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**Research Report**

## German labour costs: A source of instability in the euro area. Analysis of Eurostat Data for 2010

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## German labour costs: A source of instability in the euro area Analysis of Eurostat data for 2010

Torsten Niechoj, Ulrike Stein, Sabine Stephan and Rudolf Zwiener

Since the start of the monetary union, labour costs in the private sector have risen considerably more slowly in Germany than in the rest of the EMU countries. Most recently, in 2010, they increased by as little as 0.6 %. In the rest of the euro area they went up by 1.6 %.

As a major cost factor labour costs influence prices and the competitiveness of an economy and consequently its export performance. As an income variable they affect consumer demand and consequently imports. Thus, e.g. in Germany, below-average labour cost increases dampen domestic inflation, domestic demand and imports, while at the same time stimulating exports via an improved competitiveness. Both effects result in current account surpluses. Conversely, relatively high labour cost increases lead to strong domestic demand, but also to current account deficits. To achieve external stability labour costs should follow an equilibrium path.

Germany's gain of price competitiveness accumulated vis-à-vis the other member states of the euro area over years has contributed to massive bilateral current account imbalances. As Europe's largest economy Germany has a particular responsibility. The German example shows that not only above-average labour cost increases threaten the stability of the common currency area, but below-average increases also do.

It has been six years now that the IMK has regularly compared the trend of labour costs per hour worked in Germany to those in major European countries. In addition to productivity and exchange rate trends labour costs are key indicators for the assessment of a country's price competitiveness. As in previous years the data which this analysis is based on have been taken from Eurostat's data base. This data set consists of comparable official statistics compiled by the statistical offices of the EU member states in line with common standards. An overview of basic definitions as well as the classifications and extrapolation methods is provided in the methodological appendix ("Methodischer Anhang" – in German) of Niechoj et al. (2011). The following sections begin with an analysis of labour

costs in the private sector, in the private service sector and in manufacturing. For these sectors data for all 27 EU member states are available. Thus, the EU aggregate includes 27 countries and the euro area aggregate includes 16 countries. In addition to labour costs in the private sector this report also addresses labour costs in the public service sector for the first time. However, the respective data base is still very sketchy.

### **Private sector: German labour costs increase only slightly**

In what follows labour costs per hour worked in the private sector (industry and private services) are described for 2010. As in the previous year, Germany,

reporting labour costs of € 29.10 per hour, ranks 7<sup>th</sup> in the list of countries analysed (Figure 1a)<sup>1</sup>. Germany continues to be in the group of high-wage countries exhibiting hourly labour costs above the current euro area average of € 27.0 per hour. However, within this group of countries there is a considerable discrepancy between the country with the highest labour costs and the country with the lowest labour costs. For instance, at € 38.2 per hour private sector labour costs in Belgium exceed the respective level in Ireland and Austria (€ 27.9 per hour each) by more than € 10. As already in previous years, Germany can be found at the lower end of the group of high-wage countries with Finland, Austria and Ireland.

A look at the growth rates of labour costs in 2010 reveals that the dispersion is increasing within the group of high-wage countries: Whereas the countries exhibiting the highest labour costs, i.e. Belgium, Denmark, Sweden, France, Luxembourg and the Netherlands, recorded increases between 2 % and 3 ½ %, the gain was merely ½ % to 1 % in Finland, Germany and Austria. In Ireland labour costs even decreased slightly (-0.5 %). At 0.6 % labour cost growth was very subdued in Germany. This is confirmed by a comparison with the euro area or the EU average, which amounted to 1.6 % and 1.7 %, respectively. Even in Portugal and Spain, which were hit particularly hard by the crisis, labour costs rose faster than in Germany, expanding by 1.4 % and 0.7 %, respectively. With the exceptions of Ireland and Greece, which reported a decline of labour costs in 2010, Germany and Finland showed the lowest increase of private sector labour costs in the euro area.

Thus, the trend of past years, when German labour costs expanded far more slowly than the European average, continues. During the past 10 years labour costs in this country have risen by an average of only 1.7 % per year. This long-term average growth rate is thus more than one percentage point below the annual growth rate in the euro area and 1 ½ percentage points below that in the EU27 (Figure 1b). If the euro area or the European Union excluding Germany is chosen as a benchmark the discrepancy turns out even larger. Unlike in Germany labour costs have risen sharply in the catching-up economies, particularly in Central and Eastern Europe, in recent years. As a result the

distinction between high-wage countries, southern European countries and Eastern European low-wage countries is becoming increasingly blurred. Within the group of high-wage countries Finland, Austria, Germany and Ireland have meanwhile moved to the bottom, whereas Italy, formerly among the group of southern European countries, has converged towards the group of high-wage countries. As a result of the catching-up process of the new EU member states the level of labour costs in Slovenia and in the Czech Republic is approaching that of the Southern European countries (cf. Figure 1a).

