing, and 64% of the service sector were not recognising trade unions in 1990. The figures are expected to have risen towards the end of the 1990s. Non-unionism means that there is no collective agreement in such establishments.

At the sectoral level, generally the largest union in the manufacturing sector sets the trend in collective bargaining. In Germany, IG Metall (metal sector) acts as a leading wage setter, and the result of their collective agreement serves as the benchmark for other agreements. As a representative of the export-oriented sector, IG Metall is highly aware of the need to maintain the external competitiveness of German industry, and acts as what has been described as "social Bundesbank". (European Commission/IDS p.37) That German trade unions are highly organised and aware of external competitiveness helped to restrain excessive wage increases in the past. This pragmatic approach of German trade unions differs greatly from ideologically-oriented union movements in France and Britain.

The importance of sectoral level collective bargaining has declined considerably in Britain, and to a lesser extent, in France. In France, a considerable number of employees in small and medium enterprises (SMEs) are believed to be not covered by collective

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[12] " Administrative extension" stands for the extension of the coverage of collective agreements to non-signatory parties.

[13]. In May 1998, in its White Paper, Fairness at Work, the government proposed that employers have to recognise trade unions if at least 40% of those eligible vote in support of recognition. Only then can unions apply to impose binding procedures for collective bargaining. Such high percentages are believed to be unrealistic. Many British trade unions are keeping up the pressure for a change of the 40% threshold in recognition ballots.

bargaining. According to the International Labour Office, the proportion of employees covered by collective agreements is 90% in 1995 in France, 90% in 1996 in Germany, and 25.6% in 1994 in Britain.[14] The figures reflect the fact that the dominant level of bargaining in Britain is at the company level. In Germany and France, sectoral level agreements provide the framework, but the lack of cohesion among trade union confederations in France makes it difficult for them to bargain effectively.

7.3.1.3.2. Decline in sectoral collective bargaining

Sectoral collective bargaining in Europe is on the defensive. Increasingly, there is a move away from centralised to decentralised, company level bargaining. In Germany, sectoral level bargaining is still by far the most important, but as in the other two countries, company-level bargaining has gained importance. Even in Germany company-level bargaining through works councils sometimes undermines collective agreements. In Germany issues settled by collective agreements can be legally regulated by works agreements at the company level only if the collective agreements explicitly allow for those supplementary agreements. The supplementary nature of bargaining through works councils does sometimes create tension between the two levels of bargaining. This is because supplementary wage increases at the company level are often achieved through concessions by works councils on working conditions or working hours, agreed by sectoral collective bargaining, which then are unacceptable to the trade unions. IG Metall (metal sector trade union) took IBM's works councils to court regarding an allegedly illegal agreement on Sunday work in 1989. In 1993, IBM introduced a new bargaining structure by withdrawing from the framework of sectoral collective bargaining except for its manufacturing division.

The decline in sectoral level bargaining has to do with structural changes in the world economy, as well as institutional deadlock in trade union movements. The declining importance of the manufacturing sector and the development of the service sector accelerated

[14] Figures are taken from ILO World Labour Report 1997-98, p. 248. The figure for France is an estimate.

the decline in union density. The decline in the density of employers' organisations is a contributory factor to the diminishing influence of sectoral collective bargaining.

7.3.1.3.3. Trend towards decentralisation

Is collective bargaining in three countries converging towards decentralisation? Though company-level bargaining is gaining importance in all three countries, they have maintained their own institutional uniqueness in collective bargaining. The British case is the most laissez-faire of the three. In the French case, though decentralisation has gained importance, sectoral collective bargaining has still been very much directed by the state. The German case is perhaps the most stable among the three, though there is an increasing number of companies boycotting sectoral collective agreements. This tendency is particularly serious in eastern Germany where two-thirds of employers are already outside the system of collective bargaining and negotiate wages only at the plant level. (Financial Times 14/08/97) The collective bargaining system has recently come under increasing pressure as employers have demanded more flexibility in wages and working conditions if employment is to be guaranteed. Indeed, over the past few years, it has become increasingly common to include "opening clauses" in collective agreements, whereby plant level bargaining can negotiate variations from the sectoral norm to suit individual circumstances.[15] A recent example is the Opel agreement signed by the Opel management and the company's group works council in January 1998. The deal includes the management guaranteeing job security in exchange for workers' acceptance of more flexible working-time arrangements and pay increases below the level of the sectoral collective bargaining agreement.

7.3.1.3.4. Industrial democracy

[15]. For detailed analyses, see EIRR 245, June 1994 and 295, August 1998.

As decentralisation is setting the trend in collective bargaining of the three countries, it is important to compare the bargaining processes at the plant level. At the workplace level, works councils represent employees in both France and Germany, but not in Britain. This may, however, change with Britain implementing the directive on European works councils.[16] Hege and Dufour (1995) compared the representation legitimacy at the workplace level in France and Germany by mainly comparing the functioning of works councils. Despite the institutional differences between the two countries in terms of organisational structure, strength of trade unions and ideology, they found in their samples that within establishments, the behaviour of works councils is surprisingly similar. In both countries they found close coordination between works councils and trade unions. Trade unions provide resources for training, and technical expertise to shop-floor representatives, which works councils are dependent on. Works councillors are also dependent on external union resources for information on broader wage and employment policy issues outside their companies, in order to prepare a strategy for negotiations. Trade unions, in turn, rely on works council cooperation to exert influence as well as to recruit new entrants from the shop floor level. Thus, there seems to be no major conflict in the role of trade unions and that of works councils in France and Germany.

However, there are major differences in the mandate and functioning of works councils between the two countries, which has to do with the degree of industrial democracy.

The works council (Betriebsrat) in Germany has historical roots way back to the time of the Weimar Republic. The legally binding establishment dates back to 1920. The current mandate of works councils is based on the Works Constitution Act of 1952. For firms of five or more permanent employees, works councils have to be established. The number of works

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[16]. The European Works Councils (EWCs) Directive has now been formally extended to the UK by means of an extension directive, adopted in December 1997. The provisions of the directive will come into force in the UK in December 1999. According to a survey by the University of Southampton in October/November 1997, however, there were 18 British firms which already had voluntarily established either an EWC or an information and consultation procedure.

councillors elected by all employees is related to the size of the specific establishment. Work councillors meet the employer at least once a month.

The philosophy behind the introduction of works councils can be found in the concept of **co-determination**, the extension of democracy to the economic decision-making process at the work place. There are two institutional levels of workers' representation regarding co-determination. One is workers' participation on the supervisory board (Aufsichtsrat): works councils and unions nominate employee representatives to the supervisory board. The supervisory board selects the managing board, supervises executive management, audits annual financial accounts and annual reports, and supervises reports to the shareholders' annual meeting. The membership size differs depending on the size of the company. Under the Works Constitution Act of 1952, a third of the members must be elected by employees by secret and direct ballot. The Co-determination Act of 1976 stipulated that a half of members are to be elected by workers representatives but at least one of them must be from the group of white-collar employees. Members cannot be shareholders and members of the management board at the same time. The supervisory board convenes at least every six months.

The other institutional form of workers' representation is co-determination through works councils. The rights of works councils are stipulated as follows: first, co-determination rights on social matters including working conditions, working hours, occupational training and remuneration. Second, co-determination rights on personal matters including recruitment, transfer and dismissal. Third, veto rights on individual staff movement, such as firing, transfer and dismissal. Fourth, information and consultation rights on personnel planning and changes in the working environment. Fifth, information rights on the financial affairs of the establishment. Sixth, information and consultation rights on the introduction of new technology and major operational changes in the company. (Müller-Jentsch p.59) The works councils are institutionally independent from unions and have their own constituency. However, in reality, most work counsellors are also union members.[17] Overall union representation in works councils in Germany was 69-76% in 1990. [18]

Irrespective of union presence, the law requires French companies to establish some form of committee for employee representation. In firms with more than 10 employees, personal delegates (délégués du personnel) have to be elected by all employees. Delegates are in charge of taking care of complaints by individual workers about wages and working conditions. They also monitor compliance with labour legislation and collective agreements. In companies or plants which employ 50 or more, the establishment of an enterprise committee (comité d'enterprise), the French version of works councils, is required. In addition, these companies also have to have a health and safety committee (comité d'hygiène, de sécurité et des conditions du travail).

The enterprise committee consists of one employer representative and elected employee representative. It manages funds provided by the firm for social activities for the employees and their families. It has the right to be informed and consulted about the general affairs of business and company policies. In particular, the personnel and employment policies of a company must be approved by the committee before decisions are made. It may also negotiate agreements on profit sharing. The committee must meet monthly. Though these committees were established in a 1945 Law, the 1982 Auroux law has enhanced their influence considerably, by giving them more power to promote workplace democracy, as well as by expanding the scope of consultation to cover technical and economic affairs. The objective of the law was to strengthen the position of union delegates with respect to company management and also with respect to central union officials. Delegates or representatives of such committees do not need to be trade union members, though the majority of them are. Nevertheless, works councils in France are very weak and the degree of co-determination is rather limited. Consequently, the enterprise committee acts primarily as an (obligatory) consultation forum. As the dispute about the Renault factory closure in

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[17]. According to Huiskamp (1995), this is particularly the case of the metal industry where the majority of works councillors are members of IG Metall.

[18]. Figures are quoted in table 3.2 of Müller-Jentsch, p. 57.

Vilvoorde, Belgium[19] demonstrated, the autocratic French style of management makes it especially difficult for employers to cooperate with employees. Furthermore, the fragmented French labour movement is not strong enough to exploit to their advantage the statutory opportunities offered to them.

The European Directive on works councils only seeks the establishment of works councils for consultation purposes. German-type co-determination is not included as a feature of European Works Councils. Thus, even if implemented in some companies in Britain, the degree of industrial democracy would be much lower than in Germany.

This suggests that both Germany and to a lesser degree, France tried to integrate labour into the economic management of firms. Successful integration of labour at the plant level enhances the cooperative nature of industrial relations in Germany, and creates an environment for internal rather than external forms of labour market adjustment. Except for a few firms, such a mechanism does not exist in Britain. This suggests that the British labour market regime is geared more towards external labour market adjustment.

In terms of the mode of industrial relations in general, the cooperative culture prominent in the German labour market regime promotes internal adjustment. In contrast to their French and British counterparts, the German trade unions are pragmatic with a strong awareness of economic competitiveness. Relative to France and Britain, employers in Germany have well-institutionalised channels of communication with employees, a situation which promotes negotiation and compromise. This implies that German industrial relations are most suited among the three for internal labour market adjustment. Though France has some institutions of dialogue, the lack of effective representation of both trade unions and employers hampers productive communication among them. Britain, however, does not have institutions to facilitate cooperation, nor effective and balanced representations of both labour and employers. Consequently, French and British industrial relations are more geared towards the external mode of adjustment.

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[19]. In February 1997, the Renault management made the unilateral announcement in the Belgian Press that the company was to close down its Belgian plant at Vilvoorde in mid-summer and lay off nearly 3,000 workers in France.

7.3.2. Regulatory framework

The legal framework is one of the distinctive national features which moulds different modes of industrial relations. There are fundamental legal differences between continental European countries with Roman-Germanic law, and Britain with the tradition of Common law. The legal framework in France is underpinned by Roman codified law. Roman law distinguishes sharply between public and private law, between state and society, giving priority to the former over the latter. (van Waarden p.131) The Common law tradition in Britain draws a thin line between state and society, reflected by the old tradition of unwritten rules that gradually evolved into formal law. The focus of legal analysis in labour law is the relationship between the employer and **each** individual employee.[20] Indeed, what is negotiated collectively in Britain is only enforceable as an individual contract - covered within the domain of civil laws. German labour law covers almost all aspects of industrial relations. The German legal tradition of detailed rules and regulations is reflected in current rule-based industrial relations.

The objective of this section is to determine the dominant level of regulation in the three countries, as well as to examine the different characteristics of regulation. There are three different levels of regulation for day-to-day issues of industrial relations: by law and regulation at the national level, by regulations agreed by collective bargaining at the sectoral level, and by those agreed upon at the company level. The purpose of comparing employment regulation is to examine the philosophical and ideological differences in labour market organisation and policies. Therefore, a detailed description of differences in regulations is avoided, unless they are essential for explaining some fundamental differences in the underlying ideology of labour market regimes.

[20]. It is interesting to note that up to 1939, legal studies were almost exclusively concerned with the common law of the master and servant relationship. (Hepple and Fredman p. 33)

In France, the law (statutory legislation) sets a minimum standard which applies directly to some workers, but is further improved by collective agreements for others. In Germany, the law enshrines only minimum standards for working conditions. The standards agreed by collective agreements are usually higher and set de facto legal constraints. In Britain, there is virtually no regulation except in the area of safety at the workplace, with rules set at the company level, rather than at the national or sectoral level.

The main difference between the respective regulatory frameworks is that between the **rule-based** French and German system and the discretionary and **voluntary** British system. Accordingly, the former can be over-regulated, whereas the latter can be under-regulated. Barrel (1996) argues that the Common law system is better as far as adaptability or flexibility in labour markets is concerned, but his argument may be an over-simplification. Such "flexibility" could not address the poor employment performance in Britain during the 1970s. Streeck (1997) argues that such flexibility also contains negative connotations, as it creates discontinuity and confusion regarding fundamental rules of industrial relations. This is because, under the British political system, a simple majority in parliament can easily undo any law made by the administration's predecessors and create new ones. (p.334) Due to legislation and repeal by different governments, and the case law system, there are many overlapping, contradictory areas in the regulations in the area of industrial relations. (IDS 95, Watson Wyatt)

The German labour market is often regarded as one of the most over-regulated. However, there is considerable "flexibility within regulation" in the German system of industrial relations:[21] there are two kinds of procedures establishing regulations: regulation through law and regulation through negotiation with social partners. Under the latter, through collective bargaining, updating of regulations is possible. As mentioned above, in Germany the regulatory framework of working conditions is regulated by statutory legislation. Yet collective bargaining is an important forum to 'sectoralise' the minimum rules set by legislation. Furthermore, works councils can conclude agreements on issues not

[21]. Direct quote of Stefan Clauwaert, a researcher at the European Trade Union Institute, from personal interview on 16/6/97.

covered by collective agreements. Since 1987 works councils have also been able to interpret and negotiate sectoral agreement on working hours. This suggests more flexibility at the plant level than the seemingly rigid legal framework indicates.[22]

The following paragraphs examine in more detail the regulations in the three countries. The two areas of labour regulations which present most starkly the contrast among the three countries - dismissals and right to strike or lockout - are discussed in detail.