### **Labour costs in the private service sector: Germany ranking only in the middle of European countries**

The divergence of labour costs within the group of high-wage countries is particularly obvious in the private service sector. In 2010 the countries with the highest labour costs per hour, i.e. Denmark, Belgium, Sweden, Luxembourg and France, deviated further from the rest of the high-wage countries. Thus, at € 38.7 per hour labour costs in Denmark's private service sector exceeded the level of the respective labour costs in Austria (€ 26.5 per hour) by more than € 12. Within the bottom half of the group of high-wage countries labour costs have converged strongly – with the exception of those in Finland. Germany, Italy, Ireland and Austria reported average hourly labour costs of about € 26.5 in 2010, which is equivalent to the euro area average (Figure 2a). The fact that meanwhile German labour costs in the private service sector are ranking only in the middle of those in European countries can be explained by increases far below the average in recent years. During the past 10 years labour costs in Germany rose by an average of 1.7 % per year, whereas they went up by 2.8 % in the euro area and by 3.3 % in the EU27 (Figure 2b). In 2010 the increase of German labour costs amounted to 1.1 %, ranging well below the already limited long-term average.

In 2010 hourly labour costs increased most sharply in the top high-wage countries: Denmark, Belgium, Sweden<sup>2</sup>, Luxembourg, France and the Netherlands experienced growth rates of 2 ½ % to 3 ½ %, whereas the increase in the other high-wage countries,

<sup>1</sup> In the case of Italy hourly labour costs in 2009 (€ 26.5 per hour) were calculated on the basis of the labour cost survey of 2004 in the previous report, because the data of the labour cost survey of 2008 were still confidential at the time. Based on the labour cost survey of 2008, which could be used this time, a significantly lower figure results for 2009 (€ 25.7 per hour). This explains why Italy's labour costs in 2010 (€ 26.2 per hour) remain below the figure provided in the previous publication despite an increase of 2 %.

<sup>2</sup> In 2009 and 2010 figures for Sweden were strongly influenced by exchange rate fluctuations. In local currency labour costs rose by 3.4 % in 2009 and by 2.1 % in 2010. In euro terms labour costs declined by 6.4 % in 2009 due to a 10 % depreciation of the Swedish krona, whereas they increased by almost 14 % in 2010 as a consequence of a 10 % appreciation (Figure 5).