7.3.2.1. Regulations on dismissal

A comparison of regulations on dismissal and industrial actions (section 7.3.2.2) is useful as it reveals a clear contrast in procedures and characteristics of different legal traditions.

In France and Germany, there are comprehensive regulations regarding dismissal. Since the law of 13 July 1973 (the Labour Code), the right of dismissal is granted to the employer in France. The legal procedure is as follows: an employer summons an employee whom he intends to dismiss to an interview prior to taking action, and the employee has the right to defence. Whether dismissals are due to economic or personal reasons, employers are by law obliged to provide real and well-founded reasons. (Labour Code L122-14-2) Advanced notice is obligatory, with the period varying in accordance with seniority, and the length of employment. Works councils or personnel delegates have to be informed and consulted right after the preliminary interview with the employee concerned. Under the National Agreement of 1969, employee representatives must always be consulted about the planned dismissal of a manager. (Watson Wyatt) In the case of a redundancy for economic reasons, employers either have to offer a retraining contract at the primary interview, or they have to pay a penalty equivalent to the one-month salary of the employee. They are also obliged to inform the labour inspectorate at the Ministry of Labour of the redundancy.

[22]. The same point was made in Marsden (1995), who advocated the flexibility of seemingly regulated German labour markets relative to seemingly deregulated British labour markets.

Regarding severance pay in France, anyone who worked continuously for 2 years or more for the same employer is entitled to minimum severance pay, except in the case of an instant dismissal due to a serious fault of the employee. The sum equals 20 hours of hourly pay for wage-earners or 10% of monthly earnings for salaried employees. Indemnity increases with the number of years of continuous service. For example, someone who worked 20 years is entitled to the sum of 2.7 times his/her average monthly earnings. A dismissed employee who has worked for more than two years is entitled to take a claim of unfair dismissal to the labour tribunal if the reasons provided for the dismissal are unsatisfactory. The amount of compensation, should the reasons provided by the employer be found unfair, should not be lower than six months gross earnings.

In Germany, there are a number of procedures for employers to follow regarding dismissal of employees. There are detailed rules on consultation requirements, protective legislation and some other practical and legal requirements regarding notice periods. Employers are obliged to inform works councils in writing on planned dismissals of employees. The reasons for dismissal have to be stated and well-founded. Except in the case of immediate severance due to employee's fault, works councils have to approve the dismissal for it to take effect. The minimum notice period required varies depending on the years of service. By the law of 1993, the periods of notice for blue- and white- collar employees were equalised. There is no statutory law stipulating severance payment for fair dismissal. However, in the case of collective redundancies, a works council can negotiate with the employer on a social (compensation) plan (Sozialplan), which includes severance payments. Social plans in Germany are similar to their French equivalent in spirit but different in substance. As mentioned in Chapter 6, in France they provide mainly a contribution to the cost of retraining, whereas in Germany they provide aid for dismissed employees in a more encompassing manner. In addition to severance payments, these provisions include out-placement, time off and fares for finding a new job and hardship funds. The level of payment varies depending on the region, sector and terms of individual contracts. A typical payment for a middle manager aged 40, working for the company for 20 years would be in the range of 12-18 months of his monthly earnings. (Watson Wyatt p.144) In the case of unfair dismissal, the maximum sum payable in compensation is twelve months' pay for employees younger than 50 years old with less than 15 years of service. The sum increases for older and longer-serving employees. In Germany, the criteria for unfair dismissal are broader than in France or Britain, where unfairness is constituted by discrimination by sex, religion, affiliation, race etc. Rather, it includes also dismissals in cases where the employee could be reemployed in another capacity after suitable rehabilitation or training, or under altered conditions with the employee's consent. Thus, it is not easy to dismiss employees in Germany especially if they have been continuously in service for a long time. Any employee who is 18 years or older working for a company for more than 6 months is entitled to protection by Labour courts against unfair dismissal.

In Britain, there is no obligation to put an employment contract in writing. The EU directive on proof of any employment relationship (EC91/533/EEC), which is implemented as the Trade Union Reform and Employment Rights Act of 1993, however, stipulates that a written statement of the main terms of employment must be provided to each employee. This act only applies to employees who works at least 8 hours a week with a contract for the duration of more than one month.

Unlike in France and Germany, in Britain there has been an almost total lack of statutory regulation of employment conditions until recently. These were regulated by the individual contract of employment only, except for conditions which fell under the category of health and safety at work. Thus, there was no regulation on hours of work except for special cases such as minors or children. Likewise, there was no statutory regulation of levels of overtime, and of shift work. In addition, there is still no superstructure of binding collective agreements at industry level (administrative extension). This means almost all elements of pay and working conditions have been determined and enforced at company level, either by agreement or unilaterally from the management side.

The national working time legislation came into force in October 1998, as a result of the 1993 European Working Time Directive, which set maximum weekly working hours, paid holidays, and other minimum working conditions. The Directive was regarded as health and safety provision under the EU treaties and was therefore subject to regulation at EU level, including Britain. This required drastic changes in British labour market regulation. The British government, however, has ensured that its interpretation enables companies to exercise as much flexibility as possible. By allowing employers and employees to exercise opt-outs from the working hour limitations through an individual, a workforce or a collective agreement, Britain has so far managed to *de facto* mitigate the restrictive impact of the Directive.

According to Common Law, an employer is not required to give any reason for dismissal. The Employment Protection Act of 1978 modified this by stipulating that an employee who has been employed continuously for 6 months is entitled to a written statement by his/her employer, giving the reasons for dismissal, at least 14 days prior to dismissal. A termination of contract for health reasons constitutes unfair dismissal, whereas dismissal is possible in the case of employees' misconduct, and incompetence, given the proper procedures set by the Advisory, Conciliation and Arbitration Services (ACAS)[23] code of practice are followed.[24] Employees who are continuously employed for a period of one year can bring a claim of unfair dismissal to an industrial tribunal[25]. The notice period varies depending on the length of service. In the case of gross misconduct on the part of an employee, an employer can dismiss him/her without notice. As for redundancy, there are consultation requirements with recognised trade unions both for individual or collective dismissals. This implies that for those employers who have not recognised or have derecognised trade unions, there is no need for any consultation with employees. However, the courts have advised employers to consult individual employees and have inferred this as a

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[23]. The ACAS was established in 1974 under a Labour administration to resolve industrial disputes through arbitration. It consists of representatives from trade unions, employers and government-appointed academics. The subsequent conservative administration limited the authority of ACAS to the arbitration of conflicts in the public sector only, in addition to its role of conducting inquiries.

[24]. The code of practice includes a warning in writing to the employee, giving him/her sufficient opportunity to improve before a dismissal to be enacted.

[25] It was reduced from two years to one year in June 1999.

contractual duty. Redundancy is taken as unfair on grounds of trade union affiliation or discrimination by sex, religion and race. Unlike other EU countries, British employers may use performance criteria, absenteeism, and health records as criteria when selecting for redundancy, and they have been widely used recently. (IDS 1995, p.423 - 424)

There is no statutory provision for severance compensation, apart from the redundancy payment. The amount of redundancy payment is based on age and the length of continuous services. Those aged between 41 and 64 are entitled to a sum of one and a half weeks' pay per year of service, up to a maximum of 20 years.

7.3.2.2. Regulations on the right of industrial action

Again, regulations on taking strike action are more comprehensive in France and Germany than in Britain. In France, the basic right to strike is guaranteed by the Constitution. Strikes unrelated to issues of collective bargaining, such as political strikes are illegal. Sympathy strikes, i.e., strikes in support of primary strikes, are legal if there is a clear link of interest with the primary strikers. There is no legal requirement to hold a ballot prior to a strike. However, public sector employees are obliged to announce a strike in advance. Under statute law, a strike is not a breach of contract. Since 1985, employees have had the right to be reinstated if they are unfairly dismissed on the ground of striking. Lockouts,[26] however, are generally considered by case law to be illegal in France.

The freedom to strike or lock out is guaranteed under the constitutional right of freedom of association in Germany. Both strikes and lockouts should be exercised as weapons of last resort - after other options of negotiation in collective bargaining have been exhausted. Unlike in France, the right to lock out is equally recognised as a weapon in industrial conflicts. The obligation to work and to pay wages is suspended during strike action. A strike is a breach of contract for an employee only if he/she participates in an illegal strike. In Germany these are strikes which are not directly related to collective

[26]. Whereas strikes are regarded as the ultimate bargaining tool by employees, lockouts are the ultimate measure by employers.

bargaining, including political and sympathy strikes, though the latter can be legal in the case of direct relevance. Professional strikes are legal subject to secret ballot.

The right to strike is not recognised in the British legal framework. Consequently, striking is a breach of contract in Britain. This is in stark contrast to most EU countries where industrial action causes a suspension of contract. This implies that in Britain an employee can be fairly dismissed while he or she is participating in a strike or other industrial action. Since 1990, however, a distinction has been made between official and unofficial strikes. Since the 1992 Trade Union Act, strikes are approved as official only after the following complicated procedures have been followed: unions have to conduct a proper secret ballot by post, which should be held not more than four weeks before the strike action. The employer must be given at least seven days' notice of the ballot, together with details of those involved, and a sample copy of the ballot paper. Once the result is known, the employer must be a given the full details of the outcome and at least seven days' advanced notice of strike action, together with the details of those involved. (IDS 96a p.359) Only after these procedures have been properly taken, do strikers have immunity from prosecution. If a strike turns out to be unofficial, the employer can sue the trade unions (or the perpetrators) for civil damages through the courts. Even in the case of an official strike, employers may lawfully dismiss strikers for breach of contract if the dismissal is summary, including all the strikers. Political and sympathy strikes are illegal, and employees do not have any right to claim unfair dismissal in such a case.

On the other hand, there is no legal restriction on lockouts. Rather than lockouts, employers commonly resort to the tactic of the suspension of employees.

Therefore, regarding the regulation of industrial conflicts, the French law favours employees over employers, the British does the opposite, and German law tries to take a more balanced stance.

Stringent regulations on strikes like those in Britain do not necessarily prevent industrial conflicts taking place.

Table 7.2. Industrial conflict: the volume of working days lost per 1,000 employees in employment

	1991-92	1993	1994	1995	1996
Germany	9	18	7	8	3
Britain	49	30	13	19	58
France	27	49	40	138	59

N.B. The first column is the annual average of two years.

Source: Visser (1998)

Despite its relatively tolerant regulation, the number of industrial conflicts is much lower in Germany than in Britain. This reflects the cooperative nature of industrial relations in Germany. Confirming the confrontational nature of their industrial relations surveyed in section 7.3.1, France in particular, and Britain show high rates of disruption by industrial conflicts. This suggests that though norms are important, the reality of how regulations affect industrial relations is very much a result of the specific power relations among the actors in industrial relations - employers, employees and the state in a given society.

7.3.2.3. The level of regulation and the extent of employment protection

In France, industrial conflict and legal intervention by the state rather than collective bargaining have been the dominant mechanism of rule making in industrial relations. In this sense, the dominant level of regulation is the law rather than collective bargaining. In Germany, labour laws set minimum conditions only. Many areas of practice in industrial relations are regulated by law. However, the law merely sets out a framework for collective bargaining: social partners have some flexibility in interpreting the law according to their needs. This tendency became even more pronounced recently with the increasing use of "opening clauses" in sectoral collective agreements, as mentioned in 7.3.1.3.3. Thus, it could be argued that the dominant level is a combination of both law and collective bargaining. The law merely sets out a framework, and collective bargaining defines more suitable regulations for the negotiating parties. Britain, with its tradition of common law, does not share the same legal tradition with France and Germany. Thus, British labour laws can be easily abolished or introduced as the government changes. For instance, all provisions regarding compulsory arbitration in the case of unions seeking recognition from employers, introduced under the 1975 Employment Protection Act, were removed by the 1980 Employment Act. Therefore, company level bargaining and rules are the dominant level of regulation in Britain.

The different legal tradition of common law implies that, unlike in the Roman-Germanic legal framework, in Britain there are no collective rights for workers, guaranteed by the highest level of law, the constitution. As the legislation enacted since 1979 curbed trade union power, British workers are considerably worse off legally in terms of strikes and dismissals than their continental counterparts. Among the three countries, French workers enjoy the most favourable legal framework in respect to industrial action, whereas German workers seem to have the most protective legal framework for regulations regarding dismissal.

These factors imply that the British regulatory framework is most suited for external adjustment of the labour market. On the other hand, the French and German legal structures and regulations contain many costly procedures for employers to follow if they want to dismiss employees, thereby facilitating internal rather than external adjustment.

7.3.4. Social security regimes

This brief section deals with a comparison of social security regimes regimes related to labour markets in three countries. Social security issues are at the same time separated from and overlapping with labour market issues. As explained in section 7.3, the social security regime is strongly interrelated to the working of the labour market regime. Taken together, one can explore the social characteristics of labour market regimes much more comprehensively. Here I shall only examine the social security regime insofar as it is directly related to the labour market. Rather than going into the details of social protection schemes, I will characterise the differences only at the macro-institutional level. Following Boyer (1988) and Ferrera (1996), I compare extent (eligibility), level of benefits, financing and organisational arrangements of social security regimes.