Figure 1a

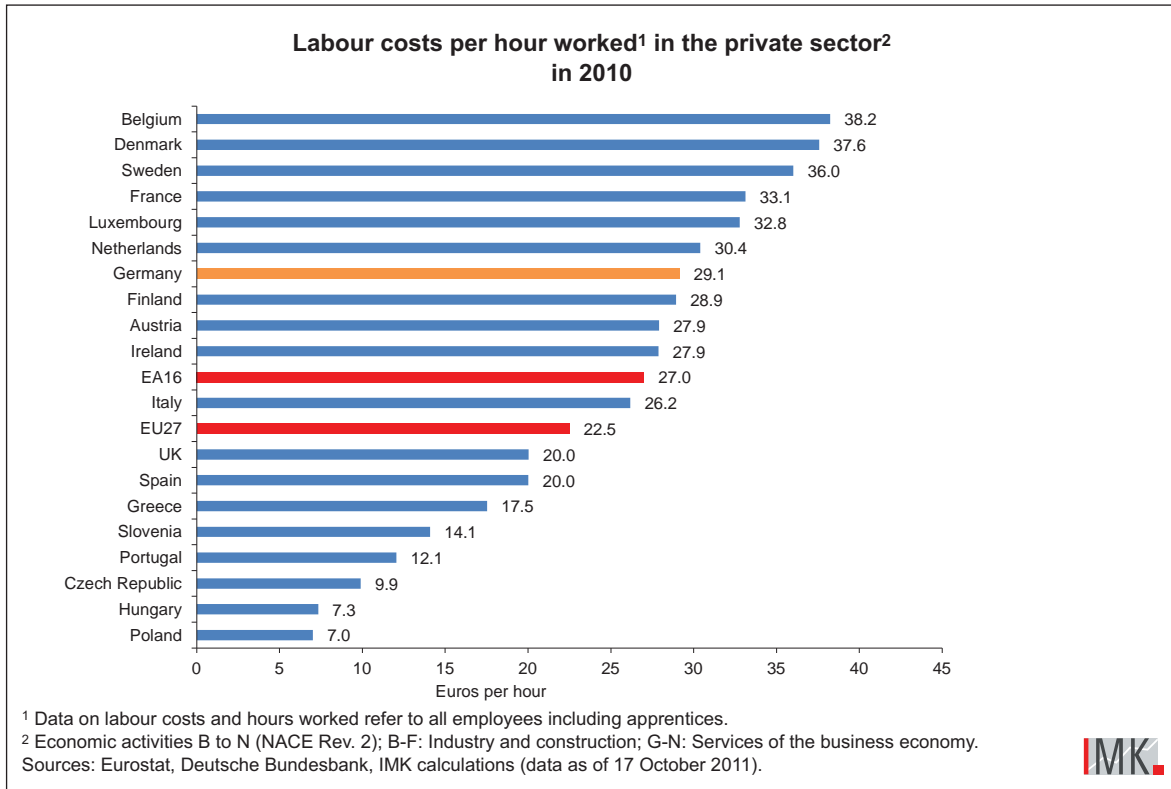


Figure 1b

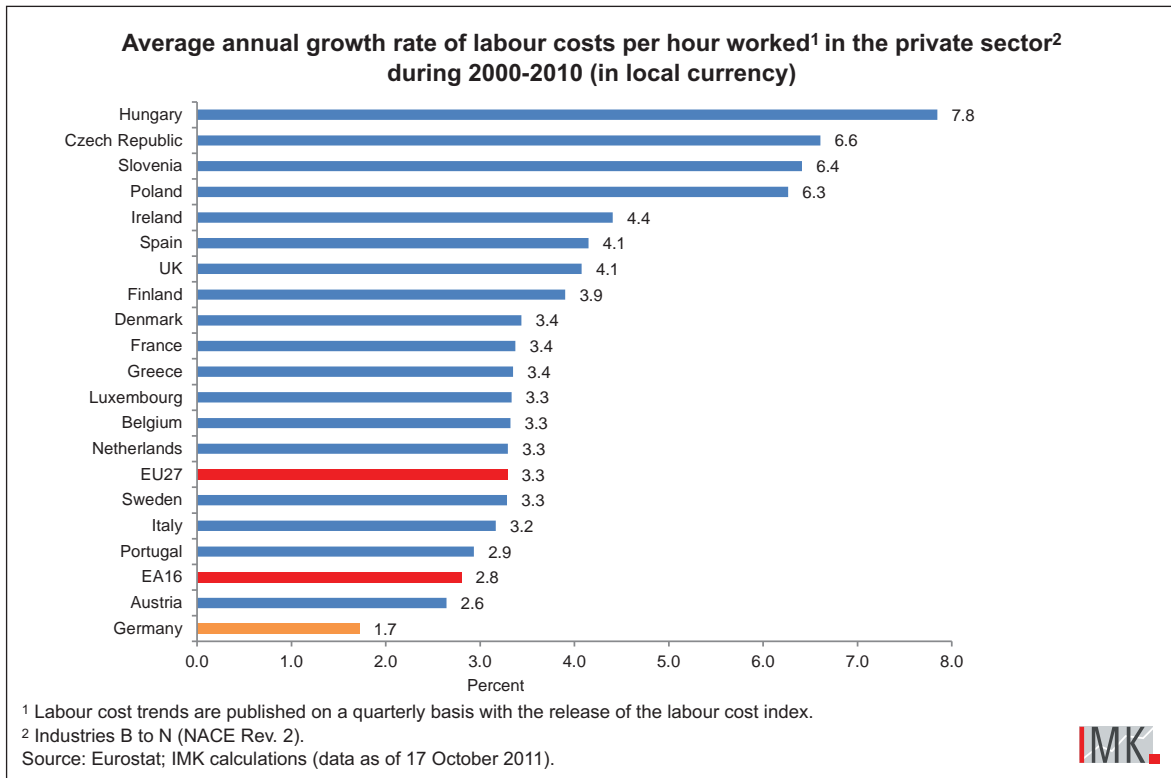