There are four types of institutional frameworks underpinning welfare regimes in Europe.[27] The first is the Scandinavian model, where eligibility is fully universal, with high levels of benefits. General taxation plays a predominant role in financing. Central and local authorities are responsible for service provision. The only exception is unemployment insurance which is voluntary, managed by the trade unions with a heavy subsidy by the state. The second is the liberal model where full universality exists only in the health area. Other benefits related to social assistance are means-tested, and amounts are small. The system of financing is mixed: health is financed by tax but cash benefits are financed by social security contributions. Public administration takes charge of providing services. The social partners do not have any significant role in managing social security provision. The third is the Bismarckian model where the coverage is conditional on employment or family status. The principle of insurance underlies the level and structure of benefits, which are mostly earnings-related, and the method of financing. Different regulations apply to different occupational groups. The coverage is very extensive, but additionally there are social assistance benefits to fill remaining gaps. Generally, the benefits are more generous than in the liberal model. Financing is mostly through professional funds, i.e., through social security contributions by employers and employees. The social partners participate actively in governing the insurance schemes: Though marginal, they have some autonomy from public authorities, especially in the area of health insurance. The fourth is the Latin model where the institutional arrangements for social protection follow a mixed pattern. Latin countries have highly fragmented and somehow unbalanced systems of welfare : with a Bismarckian income maintenance system, very generous pension schemes, but no national minimum income, which implies a severe gap in coverage. Taxation pays for health care, and the rest is

[27]. Esping-Andersen (1990) has classified three rather than four welfare regimes, but he did not examine the countries belonging to the Mediterranean model.

financed by social security contributions. The social partners play a role in benefits related to income maintenance, but states increasingly control the health sector. (Ferrera p.4-6)

In accordance with the above classification, Britain belongs to the liberal model, whereas both France and Germany fit into the Bismarckian model. The generous benefits in France and Germany are maintained by large amounts of social security contributions, which accounts for the considerable gap or wedge between labour costs and take-home pay, i.e., the tax wedge. Both France and Germany exhibit high average and marginal tax wedges[28]. For example in 1993, for a single person earning the average gross wage of a male manual worker in industry, non-wage costs accounted for nearly 50% of total labour cost (gross wage) in France and Germany, in contrast to only about 30% in Britain.[29] Employers' social security contributions in France were almost 27% of their gross wage whereas they were 17% in Germany and 10% in Britain. In Britain, employers pay no contribution for employees on very low wages, i.e., below around 20% of average earnings. In Britain, however, many employers contribute to private pension schemes on behalf of their employees, which pushes up the de facto (inclusive of non-statutory contributions) rate of social contributions.

Social security contributions are merely a component of indirect labour costs, though by far the biggest one. Other components include contributions to vocational training and to private insurance schemes.[30] Results from a Labour Cost Survey in 1992 indicate that among the three countries France has by far the highest indirect labour costs, which accounted for 31.4% of total labour costs in 1992. Britain had the lowest with around 15.4%, and Germany was in the middle with 22.9%.[31]

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[28]. The average tax wedge stands for the sum of employees' and employers' social security contributions and personal income tax as a percentage of gross labour cost, i.e., gross wages plus employers' social security contributions. The marginal tax wedge is defined as percentages of any marginal increase in gross labour costs as a result of an increase in employees' and employers' social security contributions and personal income tax. (OECD 1997)

[29]. One should note, however, that the disposable income of employees with families increases drastically with tax incentives and family/child allowances in all European countries. This is particularly the case in France.

[30]. Bonuses and holiday pay are accounted for as direct costs.

[31]. All figures in this section are from Eurostat (1997a).

The duration of unemployment benefits is indefinite in all three countries.[32] However, there are significant differences in the conditionality and the level of benefits. Here again, there is a dichotomy between the continental countries and Britain. In all three countries, one has to work a certain amount of time before qualifying for unemployment benefits. The qualifying condition for maximum duration of benefits in France is 5 years of employment, and in Germany, 3 years. In Britain, however, it is not the duration of work but a certain level of insurance contribution which is needed to qualify for insurance benefits. Only about 11 weeks of work at the 1988 earnings of an average production worker were needed to qualify in 1989.[33] Such drastic differences in eligibility are reflected by the amount granted in unemployment benefits. In 1993, the initial replacement rate, i.e. the disposable income receivable in benefits and assistance when unemployed in relation to that when in work, for a 35 year-old single person who was on average earnings when in work with a ten-year employment record was 80% in France, 61% in Germany and 41% in Britain. After 2 years of unemployment, the replacement rate was still over 70% of disposable income in France, 57% in Germany, and 41% in Britain.[34] Unlike in France and Germany, unemployment benefits are calculated as a flat rate rather than a proportion of previous earnings in Britain. This method of calculation is rooted in the philosophy underlying the British labour market/welfare regime: in contrast to the continent, in Britain, benefits are fixed to meet the basic needs of the individual or of families rather than to replace previous earnings. The French and German social security regimes - including unemployment benefits - are occupationally oriented, whereas that of British is universally oriented.

The organisational management of unemployment benefits also exhibits differences between France, Britain and Germany. In France and Germany, benefits are financed through contributions by employers and employees. In France, an autonomous bipartite body (comprised of employers and trade unions) administers unemployment benefits. In Germany,

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[32]. In Britain, however, the maximum benefit duration for unemployment insurance is 52 weeks. Afterwards, it switches to a guaranteed minimum income scheme, depending on the level of household income of the unemployed.

[33]. Data are taken from OECD (1991), p.201

[34] All figures are from European Commission. (1995).

reflecting the federal structure, they are managed at the state (Land) and local offices of the Federal Employment Institute, an independent public agency. In Britain, in contrast to its continental counterparts, unemployment benefits are financed not through a separate unemployment insurance contribution, but through a general social security contribution by employers and employees, the National Insurance Fund. The Department of Health and Social Security is responsible for administering unemployment benefits within the social security system.

The social security regimes briefly presented in this section show clear differences between France, Germany and Britain. France and Germany share a similar macro-institutional framework for their welfare systems, a similar level and a similar institutional arrangement of unemployment benefits. Britain, on the other hand, has a different kind of welfare regime and consequently, the level and system of unemployment benefits differs considerably from the two Bismarckian countries.

7.4 Labour market regime differences and their implications

The differences between the labour market regimes of the three countries investigated are all encompassing - from the institutional framework to collective bargaining, from the regulatory framework to social security regimes: in all these areas, the three countries maintain distinct institutional differences. Multi-unionism, ineffectiveness of social partners to manage industrial relations and the strong state's presence - whether in day-to-day matters or in decision-making on the overall climate of industrial relations - are common features to both France and Britain. Through the Auroux law, the French government has tried to impose a structure of industrial relations similar to Germany through industrial democracy. As Lane (1989) puts it, the statutory framework does not always coincide with the industrial relations in practice (p.209), as it has to interact with the underlying institutional framework. Consequently, despite the drastic differences in the legal framework between Britain and France, the abilities of social partners to manage industrial relations in both countries are equally poor. In terms of the system of collective bargaining, there is a growing tendency towards decentralisation, though the background against which decentralisation takes place is different in the three countries. In France, it was to promote trade union power at the plant level: in Germany, it was to increase industrial democracy; but in Britain it was to diminish trade union power. Regarding the regulatory structure, one can again see a clear contrast between the continental economies which have rigid structures to ensure employees' rights enshrined in the constitution and Britain where there is no universal over-arching legal structure. This contrast is again reflected by the clear differences between the social regimes of France, Germany, and Britain. In both regulatory and social security regimes, France and Germany share a similar ideology and institutional framework. As a consequence, the rules and conditions - regulations on dismissal and rights to strike in the regulatory regime, the level of non-wage costs and unemployment benefits in the social security regime - are comparable in the two countries. Britain, on the other hand, has a distinctively different regime in both areas. Consequently, its rules and conditions are very different from its continental counterparts.

All three countries' distinct national institutional, legal and social characteristics are reflected in their respective labour market regimes, with the British institutional, legal and social regime fundamentally different from both the French and the German regimes. The diversity of European labour markets is greater than what could be expected from the differences in the structure of production, and it reflects the importance of socio-cultural and institutional differences.

Table 7.3 below summarises the labour market characteristics of the three countries.

Table 7.3. Labour Market Regime Characteristics

	Germany	Britain	France
Organised interests of unions and employers	Highly organised, disciplined and stable	Fragmented and volatile	Rivalry among members and volatile
Relations between unions and employers	Balanced	Unstable / employer-led	weakness on both sides / larger role for state
Collective bargaining			
Dominant level	Sector but flexibility at the workplace level	Company	Sector but increasingly decentralised
Coverage	Medium to high	low	Medium to high
Style	Integrative	Adversarial	Confrontational
Pattern	Stable	Unstable	Unstable
Coordination	Considerable	Absent	Ineffective
Conflict	low but highly organised	Medium to high and dispersed	High and spasmodic
Role of the state	facilitating	abstaining in day-to-day affairs but able to shape structure of industrial relations	interventionist
Regulation	High employment protection	Low employment protection	High employment protection
Collective civil rights of workers	guaranteed by law	Not guaranteed	Guaranteed by law
Social security coverage	High	Low	High
Welfare state	State is compensator of first resort	State encourages market-oriented workfare.	State is compensator of first resort

Regarding differences in the mode of industrial relations and collective bargaining among the three countries, German-style industrial relations should promote internal rather than external forms of adjustment, as social partners have more integrative and stable relations. In both Britain and France, industrial relations regimes tend to promote external forms of adjustment, since social partners do not have an effective institutionalised forum for cooperation. Coordination is either absent or ineffective due to the lack of institutions in Britain and the lack of cohesive representation among social partners in France. As for the regulatory framework and social policies, there is more similarity between France and Germany than with Britain. They both protect individual and collective labour rights. In

Britain, an universal legal framework does not exist regarding these matters, and industrial relations are regulated in the spirit of voluntarism. The degree of employment protection is high in the former two countries and low in Britain. Social security coverage in the three countries shows the same characteristics. These factors suggest that French and German regulatory and social regimes promote an internal mode of labour market adjustment, whereas the British regimes lend themselves to external adjustment. In sum, the dominant mode of labour market adjustment judged from the respective labour market institutions is as follows: Germany is internally-oriented, Britain is externally-oriented, and France seems to be both externally and internally-oriented.

7.5. Diverse character of labour market institutions and its implication for monetary union

The institutional differences of labour markets in the three countries have not yet been reduced by the pressure for globalisation. Rather, globalisation and the process of European integration in the 1990s seem to have reinforced the dichotomy between continental European countries and Britain. This is contrary to the expectation that the pressure on labour costs from globalisation would produce convergence. This external pressure has certainly facilitated the trend towards labour market flexibility. At the same time, however, it has reinforced the existing pattern of two distinctively different paths of labour market adjustments - one predominantly characterised by internally- and the other characterised predominantly by externally-oriented labour market flexibility. This distinguishes labour markets from other product markets: the labour market is a social institution, and thus its reaction to external pressure differs from one society to another. In practice, the differences are partly induced by the British reluctance to harmonise labour market practices within the EU. However, it is mostly due to the differences in historical traditions and social preferences, as mentioned above. Since all these countries are core EU countries with similar income levels, these differences signify compelling evidence for different national social preferences in the efficiency versus redistribution trade-off. (Bean et al. 1998) They solidify different preferences and behaviour regarding labour market adjustment. Monetary union requires more intensive and broader economic policy coordination among member states. However, it looks difficult for countries with such fundamental differences in economic and social organisation to agree on economic policies which would not contradict each other and which would bring about the system-wide cohesion of Europe as an economic unit. The next chapter deals in more detail with labour market behaviour in the three countries by examining LMF in detail.

Chapter 8

Labour Market Regimes in Europe 3: Operationalising the criteria of labour market flexibility

Having studied the concepts of the LMF and labour market institutions, this chapter presents an empirical comparison of labour market regimes in France, Germany and Britain. I shall mostly use data from the European Commission and the OECD, as their data classifications are internationally compatible.[1]

The objective of this chapter is two-fold: first, it is an attempt to show objectively how and in which areas French, German and British labour markets are flexible. Second, by doing so, one can classify labour market regimes as either externally or internally oriented. Following Jenkinson and Beckerman (1986), I define flexibility as how far and how fast wages, numerical and functional factors adjust to aid in equilibrating the labour market. (p.25) One has to distinguish the concept of flexibility from variability. Flexibility means more than the variability. Flexibility focuses on the degree of response to a given change, such as changes in output, or unemployment rates. I shall use regression analyses to examine the degree of flexibility in labour cost and numerical flexibility. Given the nature of functional flexibility, it is difficult to quantify. Therefore, it will be analysed with more qualitative means.

8.1. Labour cost flexibility

This is the only area of LMF, for which quantitative indicators can be used without reservation. Since I will focus on the flexibility of wages, I shall not use conventional wage equations, as some economists do.[2] Instead, I shall examine the simple relationship between output and real and nominal wages. Following the standard approach taken by Nickell (1979), Golden (1990), and Hashimoto and Raisian (1992), I shall use regression analysis to

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[1]. For detailed sources of data, see appendix.
[2]. For example, Alogoskoufis and Manning (1988), Layard, Nickell and Jackman (1995).

estimate the responsiveness of real and nominal wages to the changing level of output, to show how elastic wages are relative to output changes. The regressions take the following simple form:

$$\ln Z_{it} = c + \alpha T + \beta \ln Y_{it} + \epsilon_{it} \qquad (1)$$

where ln Z is the logarithm of a variable chosen, such as real and nominal wages. c is constant, T is the time trend, ln Y is the logarithm of real GDP. α and β denote the regression coefficients, and ϵ is an error term. The subscripts $_i$ and $_t$ denote, respectively, the country and year of the observations. Following the time serious technique, the first difference of the variables are taken as follows, and the estimations are made using the ordinary least square:

$$\Delta\ln Z_{it} = c + \alpha T + \beta \Delta\ln Y_{it} + \epsilon_{it} \qquad (2)$$

where Δ denotes the first-difference operator. The coefficient β shows the percentage change in the chosen variable as GDP changes 1 %. The bigger the absolute numbers of coefficients, the larger the impact of changes in output on the chosen variable. This means labour market performance is more responsive to changes in output and is thus more flexible. The sign of the coefficient is also very important: by estimating the coefficients, one can also study if output and the chosen variables relate procyclically or counter-cyclically. If the coefficients show positive values, the variables relate to output procyclically. If they are negative, they do so countercyclically.

In addition, aggregate real labour costs defined in section 8.1.1. are also estimated here with the following regression.

$$\Delta\ln W_{it} = c + \phi \ \Delta\ln \Pi_{it} + \epsilon_{it} \qquad (3)$$
$$\Delta\ln W_{it} = c + \Gamma \ \Delta\ln \Pi_{it} + \Psi \ \Delta\ln Y_{it} + \epsilon_{it} \qquad (4)$$

where W stands for nominal or real wages and Π is an index of productivity. ϕ, Γ and Ψ are coefficients, indicating the responsiveness of real wages to productivity and output respectively.

Table 8.1 and 8.2 show the result of the regression using equations (2) - (4). The definition and sources of the data used, as well as a simple statistical interpretation are compiled in the appendix at the end of this chapter.

Table 8.1. Responsiveness of Nominal Wages: 1962-96

	France		Germany		Britain	
Estimated Coefficients						
GDP $_t$					-1.631	
					(-3.14)	
GDP $_{t-1}$	0.436			0.651		
	(1.06)			(1.84)		
Productivity $_t$						-1.791
						(-2.92)
Productivity $_{t-1}$		0.593	1.186			
		(1.12)	(2.71)			
Constant	0.063	0.061	0.054	0.067	0.106	0.107
	(4.13)	(3.59)	(3.99)	(5.22)	(6.84)	(6.46)
Number of observations	34	34	33	33	35	35
R-squared	0.034	0.038	0.192	0.098	0.231	0.205
Standard error of regression	0.046	0.046	0.042	0.045	0.609	0.062

N.B. T ratios are in parentheses.
For data, see appendix.

The results in table 8.1 indicate that changes in German nominal wages are more responsive to changes in GDP and productivity than for the French equivalent. The British results are contrary to expectation, since both coefficients show negative signs. When GDP and productivity go up, wages should go up as well. Thus, the coefficients of both GDP and productivity should have positive signs, as the French and German cases exhibit. The French results, however, may be ruled out as insignificant, as their t ratios are too small.

Table 8.2. Responsiveness of real wages: 1962-96

	France			Germany			Britain		
Estimated Coefficients									
GDP $_t$	0.567 (4.21)			0.556 (4.89)			0.223 (1.57)		
GDP $_{t-1}$			0.427 (3.12)			0.411 (5.27)			0.189 (1.30)
Productivity $_t$		0.809 (4.92)	0.430 (2.26)		0.791 (5.69)	0.751 (7.26)		0.295 (1.81)	0.339 (1.97)
Productivity $_{t-1}$									
Constant	0.008 (1.55)	0.003 (0.55)	-0.001 (-0.18)	0.008 (2.07)	0.003 (0.81)	-0.007 (-1.99)	0.014 (3.52)	0.013 (3.08)	0.009 (1.39)
Number of observation	35	35	34	34	34	33	35	35	34
R-squared	0.351	0.424	0.509	0.427	0.503	0.735	0.069	0.09	0.127
Standard error of regression	0.015	0.015	0.013	0.014	0.013	0.009	0.166	0.016	0.016
F-statistic			16.044			41.543			2.25

N.B. T ratios are in parentheses.

The results shown in table 8.2 indicate that the responsiveness of real wages to changes in GDP is about the same in France and Germany, whereas it is much lower in Britain. The same argument applies for the responsiveness of real wages to productivity changes. If GDP and productivity are estimated together, however, the results for the two countries diverge. Whereas the responsiveness to GDP changes stays about the same in Germany and France, that to change in productivity differs: German responsiveness is much higher than its French equivalent. The British result, again, shows low sensitivity to both changes in GDP and productivity when they are regressed together. However the weaker t-ratios of British results suggest that these figures should be interpreted with caution, as they are not statistically significant enough. The F statistic in the British case indicates that the changes in GDP and productivity are not jointly significant.

The estimation result for aggregate wage flexibility in tables 8.1 and 8.2 show that German real and nominal wages are both very sensitive to changes in productivity. This result reflects that in Germany's institutional wage bargaining system, trade unions negotiating wage rises in line with productivity rises.[3] As far as real wage flexibility is concerned, the degree of flexibility in France and Germany is more or less the same for responsiveness to output changes. The British results are statistically significant for nominal

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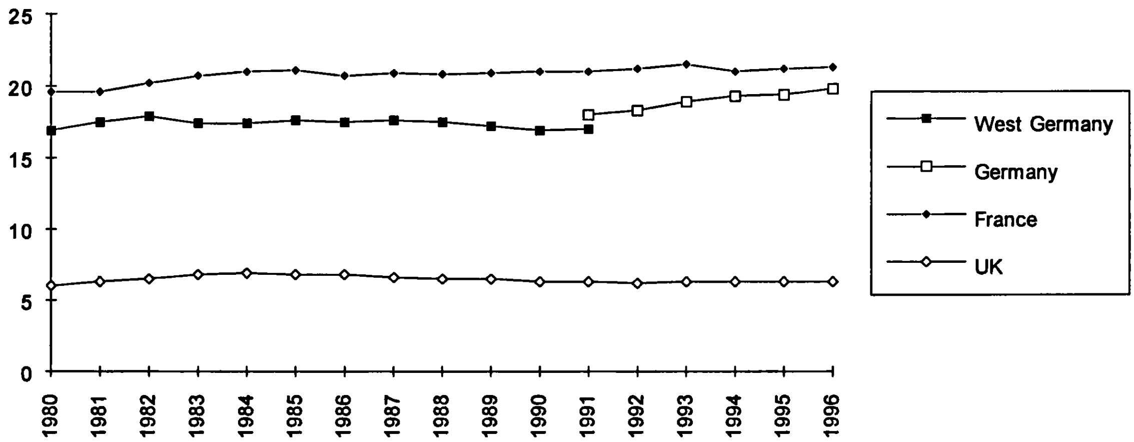
[3]. For example, see Deutscher Gewerkschaftsbund (DGB) (1996).

wages, but contrary to expectations. Those for real wages are not statistically significant, thus no decisive argument can be made. If one allows a certain level of statistical leeway, however, the regression analyses on aggregate wage flexibility indicate a higher aggregate real wage flexibility in Germany and France than in Britain.[4]

Chart 8.1: Social Security Contributions (as Percentages of GDP at Market Prices)



Source: Eurostat

Chart 8.1 shows that the proxy of non-wage labour costs, social security contributions, are much higher in France and Germany than in Britain.[5] One can observe a convergence between France and Germany in the 1990s. The low level of social security contribution implies that Britain is much more flexible than in Germany or in France in terms of non-wage costs.

In Germany, workers with lower incomes, i.e., with regular weekly working hours of less than 15 hours and earnings of no more than DM 590 for the old Länder of DM 500 for the new Länder are exempted from social security contributions. The government is aiming to reduce social security contributions paid equally by employee and employer, and to reduce

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[4] These results are supported by Coe (1985), though he uses wage equations in his estimation.

[5] Social security contributions represent around 90% of non-wage labour costs in France and Germany and around 80% in Britain in 1992. The statistics are taken from Eurostat (1997a).

taxes to enhance the competitiveness of the German economy. Labour cost reduction is one of the key economic and employment policies in France. However, it has so far only implemented a reduction in sickness insurance contributions for low-wage employees, payable by employers. In addition, the law of December 1993 introduced a progressive reduction until 1998 in the family allowance contributions payable by employers for wages between 1 and 1.6 times the SMIC (French national minimum wage). The law of June 1996 stipulates that state aid is given in the form of an exemption from social security contributions to companies which reduce their employees' working hours by at least 10% in exchange for an increase in employment by an equivalent proportion. In Britain, there have also been reductions in national insurance contributions for low earners. Thus, the gap between Britain and continental economies seems to persist.

As for relative labour cost flexibility, there are no internationally comparable data for the spectrum of productivity in industrial subsectors or regions. The OECD industrial structure statistics provides comparable statistics for an industrial breakdown of production, employment and wages and salaries. However, these statistics are only available from 1983 onwards, i.e., there are not enough observations for time series regressions. In addition, for Germany and Britain, the statistics for the service sector - the biggest contributor regarding production and employment - are missing for the whole period. Therefore, instead of a regression analysis, trends in earning dispersion are used to analyse relative wage flexibility. Relative labour cost flexibility regarding the skill level cannot be directly observed. Thus, as proxies, I shall examine occupational and educational wage differentials. Table 8.3. show the trends in earning dispersion since the 1980s. D1 and D9 refer to the upper earning limit of, respectively, the first and the ninth deciles of employees ranked in order of their earnings from lowest to highest. In other words, 10% of employees earn less than the D1 earning threshold and 90% earn less than the D9 earning threshold. Thus, D9/D1 can be used as an indicator for the dispersion of earnings.

Table 8.3.: Trends in earnings dispersion 1983-1995 Total, D9/D1			
	France	Germany	Britain
1983	3.14	2.69	2.96
1986	3.17	2.59	3.09
1989	3.28	2.46	3.27
1992	3.26	2.44	3.31
1993	3.26	2.31	3.32
1994	3.28	..	3.31
1995	..	..	3.38

Source: Author's calculation from OECD Employment outlook (1996) pp. 61-62.

Table 8.3. indicates that the earnings dispersion has been growing in both France and Britain, but diminishing in Germany. The Germans also have the lowest absolute level of dispersion among the three countries. This suggests that Germany is the least flexible among the three in terms of relative wage flexibility. The absolute level of dispersion between France and Britain has been similar. However, whereas the growth rate of dispersion for France was only about 4.5% in a decade, it was about 14% for Britain. In other words, since the 1980s, Britain has increasingly become flexible regarding relative wage flexibility, and in the 1990s, it has superseded France and become the most flexible country among the three.

Table 8.4. : Relative earnings of persons 25 to 64 years of age with income from employment by level of educational attainment and gender in 1994

Upper secondary education = 100

	Men				Women			
	Lower secondary education	Upper secondary education	Non-university tertiary education	university-level education	Lower secondary education	Upper secondary education	Non-university tertiary education	University-level education
France	85	100	134	187	75	100	131	165
Germany	97	100	116	167	81	100	111	162
Britain	79	100	119	164	66	100	150	204

Source: OECD Education at a Glance (1996), p.242

Table 8.4.1.: Earnings dispersion by skill levels
University-level education / lower secondary education in 1994

	Men	Women
France	2.20	2.20
Germany	1.72	2.00
Britain	2.08	3.09

Source: Calculated from table 8.4.

Tables 8.4 and 8.4.1 present earning differences by level of education, a proxy of skill levels. Again, Germany shows the lowest degree of dispersion among the three. For male relative wage flexibility, France is most flexible, whereas for female relative wage flexibility, Britain is by far the most flexible in 1994. Except for France, there is a wider dispersion for women than for men. This is probably because unskilled women earn much lower wages than unskilled men. Tables 8.3 to 8.4.1 consistently indicate that Germany is the least flexible country regarding relative wage flexibility, whereas Britain is the most flexible.

Finally, there are two labour market institutions to be taken into account - wage indexation[6] and minimum wage legislation. The former is no longer practised in the countries I study here. The latter exists legally in France and at a sectoral level in Germany, and will be re-introduced in the UK. The institutional setting of minimum wages varies: in France, a statutory minimum wage (SMIC) is set by the government. It is reviewed at least annually by the government in order to ensure an annual increase in purchasing power equivalent to at least half of the increase in hourly wage rates. In Germany, there is no statutory minimum wage. However, minimum standards are established by collective agreements which can be made binding through extension. Minimum wages vary by age and qualifications in both countries. Furthermore, in Germany, there are some differences across regions and industries. In Britain, the level of a statutory national minimum wage is under discussion by the government's Low Pay Commission: it is composed of representatives from employer bodies (particularly in industrial sectors where low pay is a problem), trade unions and independent bodies. The government will make the final decision on what the minimum wage will be. This institutional arrangement may resemble more the French than the German system, with national minima varying according to age and training. As for the level of minimum wages, a statutory minima in France was 50% of average earnings in 1993, an average minimum wage in Germany was 55% of average earnings in 1991. In Britain,

[6]. Wage indexation is a mechanism for periodic adjustments in the nominal value of wage contracts in line with movements in a specified price index. It is believed to have fuelled wage inflation in the 1970s.

minimum wages used to be set by Wages councils by industry before 1993[7]: they were 40% of average wages in 1993.[8] As mentioned in section 7.1.1, there is no conclusive evidence of the adverse effect of minimum wages on employment. Nevertheless, the low level of minimum wages relative to average earnings in Britain is another indicator that Britain is the most flexible country in terms of relative wage flexibility.

8.2 Numerical flexibility

Unlike labour cost flexibility, numerical flexibility cannot be analysed by statistical analysis alone. Therefore, I shall introduce a number of statistical indicators, which reveal some of the picture. In addition, institutional factors introduced in chapter 7 have to be taken into account to complement the statistical analysis.

A general indicator of internal numerical flexibility is to measure how working hours responded to changes in output. As in the previous section, I examine the degree of responsiveness by estimating the equation (2). Larger positive coefficients indicate higher pro-cyclical sensitivity of working hours to economic growth or decline, i.e., flexibility. A coefficient not significantly greater than zero indicates that changes in working hours are not sensitive to changes in output, implying the existence of rigidity in the response of working hours to output.

Table 8.5. Responsiveness of working hours: 1962-95

	France	Germany	Britain
Estimated coefficients			
GDP t	0.24	0.43	0.266
	(2.78)	(4.91)	(2.84)
Time trend	0.001	0.001	0.001
	(2.68)	(1.97)	-2.24
Constant	-0.022	-0.024	-0.014
	(-3.79)	(-4.45)	(-2.85)
Number of observation	33	34	33
R-squared	0.225	0.439	0.275
Standard Error of Regression	0.007	0.011	0.011

N.B. T ratios are in parentheses.

[7]. The 1993 Trade Union Reform and Employment Rights Act abolished all wages councils except in agriculture.
[8]. Figures are from EIRR 266, p. 16.

The results in table 8.5 show all coefficients are positive to a different degree. Germany has the highest flexibility of working hours in response to changes in output among the three, and France and Britain have about the same degree of flexibility, both significantly lower than in Germany.

The flexibility of working hours is conditioned by some legal and contractual limitations to working time. Table 8.6 summarises the different regulatory arrangement in the three countries.