Figure 2a

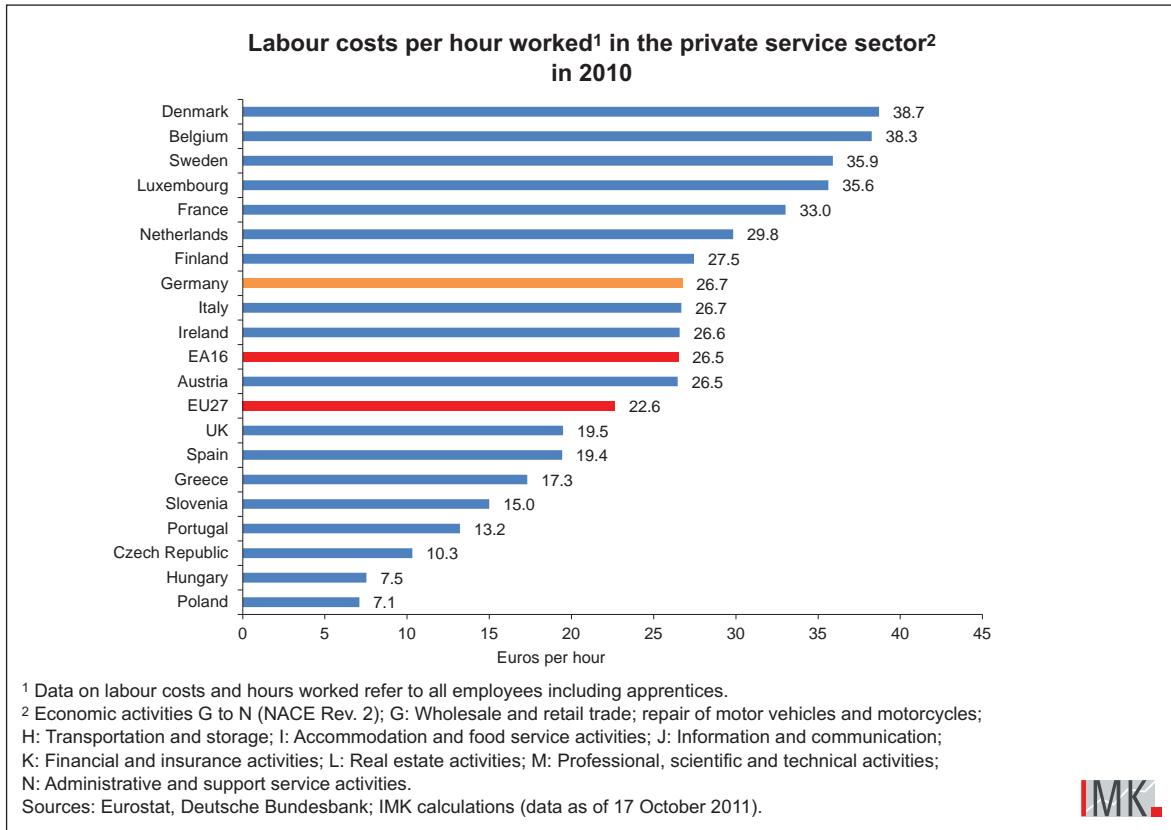
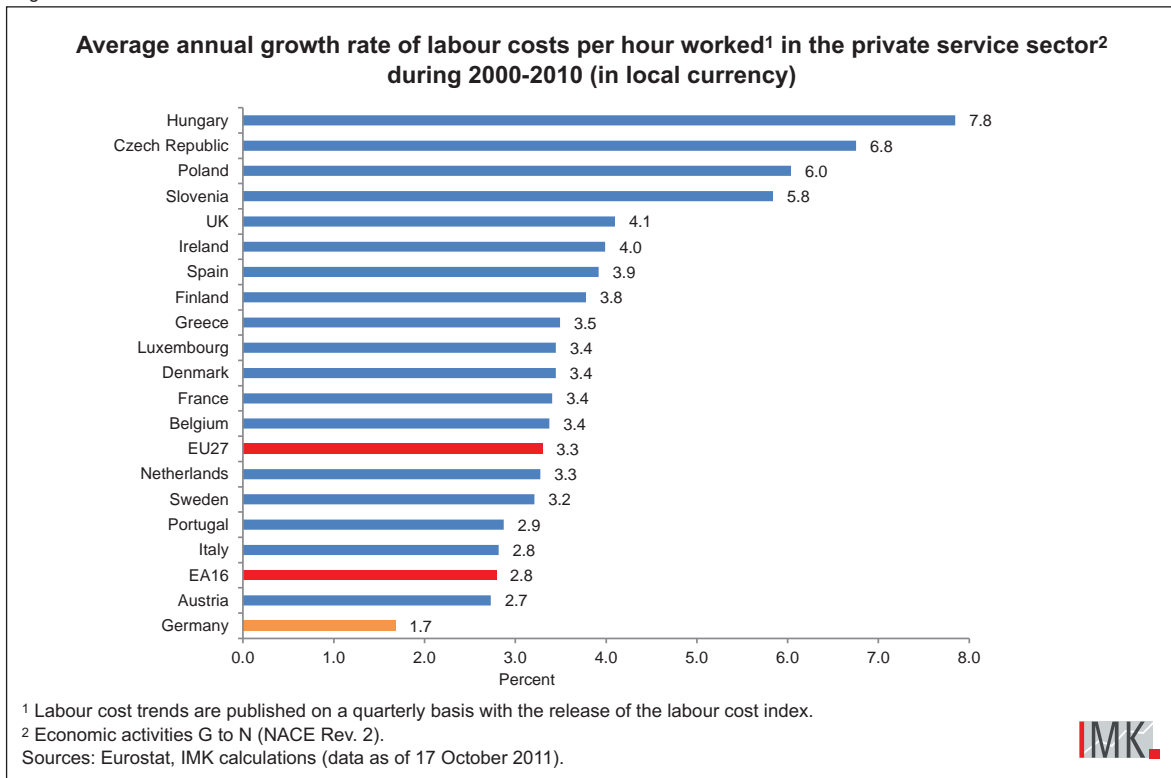