Table 8.6.: Regulations on working time

	France	Germany	Britain
Statutory limit	Reduced to 39 to 35 hours normal working per week, sectoral variations exists. Absolute maximum of 48 hours per week. Statutory daily maximum are 10 hours.	48 hours per week, sectoral variations exists. Statutory daily maximum of 8 hours.	No general legislation.
Overtime	9 hours per week or 130 hours per year, or more if included in a collective agreement.	2 hours per day over a period of 6 months or 24 weeks, provided that the average working day does not exceed 8 hours.	By agreement between employers and employees and their representatives.
Annual paid Leave	5 weeks.	24 days in all Bundesländer, 5 - 6 weeks under collective agreements.	No legislation. Nearly 40% of full-time employees receive 20-25 days of annual leave.
Flexibility options	The 1993 five-year employment law encouraged annualised hours arrangement. By means of sectoral, company or enterprise-level collective agreement, employers may vary average daily and weekly working time over a specified reference period, around an agreed average, as long as statutory maxima are observed.	Greater flexibility in collective agreements, by averaging out over a longer period or on annual basis. For example, the 35 working hour metal sector agreement in 1995 included a flexibility clause allowing employees to work up to a maximum of 38.8 hours a week, and overtime payments for hours worked over and above 38.8 hours.	Many companies have introduced annual hour schemes.

Source: European Commission (1997) Employment Observatory: tableau de bord 1996,, EIRR 278, 280, 281 (1997).

The reduction of working time is encouraged in France and Germany in the spirit of work-sharing. In France, the Jospin government proposed that a statutory limit of 35 hours per week should be phased in by 2000 for private sector companies employing more than 20 people. (Financial Times 11/12/97) It was passed as the Loi Aubry in June 1998. Many companies in France reduced working hours and employed extra staff instead, taking advantage of financial incentives given by the government. In Germany the reduction of working time in order to expand employment is the main bargaining issue at sectoral as well as plant-level collective bargaining. In the West German metal industry, a 35-hour working week has been introduced since October 1995, and IG Metall is aiming for a further reduction of the working week (possibly towards 30 hours) in order to safeguard more jobs. Volkswagen and Bayer, for example, struck working time reduction agreements to save jobs in summer 1997. In both countries, early retirement is also promoted as a measure to reduce the working hours of older workers and to recruit young unemployed persons or trainees in their place. Britain alone has been refusing to approve the EU level Working Time Directive of November 1993 (Council Dir 93/104/EC), and challenged its legal basis. However, the European Court of Justice dismissed the British application in November 1996. Consequently, Britain must, like other EU members, act to comply with the directive and incorporate its provisions into national law. The directive sets out a maximum weekly working time of 48 hours including overtime, a minimum leave period of four weeks per year and other conditions for minimum rests and night shifts. Although the Directive only required cosmetic changes in France and Germany, it requires Britain to introduce a completely new statutory framework.

Table 8.7.1. Flexible working by country

	France	Germany	Britain
% allowing flexible working	46	83	44
of which % using:			
Job sharing	23	7	17
Flexitime	59	89	47
Short-term contract working	59	50	46
Part-time working	46	59	85
Seasonal working	41	14	37
Working from home	9	13	24

Source: 3i European Enterprise Centre (1997)

Corresponding to the legal provision in table 8.6, the average hours actually worked are the longest in Britain. It is estimated that 16% of the total workforce worked more than

48 hours a week, the maximum working week stipulated by the EU Working Time Directive. According to the enterprise survey results by 3i European Enterprise centre (1997), 47% of the British workforce work over 40 hours a week, whereas the corresponding figures are 10% in France and 14% in Germany. 44%, 83% and 68% of the workforce worked between 36 to 40 hours per week in Britain, France and Germany respectively.[9] German workers work the shortest hours per week among the three. On the other hand, table 8.7.1 reveals that Germany has the highest overall percentage of establishments practising flexible working. Tables 8.5 to 8.7 also indicate that despite the fact that the German workforce works fewer hours, it is the most responsive to changing levels of output. These findings imply that first, there are factors other than regulation, such as a lower level of wages[10] and a higher consumer debt ratio, which are the driving force behind the British workforce's longer hours working: second, it is difficult to rank internal numerical flexibility, as there are a number of different and conflicting indicators. One can probably argue as follows: as far as relative (de facto) adaptability is concerned, Germany is internally most flexible, but as far as absolute (potential) flexibility is concerned, Britain would score a higher ranking. Despite Germany's legal restriction, the results of table 8.5 indicate that Germany is the most internally numerically flexible country.

Data on atypical working included in table 8.7.2 - part-time, fixed-term and temporary contracts - are normally regarded as a benchmark for external numerical flexibility. Except for part-time permanent employees, whose rights of non-discrimination were agreed upon by the European-level agreement on part-time work in June 1997, atypical workers are considered as peripheral staff.

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[9]. Figures are from EIRR 281 (1997) and 3i European Enterprise Centre (1997). The result of the latter is based on a survey taken in November and December 1996.

[10]. The same argument was made by European Industrial Relations Observatory. 1. 1997, p.8.

Table 8.7.2. Atypical working (% total employed) in 1995

	France	Germany	Britain
Part-time employment	15.6	16.3	24.1
fixed-term employment	12.3	10.4	7.0

Source: Eurostat(1996) Labour Force Survey 1995

Tables 8.7.1 and 8.7.2 both show that Britain has the highest proportion of part-time employees, and France has the highest proportion of fixed-term employees. In both France and Germany, part-time employment is increasingly a means to reduce unemployment through work-sharing. The use of fixed-term employment in France and Germany is an important means to create a more flexible workforce. In France, fixed-term employment is particularly high partly because of the high proportion of seasonal workers in the agricultural sector. According to the survey by the European Foundation for the Improvement of Living and Working Conditions (1994), the main reasons for the use of fixed-term employment are 1) tasks only last for a fixed period, 2) fixed-term employees replace temporarily absent staff. By law, most employment rights of fixed-term employees are the same as that of permanent staff in France and Germany. There is no statutory right to equal rights with permanent staff in Britain, but employment protection laws even for full time employees are less strict than in France and Germany. Therefore, the use of fixed-term employees has more to do with the flexible handling of the workload than with the high labour costs. For employers, furthermore, it is a convenient way to control the (numerical) volume of the labour input, as in times of economic downturn, the contracts of fixed-term employees would simply not be renewed.

For more direct indicators of external numerical mobility, the regression result for the responsiveness of employment to changes in output can be used, from the regression analysis presented in equation (2). Again, a positive coefficient suggests that changes in the level of employment procyclically relate to changes in output: when output grows, employment grows, and vice versa. Larger coefficients means that employment changes are more sensitive to output fluctuation.

Table 8.8. Responsiveness of employment: 1962-96

	France	Germany	Britain
Estimated coefficients			
GDPt	0.379	0.471	0.44
	(6.87)	(6.29)	(3.86)
Time trend	0.001	0.001	
	(2.89)	(3.30)	
Constant	-0.015	-0.022	-0.008
	(-3.97)	(-4.64)	(-2.54)
Number of observation	35	34	35
R squared	0.638	0.57	0.311
Standard Error of Regression	0.004	0.009	0.013

N.B. T ratios are in parentheses.

Table 8.8 indicates that changes in the number of people employed in Germany are the most sensitive to changes in output. Thus, according to this result, Germany is the most externally numerically flexible country, followed by Britain and then France. This result is somehow unexpected, as the German labour market is believed to be one of the most rigid. However, this result confirms the findings of Hashimoto and Raisian (1992), who investigated the period between 1950-83.

In addition, statistics related to labour (occupational) mobility, such as job and labour turnover, and enterprise tenure indicate the degree of external numerical flexibility. Job turnover measures job flows by adding gross job gains and gross job losses. Labour turnover measures the flow of workers in and out of jobs (hires and separations - quits or layoffs). Enterprise tenure measures the length of service of employees. Yet, as Schettkat (1996) put it, the concepts and definitions of what is called labour market flow analysis are not yet standardised. Labour and job turnover are measured between two points of time. There is no consensus on how long the interval should be. This is a peculiar problem for flow analysis, as quarterly and annual data can present very different pictures.[11] This is because with a shorter period of interval, temporary arrangements are also counted. For this reason many experts prefer the measurement to be on an annual basis. There are no internationally standardised data: national data on job and labour turnover in various countries are not

[11] Davis and Haltiwanger (1992) found that the job turnover rate in the US manufacturing industries during 1979 and 1983 ranged from 13% to 20% per year if measured on an annual basis. Based on quarterly data, on the other hand, results showed annual job turnover rates of between 31% and 57%.

uniform and differ in terms of coverage, sources and reference periods. Though the OECD (1994,96a) attempted comparative studies, "accurate cross-country comparisons are hindered by often major differences in the type of data available." (OECD 1994, p.127) Thus, rather than using these controversial set of data, I shall use more straight-forward and less statistically biased data on enterprise tenure.

Table 8.9. Distribution of employment by enterprise tenure, 1995

	France	Germany	Britain
Current tenure (%)			
Under 6 months	10.1	7.9	10.5
6 months and under 1 year	4.9	8.2	9.1
1 and under 2 years	8.0	9.4	10.7
2 and under 5 years	17.7	22.0	19.5
under 5 years	40.6	47.5	49.8
5 and under 10 years	17.4	17.2	23.5
10 and under 20 years	23.3	18.4	17.3
20 years and over	18.7	17.0	9.4
Average tenure (years)			
Total	10.5	9.7	7.8
Men	11.0	10.6	8.9
Women	10.3	8.5	6.7
Median tenure (years)			
Total	7.7	10.7	5.0
Average tenure by selected industries (years)			
Manufacturing	12.1	10.8	9.0
Wholesale and retail trade	8.0	8.0	5.9
Hotels and restaurants	5.1	4.8	4.1
Transport, storage and communication	13.1	12.1	9.2
Financial intermediation	14.2	11.1	8.7
Real estate, renting and business activities	7.9	7.1	5.7

Source: OECD Employment Outlook 1997, p. 138-40.

Table 8.9 shows that Britain has the largest proportion of employees working short-tenure among the three countries. Germany shows the smallest proportion in this regard. The average tenure is longest in France and shortest in Britain. The median tenure in Germany is longer than in France, probably because many young people in France have shorter tenures. In 1995, the average tenure of the workforce aged between 15-24 years was 1.6 years, while it was 2.4 years and 2.2 years in France, Germany and Britain, respectively.[12] Again, Britain

[12]. Figures are from OECD Employment Outlook. 1997, p.139.

shows the shortest median tenure. In a selected industrial breakdown, France has the longest tenure in manufacturing and private service sectors, with Britain exhibiting the shortest tenure in all sectors, with Germany in the middle of the two extremes. The results indicate that France and Germany have lower short-term turnover (indicated by the proportion of workers with tenures less than one year) and higher long-term stability (indicated by average or median tenures), whereas Britain has higher short-term turnover and lower long-term stability in employment.

There are some institutional factors which pose constraints on labour mobility. They include the structure of the housing market, mutual recognition of professional qualifications, the non-portability of private pensions, and employment protection regulations (EPLs). In this thesis, I shall concentrate on EPLs as a primary factor to influence labour mobility. Albeit important, the housing market, recognition of qualifications, and pension portability are secondary factors affecting labour mobility. Therefore, I shall only briefly sketch the debate here. For Britain, research has shown that individuals who live in privately-rented housing tend to be more mobile geographically than owner-occupiers or those living in publicly-rented housing.[13]

Table 8.10 Breakdown of housing by tenure (%) in 1980s

	France	West Germany	Britain
Owner-occupied	51	37	67
Privately-rented	23	45	7
Municipal	)18	)18	23
Social	)	)	3

N.B.: "Municipal" refers to local government and state-owned housing. "Social" refers to housing association, co-operative and equivalent semi-public housing.

Source: Drake (1991)

As table 8.10 shows, the higher house ownership ratio and municipal housing (publicly-rented accommodation) in Britain relative to continental economies suggests that the potential barrier to mobility in Britain may be higher than on the continent. Professional

[13] For details, see Hughes and McCormick (1987).

qualifications are still a reflection of the idiosyncratic regimes of national educational and vocational training, and are not mutually recognised. This is a problem particularly for a skilled workforce and hampers their mobility outside the country where they acquired their qualifications. EU citizens are legally free to work anywhere within the EU, but the lack of mutual recognition of professional skill is, along with the language barrier, a predominant reason for the lack of intra-EU labour mobility.[14] Unlike public pension schemes, private pension schemes are generally not portable once employees are disassociated from the company - the pension fund provider. The level of retirement benefits is a function of years of service and average earnings. This may create a disincentive for changing the employer, particularly for older workers. Higher reliance on private pensions in Britain may also create a potential barrier to labour mobility. Unlike the traditional 'defined benefit scheme', the portability problem does not arise with 'defined contribution funds'. The main difference between defined benefit and defined contribution schemes is the distribution of risk between the member and the sponsor: in the former system, members trade wages for pensions at the long-term average rate of return in the capital market, while employers bear the investment risk, topping up benefits if the fund proves inadequate. In the latter system, all the risk of returns caused by the capital market fluctuation is borne by employees. In Britain, for example, those retired in 1974 often had pensions less than half of the value of those retiring in 1973, due to the bad performance of capital markets. (Davis p. 17) In Britain, the defined contribution system was only used by 14% of occupational pension funds members in 1991. Increasingly, however, many firms are switching or applying the defined contribution system to new employees. In Continental Europe, the pension fund investments are still in their infancy. The majority of private pension funds consist of defined benefit schemes, where portability is a problem. This is one reason why the Trade Union Congress is pushing the issue of portability of pensions at both domestic and European level.[15]

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[14] For a discussion of the reasons for low labour mobility in the EU, see European Economy (1995), table 29.
[15] Based on the interview with Dave Feickert, European Officer, at TUC office in Brussels on 19/06/97.

Employment protection laws (EPLs) directly influence firing and hiring behaviour of firms, by setting rules governing unfair dismissal, layoffs, severance payments, minimum notice periods, administrative authorisation for dismissals and prior discussion with labour representatives. The previous chapter explained regulatory arrangements related to dismissals. This section interprets the strictness of employment protection by ordinal scaling. Each indicator in each country is to be ranked in a scale from 0 to 3, where higher score (ranking) indicates stricter EPLs. Ordinary scaling gives numbers according to the order or preferences of a set of objectives, but not at regular intervals. Number 3 is higher in ranking than number 2 or 1. However, these numbers can indicate ranking only, and cannot tell how much or to what degree number 3 is stricter than lower numbers. For those indicators where rankings are already available from existing studies, a re-adjustment of scaling has been undertaken where necessary. The simple sum of the ranking numbers would show the relative degree of protection among the three - the larger the sum, the stricter the EPLs.

Table 8.11 introduces the ranking of EPLs from different sources. The ranking of the OECD (1994) comes from the evaluation of inconveniences in the administrative procedure for individual dismissal, notice periods, severance pay, and the degree of difficulty in dismissal concerning the definition of unfair dismissal, trial period, compensation and reinstatement. The International Organisation of Employers (IOE) classified regulatory constraints as insignificant (score 0), minor (for termination of regular contracts), insignificant or minor (for fixed-term contracts) (both score 1), serious (score 2) or fundamental (score 3). A ranking by Bertola (1990) is based upon his reading of various evidence provided by Emerson (1988), based on an EC Ad Hoc Survey undertaken in 1985. The update of this survey, the EC Ad Hoc Survey (1995), is based on questionnaires sent to employers regarding the obstacles to employing more people. (table 5, p.78). Taking the EU country which has the highest percentage of employers complaining about insufficient flexibility in hiring and shedding staff as score 3, the percentage results of replies of the employers in three countries are adjusted to the scaling below.

Table 8.11. Ranking of the strictness of EPLs

Source	OECD (1994)	IOE (1985)	Bertola (1990)	EC Ad Hoc survey (1995)	Total
France	2	2.5	2.4	2.4	9.3
Germany	2.3	2.5	1.8	2.3	8.9
Britain	0.3	0.5	1.2	1.5	3.5

The total index of strictness of EPLs is highest in France, followed by the slightly lower score for Germany, and then the much lower score for Britain. The ranking between France and Germany is very close by any scaling. OECD (1994) ranked German EPLs stricter than France's, because Germany scored much higher in difficulty of dismissal than France, by having a wider definition of unfair dismissal (as mentioned in Chapter 7), longer trial periods, higher levels of compensation, and the obligation of reinstatement. Bertola (1990), on the other hand, considers France to be stricter than Germany, because he takes account of enterprise tenures and the annual average of new recruits and separations. Job turnover in 1982 shown in Emerson (1988) indicates much lower turnover in France than in Germany. The very low ranking of the British EPLs corresponds to the institutional analysis in chapter 7.

Tables 8.9 and 8.11 both point to a shorter enterprise tenure and lax EPLs in Britain. They also show longer tenure and stricter EPLs in France and Germany. Therefore, these data indicate higher external numerical flexibility in Britain relative to France and Germany. Overall, tables 8.5 and 8.8 suggest significant adjustment of numerical labour input in Germany: it is most internally and externally numerically flexible regarding responsiveness of working hours and employment changes to output. However, by taking account of the results from tables 8.9 and 8.11, Germany looks, along with France, externally numerically inflexible. These results also indicate that Britain tends to belong to the opposite camp - externally very flexible, but internally not too flexible in practice. The data on France show that it is not internally flexible, but externally not flexible either, especially judged by the degrees of responsiveness to output and strictness of EPLs.

8.3. Functional flexibility

As Beatson (1995) put it, the operational definitions of functional flexibility are more difficult than the understanding of the concept itself. Basically one needs a database which covers a large number of firms' internal job classifications and the contents of employees' actual workload. One visible and conventional indicator for functional flexibility is the degree of job demarcations set in union legislation. Using this indicator, the French and in particular the British workforce are much less functionally flexible than German workers. (OECD 1986, Lorenz 1992). However, this is an area increasingly covered by work councils, through which plant-specific working conditions are decided. This means that it is almost impossible to give an objective yet clear picture of functional flexibility.

The other problem is the lack of international comparison. The OECD, however, is the leading research institute in this area. One of its studies (1989) finds that in France and Britain, people interviewed identify flexibility as "fixed-term contracts", "the ability to lay off workers" or "flexible working hours", while in Germany their concern for flexibility was more to do with multi-skills, qualifications and especially training. In other words, the French and the British identify flexibility with its external aspect, whereas the Germans identify it with its internal aspect. A less descriptive and more objective way is to give a snap-shot picture of the degree of functional flexibility through large scale interviews in all plants. Such a study would be extremely costly and time-consuming. Yet, even with such interviews, it is difficult to compare the status quo of functional flexibility in different countries analytically. For, it is difficult to distinguish between implicit and explicit forms of functional flexibility. In other words, countries with a tradition of rigid job demarcation register slight changes in job specification as flexibility, whereas those with traditionally higher functional flexibility may include a variety of functions in a single job specification. As long as there is no international standardisation of job functions and specifications, an international comparison cannot be done objectively. These complications explain the fact that there is no published comprehensive empirical study on the international comparison of functional flexibility.[16] For this reason, the existing analytical works comparing LMF among (mostly) OECD countries only deal with labour cost and numerical flexibility.[17]

It is mainly the sociological approach in the discipline of industrial relations, describing the different cultures and traditions of management-workforce relations, which touches the issue of functional flexibility.[18] This particular flexibility is deeply rooted in the historical, cultural and social traditions of industrial relations. Thus, as mentioned, unlike labour cost or numerical flexibility, it cannot be objectively compared in quantitative terms. Lane (1995, p.202) among others[19] argues that functional flexibility is affected by the system of vocational education and training. This is because training and development of the workforce for persistent restructuring and improvement of the workplace are important preconditions for functional flexibility.

Functional flexibility demands an environment with a higher share of skilled relative to unskilled workers. Thus, the examination of the skill-level of the workforce is one of the indicators for functional flexibility. I take educational attainment and training as the benchmark for skill level, for education and training help to increase the skill and qualifications of workers, which makes them more able to accomplish required tasks and to adapt to new job requirements.

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[16]. There are national surveys, such as the Workplace Industrial Relations Survey (WIRS) in Britain, the INSEE survey in France, and the IAB establishment panel in Germany, which deal with the issue at least partly. However, their survey formats are not compatible to conduct rigorous international comparison.

[17]For example, see a number of publications by the OECD, Klau and Mittelstädt (1986), Koshiro ed.(1992), Buechtemann ed. (1993) Blank ed. (1994), and Beatson (1995).

[18] In particular, see Maurice et. al. eds. (1986), Boyer ed. (1988), Lane (1989, 1995), Lorenz (1992), Streeck (1992), Bamber and Lansbury eds. (1993), Schmid ed. (1994), and Van Ruysseveldt, Huiskamp. et. al. eds. (1995).

[19].For example, see Marsden (1986), Maurice et al. (1986), OECD (1989, 1990), Eyraud et al. (1990), Lorenz (1992), Kühl et al. (1996).

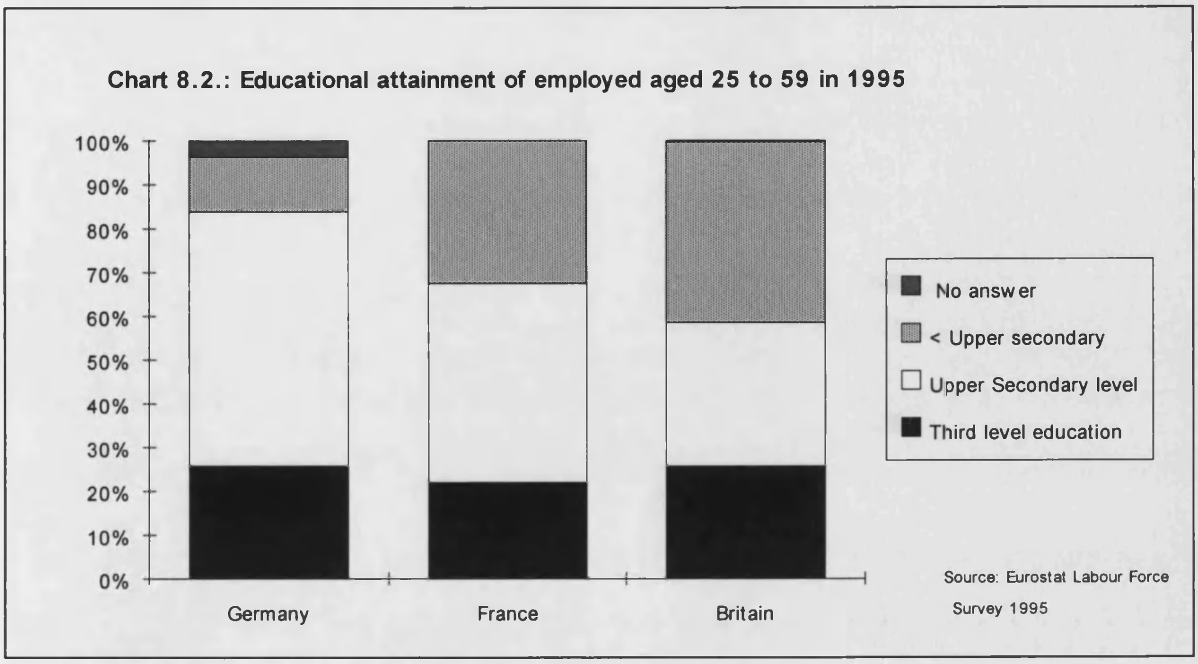

Table 8.12.1: Employment status by skill level of persons aged 25 to 59

In percentages, in 1995

	Germany	France	Britain
		Total	
Skilled employed	83.9	67.5	58.5
Unskilled unemployed	23.1	46.6	55.6
		Males	
Skilled employed	86.2	68.7	62.9
Unskilled unemployed	22.9	47.0	54.3
		Females	
Skilled employed	80.6	65.9	53.1
Unskilled unemployed	23.2	46.4	58.0

Source: calculated from Eurostat Labour Force Survey 1995 (table A1 in appendix)

Table 8.12.2.: Occupational qualification and nature of job in 1994 (%)

	Germany	France	Britain
Occupational qualification			
yes	89	75	53
no	10	24	43
no reply	0	1	4
Types of training			
in-house	46	32	23
external	43	43	33
Nature of present job			
skilled	75	77	57
unskilled	17	19	36
no reply	7	4	7

Source: European Economy (1995)

Chart 8.2 clearly presents Germany as having the highest proportion of employees with higher level of education, i.e., upper secondary and third level (education following after a complete course of secondary level education, i.e., tertiary education - colleges and universities), whereas the British workforce is the least educated with the French being in the middle. Table 8.12.1 interprets workers above the level of educational attainment of upper secondary level as skilled, and those who did not continue to or finish upper secondary level as unskilled. Germany has for both sexes the highest proportion of skilled employed and the lowest proportion of unskilled unemployed. Britain shows the opposite picture by having the lowest proportion of skilled employed and the highest proportion of unskilled unemployed. Table 8.12.2 is based on the results of an ad hoc labour market survey in 1994.[20] According to table 8.12.1, the German workforce is the most occupationally qualified and skilled, with the British workforce the least on both counts, and the French, again, in the middle of the two. However, more than their German equivalent, the French workforce perceives itself as skilled. This may be because the French job classification system is less standardised than the German or British systems.[21] As for the provider of training, it is predominantly in-house

[20] Data must, however, be interpreted with caution as they rely in part on self-evaluation. This is inevitable as the concept of vocational training differs from one country to another.

[21] Marsden (1990) argued that the French system has institutional support for internal labour markets, as opposed to occupational labour markets. In the former labour market, horizontal mobility is difficult, because skills are not properly standardised as in the latter labour market. However,

training in Germany, while external providers prevail in France and Britain. These results, evident from both tables, suggest that the German workforce are the most suited and the British the least suited to functional flexibility.

Besides education and in-house training, skill-levels can also be enhanced by publicly-organised training schemes in the form of active labour market policies (ALMPs). Although the effectiveness of large-scale public training programmes is widely contested[22], they are increasingly promoted in continental Europe as a means of coping with high and persistent unemployment. In contrast to passive labour market policy which merely provides social benefits, ALMPs directly provide measures aimed at reducing unemployment. Among measures such as youth employment programmes, direct job creation, and subsidised employment, labour market training is the prime programme with the largest proportion of ALMPs expenditure.

Table 8.13: Public expenditures on labour market programmes as a percent of GDP

	1985			1995		
	Germany	France	Britain	Germany	France	Britain
Public employment services and administration	0.21	0.13	0.14	0.23	0.15	0.20
Labour market training	0.20	0.25	0.09	0.38	0.38	0.10
Youth measures	0.05	0.17	0.25	0.06	0.25	0.12
Subsidised employment	0.17	0.06	0.22	0.41	0.42	0.02
Measures for disabled	0.19	0.05	0.03	0.26	0.09	0.03
Unemployment compensation	1.41	1.20	2.01	2.08	1.43	1.33
Early retirement for labour market reasons	0.01	1.21	0.05	0.06	0.36	--
Total	2.23	3.07	2.79	3.48	3.09	1.79
Active measures	0.81	0.67	0.72	1.34	1.30	0.46
Passive measures	1.41	2.41	2.06	2.15	1.79	1.33

Source: OECD Employment Outlook 1991, 1997.

Table 8.13 shows that Germany and France have a much higher proportion of spending on labour market programmes. In addition to the level of spending, there are a number of stark contrasts between the continental economies and Britain. First, whereas the

vertical mobility (e.g. moving from a semi-skilled to skilled worker) in the former labour market is easier than the latter.

[22] For example, see Schmid, G., B. Reissert, and G. Bruche (1992), Auer (1994), Field, Halligan and Owen (1994), and European Commission (1996a).

former share an increasing trend in the proportion of active relative to passive measures, the latter shows a decreasing trend in ALMPs. Passive measures include unemployment compensation and early retirement for labour market reasons, with the rest - public employment services and administration, labour market training, youth measures, subsidised employment and measures for the disabled being active measures. The low spending in Britain on ALMP may change in 1998-99 with the introduction of the welfare-to-work labour market programme by the New Labour government. However, given the programme is financed by one-off windfall taxes, it is yet to be seen whether such an increase will last or not. Second, the proportion of participants in subsidised employment, subsidies to employers who hire the long-term unemployed and those from other special groups, was higher in France and Germany, than in Britain in 1995. Third, no significant amount of spending for early retirement policies was recorded in Britain in 1995. It was still a minor component of ALMPs in 1985, but steadily declined towards the end of the 1980s and ceased to be recorded by 1990.