Figure 2b



Germany, Finland and Austria, ranged merely between 1.1 % and 2.2 %. Among the economies receiving particular attention in the context of the euro area crisis, Spain (+0.8 %) and Portugal (+0.4 %) reported slightly rising labour costs, whereas labour costs stagnated in Ireland and even declined by 1.1 % in Greece. By contrast, Italy experienced a surge by 2.8 %. With the exception of Hungary and the Baltic countries, which recorded a decline of labour costs in 2010, labour costs increased in the remaining Central and Eastern European EU countries. In Slovenia, Slovakia, Poland and the Czech Republic the increases measured in local currency were very moderate at 1 % to 1.3 %. However, due to the strong appreciation of the Czech koruna and the Polish zloty (cf. Figure 5) labour costs measured in euros surged by 5 ½ % in the Czech Republic and by almost 10 % in Poland.

### **Manufacturing: German labour cost decreasing marginally**

In 2010 Germany recorded hourly labour costs of € 32.9 in manufacturing, thus ranking fifth behind Belgium, Sweden, Denmark and France (Figure 4a). Germany remains in the group of high-wage countries. However, in manufacturing, too, Germany is observed to depart further and further from the top of the high-wage countries. In just two years the difference with Belgium, the country with the highest labour costs, has risen from just over € 4 to about € 6.5 per hour and the gaps with Denmark and France have also increased. Sweden is a special case, as its labour costs (measured in euros) fluctuated strongly in 2009 and 2010 due to marked exchange rate movements (Figure 5). In 2009 a 10 % depreciation of the Swedish krona caused the Swedish labour costs (measured in euros) to fall below the level of the German labour costs. After the 10 % appreciation in the following year this effect reversed, so that Sweden is ranking clearly before Germany again now.

The growth rates of labour costs indicate that the dispersion within the group of high-wage countries widened in 2010: Whereas the countries exhibiting the highest labour costs, i.e. Belgium, Sweden, Denmark and France, recorded strong positive growth rates between 2 and 3.8 %, labour costs in all other high-wage countries except for the Netherlands (+0.6 %) declined. Whereas labour costs in Germany (-0.1 %) and in Luxembourg (-0.3 %) decreased imperceptibly, Ireland (-0.7 %), Finland (- 1.1 %) and Austria (-1.3 %) reported clearly negative growth rates. This is remarkable as the only other countries recording falling labour costs were Estonia (-0.7 %), Latvia (-3.6 %) and

Lithuania (-2.3 %), which, in the case of these countries, is not surprising, as they are still struggling with the effects of the financial and economic crisis. The disparate labour cost trends across European countries in 2010 are reflected in low growth rates in the euro area as a whole (+1 %) and in the EU27 (+1.3 %). Only Sweden, Poland, the Czech Republic and the United Kingdom stand out from this general picture with increases of labour costs ranging between 6 ½ and almost 14 %. However, these high growth rates mainly result from strong appreciations of the respective currencies in 2010 (Figure 5).

Despite the diverging trends in 2010 average labour costs in manufacturing have evolved similarly to those in the private sector during the past 10 years (Figure 4b). Germany's long-term average increase is a mere 1.8 % and thus by far the lowest of all EU countries. Greece and Austria can also be found at the bottom of the ranking. However, their average labour cost increases still amounted to 2.2 % and 2.6 % per year, respectively. All other countries have shown much higher growth rates of 3 % and above.

For a methodologically sound comparison of the labour costs which actually accrue in the production of industrial goods, intermediate input linkages have to be taken into consideration. This is all the more important the larger the divergences are between the labour costs of individual sectors. In Germany, for instance, labour costs in the private service sector were almost 20 % below those in manufacturing in 2010 at € 26.7 per hour. Thus, the Cologne Institute for Economic Research (IW Köln)<sup>3</sup> is right to adjust its calculations of labour costs in the German industrial sector by taking this intermediate production into account via additional calculations. In a recent publication the resulting cost advantage for the manufacturing sector is estimated at 5.1 % or € 1.75 per hour (Schröder, 2011, p. 17). The Halle Institute for Economic Research derives larger cost economies on the basis of an input-output calculation for 2006 (cf. Ludwig/Brautzsch, 2010, Table 12, p. 26). Taking total intermediate production and all links with other sectors into account cost economies of almost 13 % are identified. Even if the results of input-output analysis overestimate the size of the cost economies, as they are based on persons rather than hours worked thus neglecting the high share of part-time employment in the service sector, they still provide impressive evidence that the cost-saving effect is decisively caused by the direct use of intermediate products. The actual cost-saving effect is estimated at 8 % to 10 %

<sup>3</sup> A think-tank funded by employers and business associations.

### Labour costs in the public service sector: Data base still very limited

The most recent labour cost survey in 2008 (LCS 2008) coincided with the introduction of a new classification of economic activities, NACE Rev. 2. Classifications of economic activities are occasionally adjusted to take account of structural changes in an economy. As the service sector is becoming increasingly important in many countries, whereas the weight of the primary and secondary sectors is continuously decreasing, a key objective of the NACE Rev. 2 is the detailed coverage of the service sector. With the labour cost survey of 2008 the new classification of economic activities was also introduced at the European level. However, the expectations that this would lead to a significant improvement of the data availability concerning the public service sector have not yet materialised. Data gaps are still so large that a comparison of labour costs in the public sector at the European level is feasible only to a limited extent.

The approach to the calculation of labour costs per hour worked in the public service sector is as follows: The labour costs of employees and apprentices as well as the actual hours worked by the employees and the apprentices have been taken from the national labour cost surveys (LCS 2008). The labour costs per hour worked calculated on the basis of these data have been extrapolated for the following years using the growth rates of the corresponding labour cost indices (LCI) of the respective countries. Unfortunately, there are currently no data on labour costs in the public service sector for Belgium, Austria, Italy, Sweden, Luxembourg and Malta, so that hourly labour costs cannot be calculated for these countries. Nevertheless Belgium, Luxembourg and Malta provide a complete time series of the labour cost index (LCI), so that these countries can at least be included in the comparison of average long-term labour cost growth. For France and Spain current statistics on labour costs per hour are available, but time series of the labour cost index are so short that these countries cannot be included in the comparison of long-term average growth rates of labour costs. Due to missing data Italy, Austria and Sweden have to be left out completely.

The public service sector consists of the economic activities O to S:

- O: Public administration and defence; compulsory social security
- P: Education
- Q: Human health and social work activities
- R: Arts, entertainment and recreation
- S: Other service activities

Although this sector is very heterogeneous in its composition and key countries are missing from the analysis, three analogies can be drawn with the private sector results: Firstly, with hourly labour costs of € 28.6 Germany is in the group of high-wage countries together with the Netherlands, Ireland, France and Finland. However, the differences between the individual high-wage countries are much smaller here. In 2010 hourly labour costs in the Netherlands were only € 6 above those in Germany (Figure 3a). Secondly, the analysis of the average growth rate of labour costs during the past 10 years reveals that Germany experienced the lowest increase among all EU countries at a rate of 1.1 % per year (Figure 3b). Thirdly, in 2010 the increase of labour costs in the public service sector was considerably below its long-term average in Germany. Here labour costs increased by only 0.3 %, whereas they rose much faster in the Netherlands (+1.3 %), France (+2.1 %) and Finland (+3.4 %). By contrast, Hungary and the Baltic countries, which still had not recovered from the crisis of 2008, reported labour cost declines between 2.1 % (Estonia) and almost 10 % (Latvia). The euro area countries which are currently taking massive austerity measures to reduce government debt, also recorded negative growth rates. For instance, hourly labour costs decreased by 0.7 % in Spain, by 3.1 % in Portugal and by 4.5 % in Ireland. In Greece labour costs stagnated in 2010 after falling by almost 12 % in the previous year.