Table 8.14.: Participant inflows in ALMPs in 1995 as a percent of the labour force

	Germany	France	Britain
Public employment services and administration	--	--	--
Labour market training	2.0	3.5	1.0
Youth measures	0.7	2.8	1.0
Subsidised employment	1.4	4.4	0.1
Measures for disabled	0.3	0.4	0.2
Total	4.4	11.1	2.3

Source: OECD Employment Outlook 1997

Table 8.14 shows a high proportion of participants in labour market training compared to other measures of ALMPs for all three countries. France shows by far the highest inflows of participants in ALMPs. This result corresponds to the higher proportion of ALMPs in France relative to Germany (not to mention Britain), recorded in table 8.13.

The size of and expenditure on ALMPs differs, depending on historical and institutional factors. The systems of training are also diverse, reflecting long-standing traditions of idiosyncratic industrial relations. Lynch (1994) classified the respective training regimes as follows: Germany's system is based on apprenticeship training, France's on employer training taxes, and Britain's on government-led or school-based training schemes. Germany and France share the characteristic that their training systems are both work-place based, financed by social partners; in Britain, in turn, they are very much government-led programmes financed by tax payers. In Germany, the national strategy of training is designed by the tripartite co-determination among employers, unions and government. The actual training is largely run by companies. Local chambers of commerce (employers organisations) use moral persuasion to prevent excessive poaching of trainees. The local governments are responsible for vocational schools which closely cooperate with employers and unions. They also coordinate curricula among vocational schools, since trainees receive nationally recognised certificates of skills upon completion of training. Germany has a highly structured initial training system through apprenticeship, but further training of employees is company-based and less structured than this initial training system. In France, a company with more than 10 employees has been obliged to pay employer's training tax since 1971. If a firm cannot document training expenses above a certain threshold, (greater than 1.5% of its gross payroll in 1996) it must pay the difference in the form of the tax.[23] In France, social partners control the funds financed by taxes. The funds set up under the terms of collective agreements are jointly organised except for the metal, chemical and banking sectors, and reflect the government's overall employment policies. By submitting their on-the-job training plan, firms can apply for funds. Unlike Germany, France has a less developed structure of initial training, but the French state has developed a supporting structure for further training. Since the 1980s, the British government has replaced the declining apprenticeship-based initial training system with a government-led youth training scheme. It uses training as part of employment policies, by targetting special groups of people such as the young, long-term unemployed, or single parents. Unlike in Germany and

[23] Figures are based on Heidemann (1996).

France, training programmes are organised and financed by the state. The responsibility of training lies with the employer-led Training and Enterprise Councils (TECs) in England and Wales and Local Enterprise Companies (LECs) in Scotland. They are independent but accountable to the government. The funding for training is now based on the success rate of their trainees in achieving National Vocational Qualification (NVQ) awards. As tables 8.12.1 and 8.12.2 highlight, the general skill level of the British workforce is behind their Continental equivalent. The institutional framework of training in Britain needs to be overhauled if it is to be effective.

With the above classification of the LMF, macroeconomic indicators were used to study the degree of flexibility. They cannot, however, capture the flexibility at enterprise level. This is a serious flaw for assessing functional flexibility in particular, and the reliance on indirect data is only the second best solution. Building up a comparable cross-country microeconomic database is the urgent task of international organisations such as the OECD, EU and ILO.[24]

8.4. Evaluation

This section sums up what has already been examined in this chapter, in order to come to a conclusion on the implication these findings have for the *problematique* of regime compatibility. The tables 8.15.1 and 8.15.2 below summarise the ranking of different LMFs.

[24] The OECD has an ongoing project on "Technological and Organisational Changes and Labour Demand, Flexible Enterprise: Human Resource Implications." which is expected to be the first contribution of the large-scale comparative cross-country analysis of LMF using direct data from enterprise surveys.

Table 8.15.1.: Ranking of LMFs: breakdown

Type of flexibility		Tables/Charts	France	Germany	Britain
Wage/Cost	Aggregate flexibility	Table 8.1.	2	1	3
	(external)	Table 8.2.	1	2	3
		Chart 8.1.	3	2	1
	Relative flexibility	Table 8.3.	2	3	1
	(external)	Table 8.4.	2	3	1
	Total		10	11	9
Numerical	Internal flexibility	Table 8.5.	3	1	2
		Table 8.6.	--	--	--
		Table 8.7.1.	2	1	3
	Total		5	2	5
	External flexibility	Table 8.7.2.	3	2	1
		Table 8.8.	3	1	2
		Table 8.9	2	3	1
		Table 8.10.	--	--	--
		Table 8.11	3	2	1
	Total		11	8	5
Functional	Internal flexibility	Chart 8.2.	--	--	--
		Table 8.12.1.	2	1	3
		Table 8.12.2.	2	1	3
		Table 8.13.	2	1	3
		Table 8.14.	1	2	3
	Total		7	5	12

N.B.: -- means either irrelevant or redundant.

Table 8.15.2. : Ranking of LMFs: aggregation

Type of flexibility		France	Germany	Britain
External flexibility	wage/cost	10	11	9
	external numerical	11	8	5
Total		21	19	14
Internal flexibility	internal numerical	5	2	5
	functional	7	5	12
Total		12	7	17

Source: Table 8.15.1.

Figure 8.1. Degree of labour market flexibility

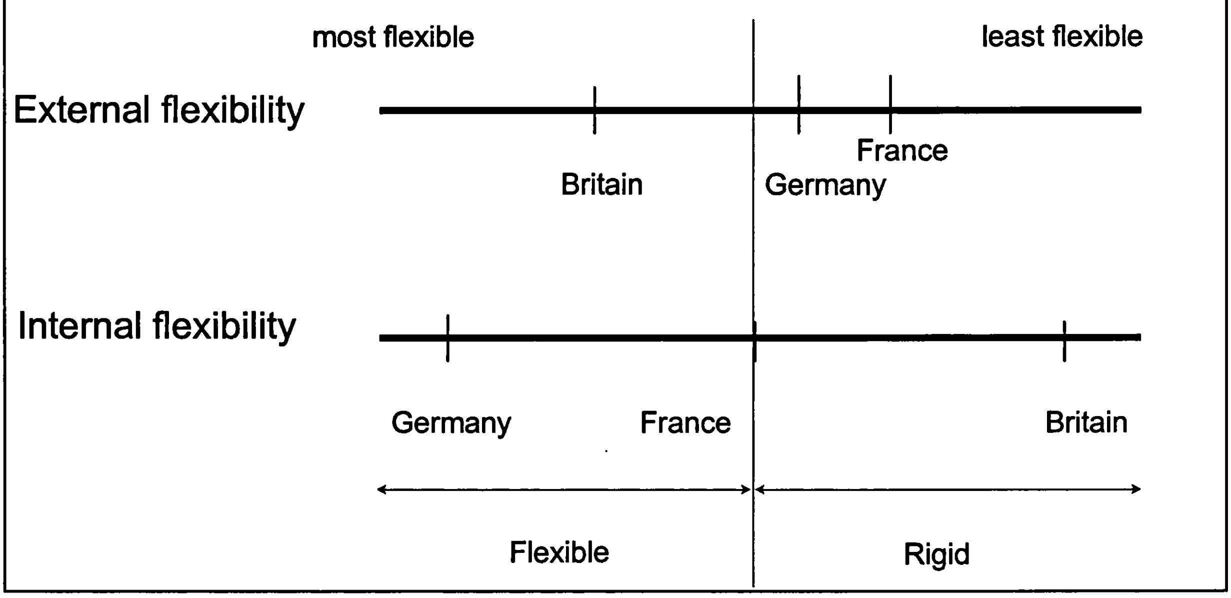

Table 8.15.2 is the simple sum of the rankings of the degree of LMFs in different kinds of flexibilities, shown in table 8.15.1. Table 8.15.1 is ordinal scaling, which has ranked flexibility of the three countries as the 1st, 2nd and 3rd in each table studied. The larger the number is, the more rigid is its labour market regarding a particular flexibility indicated. Due to the number of variables concerned, the largest total score for external flexibility is 27 and the smallest is 9. The largest total score for internal flexibility is 18 and the smallest is 6. Figure 8.1 graphically presented the degree of flexibility according to table 8.15.2. The numbers in table 8.15.2 were adjusted to percentages on a scale between the largest and smallest scores possible. For example, in case of external flexibility, number 27, the largest score possible was taken as 100% and number 9, the lowest score possible was taken as 0%. In case of internal flexibility, the number 18 is 100% and the number 6 is 0%. In figure 8.1. both horizontal lines present the degree of flexibility between 33% (as zero point) and 100%. For external flexibility, scores are 78%, 70% and 52% for France, Germany and Britain, respectively. Regarding internal flexibility, they are 66%, 39%, 94% in France, Germany and

Britain respectively. The dotted vertical line shows the half point which marks the dividing line between flexibility and rigidity. France is least flexible regarding external flexibility, and Britain is the most flexible country. The German high score is similar to that of France, which indicates the presence of external rigidity. Germany is, on the other hand, most flexible concerning internal flexibility, with Britain being the least flexible country. The breakdown in table 8.15.1 indicates that the degree of internal LMFs in France is neither flexible or rigid, being at the half point. However, being both externally inflexible, the French performance is closer to the German result rather than the British. Therefore, figure 8.1. exhibits that German and French labour market regimes are inclined to be externally inflexible. Taking into account the institutional efforts for internal adjustments in France, examined in Chapter 7, one can interpret the French labour markets as being similar to the German rather than the British regarding internal flexibility. The British labour market, on the other hand, tends to be externally flexible and internally inflexible. This confirms the results of the investigation of labour market institutions in Chapter 7. Therefore, Britain and its biggest Continental counterparts - France and Germany - may have fundamentally different labour market regimes with possibly contradictory strategies of labour market flexibility.

8.5. Implication for EMU

What are the implications of the findings in this chapter for monetary union? It is worthwhile to recall here Boyer's argument, introduced in Chapter 7, that different labour market regimes, one distinguished by external LMF and the other by internal LMF, would not co-exist well. According to this hypothesis, close economic coordination among the three countries would be difficult, as they have fundamentally different labour market regimes and social preferences.

EMU, under the Maastricht framework, imposes a single interest rate for all EMU member states. Regarding economic adjustment, it leaves room for manoeuvre for national fiscal and economic policies. However, as the case study of American monetary union showed, a single currency was difficult to manage with inconsistent economic management and ideologies. Though it may not require a "European economic government"[25], it would *de facto* require dense economic coordination among member states, if it to be run smoothly. Consequently, the hypothesised monetary union among France, Germany and Britain would have a difficult future. Persistent disagreements on economic policies and management could be expected given that they have incompatible labour market regimes. It is, indeed, in the labour market where most economic adjustments have to be taken under monetary union. Therefore, a certain degree of compatibility of labour market regimes would be crucial for the success and sustainability of monetary union. However, in case of monetary union among the three countries studied, this condition has yet to be fulfilled.

This and previous chapters have demonstrated the structural differences of the labour market regimes among the three countries. The objective was to show the presence of structural incompatibility of the labour market regimes which may hamper the long-term sustainability of EMU. However, this is not to argue that hypothesised monetary union among the three is bound to fail. With the presence of strong political commitment and leadership, it is possible to initiate changes in structure, as the EMS experience reviewed in chapter 1 illustrated. However, it is not the task of this thesis to examine this. Rather, the purpose of this chapter is to clearly point out where the problem lies in the management of

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[25]. Oskar Lafontaine, the Finance Minister of Germany from September 1998 and March 1999, argues for the formation of a European economic government for a greater degree of cooperation on taxes and spending. He also urges drawing the employers and the trade unions into the process of macro-economic policy coordination. For details, see Financial Times 26/10/98, p. 22.

such a monetary union: the problem is rooted in the regime differences and incompatibility of labour markets, which is considerable in the case of the three countries examined. The chapter was aimed at showing how big the structural problems that policy makers have to face in management of post-EMU are and to point out the huge task ahead for European policy makers.

Appendix

Sources of Data

Annual data of France, Germany and the UK:
N.B.: Due to data consistency over the time series since 1961, Germany covers West Germany only, even after the unification of Germany in October, 1990.

Employment: Occupied population: total economy in 1000, 1961-1996 from Eurostat. (Taken from European Commission Data base)

Output: Gross Domestic Product at 1990 market prices in billions of ECU, 1961-1996 from Eurostat. (Taken from European Commission Data base)

Productivity: Gross Domestic Product at 1990 market prices per person employed in 1000 ECU, 1961-1996 from Eurostat. (Taken from European Commission Data base)

Wages: Nominal Compensation per employee: total economy in 1000 ECU, 1961-1996 from Eurostat (Taken from European Commission Data base); Real Compensation per employee, deflator GDP: total economy (1991=100), 1961-1996 from Eurostat. (Taken from European Commission Data base)
N.B.: Compensation is a concept of wages defined as cost to the employer. In a breakdown, it includes earning (basic wages for normal time worked, premiums, bonuses, allowances, remuneration for time not worked, bonuses and gratuities, housing and rent allowances), plus severance and termination pay and employers' contribution to social security, pensions and related schemes. (Rassou 1994)

Non-wage cost: Social security contributions in billions of ECU, 1961-1996 from Eurostat. (Taken from European Commission Data base)

Working hours: ILO Yearbook of Labour Statistics, Table 4.A. Hour of work by economic activity per week by wage earner (manual or production workers), all sectors excluding major division 1 of the International Standard Industrial Classification (i.e. agriculture, hunting, forestry and fishing), 1961-1995.

N.B.: Statistics for Germany and the UK since 1986 cover hours paid for, whereas those for France and the UK during 1961-1985 cover hours actually worked, including overtime, but excluding hours paid for but not worked, such as paid annual leave, paid public holidays, paid sick leave.

The interpretation of statistical results:

The purpose of this section is to explain the practical interpretation of the statistical results. Consequently, any formula or mathematical calculation of a particular statistic is omitted, and only the essentials needed to interpret the statistical result are pointed out.

1. T ratio: the t value is used for determining whether a particular variable considered is statistically significant. The reference values for t statistics are available in a T-table, and a t value depends on the number of observations. For example, in case of 30 observations, the following critical t values correspond to certain statistical significance:

$|t| > 1.697$ = significant at the 10 per cent level.
$|t| > 2.045$ = significant at the 5 per cent level.
$|t| > 2.457$ = significant at the 1 per cent level.