Figure 3a

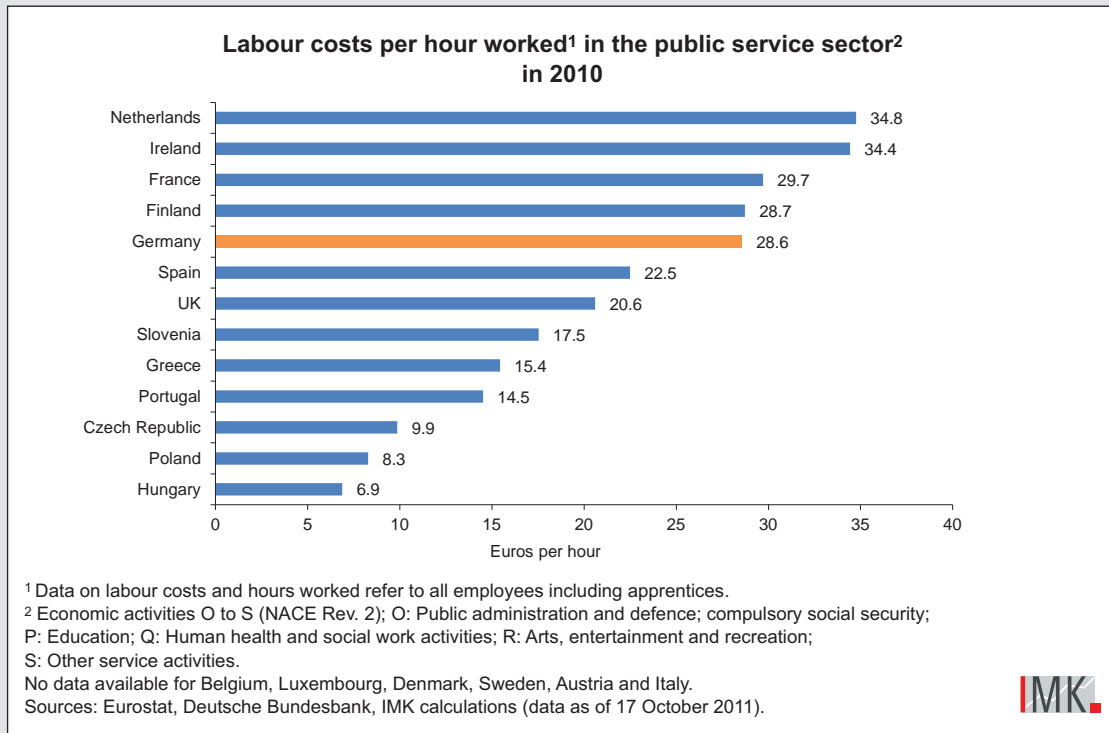


Figure 3b

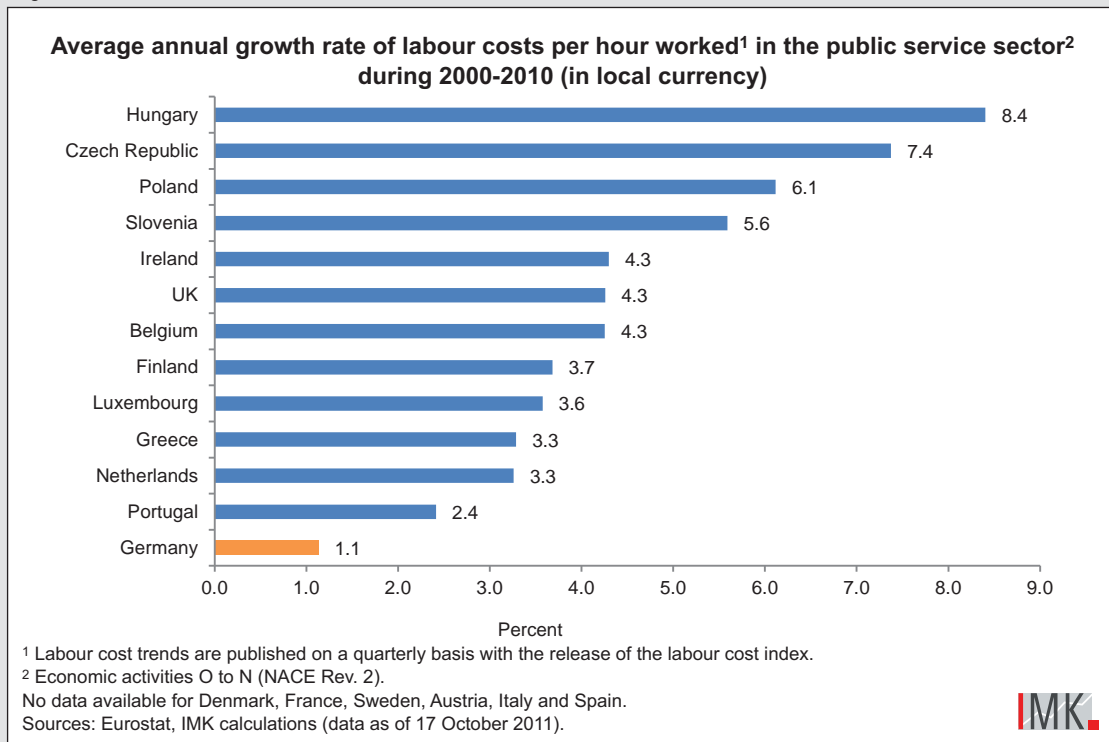