The larger a t value is, the more statistically sound the coefficient of a particular estimation. (N.B.: The 1% level significance is superior to 5 or 10 % level significance, as a 1 % level significance is equivalent to a 99% probability of the statistics being sound, whereas 5% and 10% correspond to a 95% and 90% probability, respectively.)

2. F test: When we are dealing with the significance of a number of independent variables as a set, we use the F value instead of the t value in order to test the joint significance. If the F value exceeds a chosen critical value, the independent variables as a set can be interpreted to influence the dependent variable. The critical F value varies depending on the number of independent variables and observations, and can be found in an F-table. For example, a critical value of F-statistic, (2,31) F is:

$F > 3.44$ = significant at the 25 per cent level.
$F > 9.46$ = significant at the 10 per cent level.
$F > 19.5$ = significant at the 5 per cent level.
$F > 99.5$ = significant at the 1 per cent level.

3. R squared and standard error of regression: both indicate the statistical soundness of the regression. The R squared shows to what degree the move of independent variables explain the move of the dependent variable, i.e., the proportion of the variation in the dependent variables explained by variation in the independent variables. The standard error of regression indicates the degree of statistical soundness of the regressions as a whole. The closer R squared is to 1, and the smaller the standard error, the better the statistical results. In a time series analysis with a small number of independent variables, however, the low value of R squared is not an obstacle to interpreting the statistical result as sound.

Table A1 . : Employment status by educational attainment level of persons aged 25 to 59 years (in percentages)

		Germany		France		Britain	
		1993	1995	1993	1995	1993	1995
		Male and Female					
Employed	Third level education	23.9	25.8	19.1	22.1	24.1	25.7
	Upper Secondary level	54.9	58.1	44.5	45.4	30.5	32.8
	<upper secondary	13.3	12.5	36.3	32.6	43.2	41.3
	No answer	7.9	3.7	0	0	2.2	0.2
Unemployed	Third level education	13.5	14.9	11.2	13.5	11.3	12.7
	Upper Secondary level	55.6	56.8	38.1	39.9	29.5	31.5
	<upper secondary	22.9	23.1	50.6	46.6	56.5	55.6
	No answer	8	5.2	NA	NA	2.7	0.3
Inactive	Third level education	9	9.9	8.1	10.6	9.8	10.6
	Upper Secondary level	53.1	55.5	30	31.8	21.2	23.6
	<upper secondary	29.5	28.8	61.9	57.5	67.4	65.7
	No answer	8.3	5.8	0	0.1	1.6	0.1
Total	Third level education	20.2	21.8	16.5	19.3	20.6	22.1
	Upper Secondary level	54.5	57.5	41.4	42.5	28.7	31
	<upper secondary	17.3	16.5	42.1	38.1	48.6	46.7
	No answer	8	4.2	0	0	2.1	0.2
		Males					
Employed	Third level education	27.4	29.4	17.8	20.3	25	26.5
	Upper Secondary level	54.2	56.8	47	48.4	35	36.4
	<upper secondary	10.6	10.2	35.1	31.4	37.9	36.9
	No answer	7.8	3.6	NA	NA	2	0.2
Unemployed	Third level education	15.4	17.6	11.9	14.1	10.9	12.3
	Upper Secondary level	51.3	53.7	37.9	39	31.7	33.1
	<upper secondary	23.1	22.9	50.1	47	55	54.3
	No answer	10.2	5.8	NA	NA	2.4	0.4
Inactive	Third level education	13.7	14	8.1	10	11.7	11.8
	Upper Secondary level	60.2	62.2	32.2	34.2	27.1	29.3
	<upper secondary	17.6	17.7	59.5	55.6	59.4	58.8
	No answer	8.6	6.1	NA	NA	1.9	NA
Total	Third level education	25.4	27.1	16.5	18.9	22.5	24
	Upper Secondary level	54.6	57.1	45.1	46.4	34	35.5
	<upper secondary	12	11.7	38.3	34.7	41.4	40.3
	No answer	8	4	0	0	2.1	0.2
		Females					
Employed	Third level education	18.9	20.7	20.9	24.3	23	24.7
	Upper Secondary level	55.8	59.9	41.3	41.6	25.1	28.4
	<upper secondary	17.2	15.7	37.8	34.1	49.6	46.8
	No answer	8.1	3.7	NA	NA	2.3	0.1
Unemployed	Third level education	11.8	12.5	10.6	12.9	12.2	13.4
	Upper Secondary	59.4	59.6	38.3	40.7	25	28.4
level							
	<upper secondary	22.8	23.2	51.1	46.4	59.4	58
	No answer	5.9	4.7	NA	NA	3.4	NA
Inactive	Third level education	7.6	8.5	8.1	10.8	9.2	10.2
	Upper Secondary	50.9	53.3	29.3	31	19.4	21.7
level							
	<upper secondary	33.2	32.5	62.5	58.1	69.9	68
	No answer	8.3	5.7	NA	NA	1.5	0.1
Total	Third level education	14.8	16.4	16.5	19.7	18.6	20.2
	Upper Secondary	54.5	57.9	37.7	38.7	23.5	26.5
level							
	<upper secondary	22.7	21.3	45.8	41.5	55.8	53.2
	No answer	8	4.4	0	0	2.1	0.1

Source: Eurostat Labour Force Survey 1993, 1995

Conclusion

The purpose of this thesis has been to criticise the current Maastricht framework for EMU and provide an alternative framework with a structural perspective. Namely, the Maastricht convergence criteria have been criticised for focussing too narrowly on some demand side variables, and for ignoring real and structural factors which will be crucial for the regime shift and the new regime building necessary under monetary union. My contribution here has been to provide a broader structural framework, the French regulation theory, in order to assess the sustainability of EMU. I focussed on labour market regimes, as they are pivotal for the proper functioning and socio-economic sustainability of EMU. Labour market regimes are crucial, since labour markets are bound to become the dominant adjustment mechanism in the Euro zone. In addition, as the EMS experience has suggested, idiosyncratic labour market structures, unlike monetary structures, can work as a real constraint on the policy makers' intentions to the undertake domestic structural reforms required by international monetary cooperation.

Conventional wisdom often argues that Britain is not an ideal country to join EMU since its business cycle is different. Arguing from a structural point of view, I conclude that in the presence of structural incompatibility in labour markets, EMU membership could pose problems for Britain in the long run: its social preferences and modes of labour market adjustment are not compatible with the core continental economies. This is not to say that EMU, if it comprised all three countries investigated here would be destined to fail. Rather, one purpose of my thesis is to provide policy makers with concrete information about the task lying ahead of them. In this respect my thesis points out that labour market structures matter as an area policy makers have to concern themselves with, given the risk that current labour market incompatibilities pose for the long-run sustainability of EMU.

By questioning the current quantifiable Maastricht targets, this thesis has sought to map out a more comprehensive way to prepare the ground for a viable monetary union. Some may criticise my thesis as too speculative, because EMU is in its nascence and it is therefore too early for a critique focussing on the long-term sustainability of this specific project. Aside from a critique of the Maastricht criteria, however, this thesis presents an alternative framework to assess the viability of monetary union in general, which has enduring relevance as a scholarly contribution to the *problematique* of monetary union.

A theory developed by international political economy, the theory of hegemonic stability (HST) argues that for an economic system to work smoothly, there has to be a leader and a clear hierarchy in power distribution among the participants. As there is no clear single leadership pushing for the EMU project, and the distribution of power among the three biggest member states of the EU is oligopolistic, the HST situation does not hold for the case of EMU. Despite the relative preponderance of the German economy, Germany is not in a position to force other member states into structural adjustment towards the German model.

Searching for an alternative framework, the obvious candidate was the theory of OCA. The theory of OCA surveyed in Chapter 2 suggests that monetary union composed of a relatively homogenous group of member states is ideal. In order to complement and expand the insights provided by this economic theory with a political economic perspective, the broader concept of regime compatibility was introduced, using the French regulationists' approach. The term 'regime' in the regulationists' connotation refers to the mode of socio-economic interaction between capital and labour. By examining the differences in 'mode of regulation', i.e. the way in which markets, institutions and social actors interact, it was possible to contrast the structural differences among regimes. It was argued that regimes which are built upon fundamentally different social preferences are not structurally compatible. Monetary union comprising different regimes lacks coherence and therefore might be difficult to sustain.

With this hypothesis in mind, Chapters 4 and 5 have examined historical cases of monetary unions, with the conclusion that heterogeneity contributed to the collapse of historical monetary unions. In addition to the institutional problem of bimetallism and the lack of control over money supply, the LMU was less sustainable than the SMU due to the heterogeneity of its membership. As soon as France lost its hegemonic influence, the diversity of economic structures translated into the irresponsible management of money, conflicts over policies, and the eventual breakdown of the LMU.

In addition to the differences in political economic orientation and economic structure, there was a stark difference in economic, and in particular, labour systems between the North and the South of the United States before the Civil War. Despite the fact that there was already a political union in America, the frontier of the nation was persistently changing. Furthermore, 'nationalism' as a centripetal force to keep the nation together was underdeveloped. Hence the intensification of sectional conflicts and differing needs for financial arrangements, rooted in economic structural differences, contributed to the repeated breakdown of the federal system of banking and led ultimately to the conflict of the Civil War. These historical experiences have shown us that monetary unions consisting of members with divergent social and economic interests and structures did not last, and hence were not viable.

As the American case has demonstrated, differences in labour market regimes are the key to understanding the structural differences in the current EMU project. The labour market will be the very area where conflict is most likely to arise, as it will have to bear the major adjustment burden after the loss of the exchange rate instrument. Chapters 6 and 7 showed that France, Germany and Britain have very different labour market conditions, policies and institutions. If countries with different wage formation characteristics have to face common demand or supply shocks, they will show differing wage and price developments. Monetary union, however, requires convergence of prices and allows only one interest rate for the heterogeneous Euro zone. As a consequence of heterogenous structures, divergence in unemployment levels will be unavoidable, which may be exacerbated by the relative immobility of labour in Europe. (Heylen, Van Poeck and Van Gompel P. 98) In this sense, the other side of the coin of the nominal convergence achieved by the Maastricht criteria may well be real divergence. With the restrictions imposed by the stability pact, and without effective federal fiscal transfers, such real divergences could persist and become politically unsustainable. The single currency may become a symbol of economic destitution for countries in economic difficulties. Discontent in some countries may force them to secede from EMU, as the South did from the Union in the American case[1]. On the other hand, should the European Central Bank decide to bail out these countries, the moral hazard problem would arise. In either case, the future management of monetary union, consisting of member states with divergent socio-economic interests, faces difficulties that might lead to the breakdown of EMU, even with a strong commitment by policy makers to the project.

A successful monetary union, therefore requires a certain degree of agreement on real / structural factors.[2] However, as Freeman (1988) put it, there is no guarantee that labour market institutions that are successful in one country can be transferred to another and operate there to produce the same outcome. Rather, taking the regulationist approach, such a transfer of one institutional setting developed in one society to another almost always brings about totally

[1]Feldstein (1997) also drew this parallel.

[2] Although I raise the general point of the importance of studying structural aspects, this thesis has focussed solely on labour market regime compatibility. Given the central role of national labour markets for adjustment in a monetary union, structural differences in labour market regimes may be the cause for severe friction among the EMU participants. However, a similar study regarding the financial and credit market regime or industrial organisations may also provide some interesting implications for EMU.

different outcomes and often ends in miserable failure. Therefore, rather than structural convergence, I have examined structural compatibility by studying the nature of labour market flexibility in France, Germany and Britain in Chapter 8.

Neo-liberal practitioners have propagated labour market flexibility as the panacea for almost all economic problems that industrialised countries currently face - from economic stagnation and high unemployment to EMU. However, the concept of labour market flexibility is too easily used by politicians, without any clear indication of the kind of flexibility to be pursued. An examination of different kinds of flexibility has led to the conclusion that, generally speaking, the German labour market behaves flexibly internally, with the British being externally flexible, and the French being externally inflexible and internally neither flexible nor inflexible. Taking account of the institutional factors investigated in Chapter 7, France has been nevertheless classified as being in the same camp as Germany, i.e., the internal flexibility camp. Following Robert Boyer's argument, I have argued that there is a fundamental incompatibility in national ideologies, concepts and practices in labour market policies in Europe: the concept and practice of internal labour market flexibility are hard to reconcile with those of external labour market flexibility. In other words, the British and continental labour market regimes are not structurally compatible. Without substantial progress towards a common labour market regime for Europe, such differences in labour market policies could lead to fundamental conflict between the dominant externally flexible Anglo-Saxon model and the dominant internally flexible continental model. Such a conflict would, no doubt, arise over the management of Euro-wide economic policies, which may disrupt the successful management of the Euro.

This, of course, is contingent on political developments themselves. If the European leaders are very strongly committed to the further development of European integration, the structural differences may be diminished, and the relevant conditions for sustainable monetary union would eventually be achieved. Yet, in the same way as structural compatibility alone does not necessarily lead to monetary union, commitments by policy makers alone cannot guarantee its success. The objective of this thesis, therefore, is to articulate the structural constraints which political agents face in the challenge to create a sustainable EMU.

The effective centralisation of money only came about in America after the ultimate confrontation of two different economic systems - emerging capitalism in the North and defensive proto-capitalism in the South. Only after the establishment of a decisive hegemony by the former regime, could America achieve social and economic cohesion as a nation and a relatively stable and long-lasting monetary union that established the dollar as a full national currency.

European Monetary Union will create a single currency with countries of diverse labour market regimes. The conflict in Europe may be characterised as a contest of two different types of capitalism - i.e., Anglo-Saxon free market vs. continental compromise capitalism. As in the case of America, it may be difficult to create a viable monetary union without having socio-economic cohesion and a common orientation of economic and social policy. In the case of Europe, the need to achieve structural compatibility could be even more acute as the EU attempts monetary union without fully-fledged political union. Indeed, EMU may in future be regarded as a catalyst for a regime shift: EMU may either open up Pandora's box, or promote structural compatibility or convergence of socio-economic regimes and even a full political union in the future - but these prospects are for future scholars to explore.

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