Figure 4a

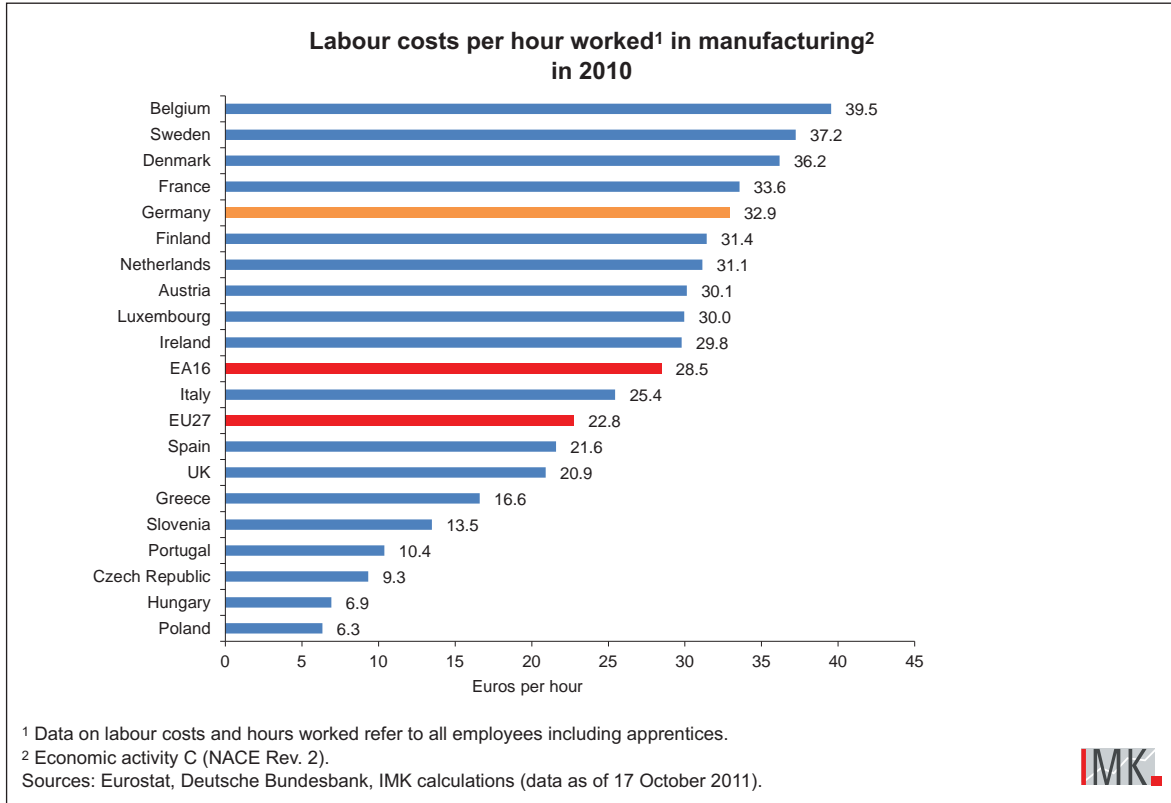


Figure 4b

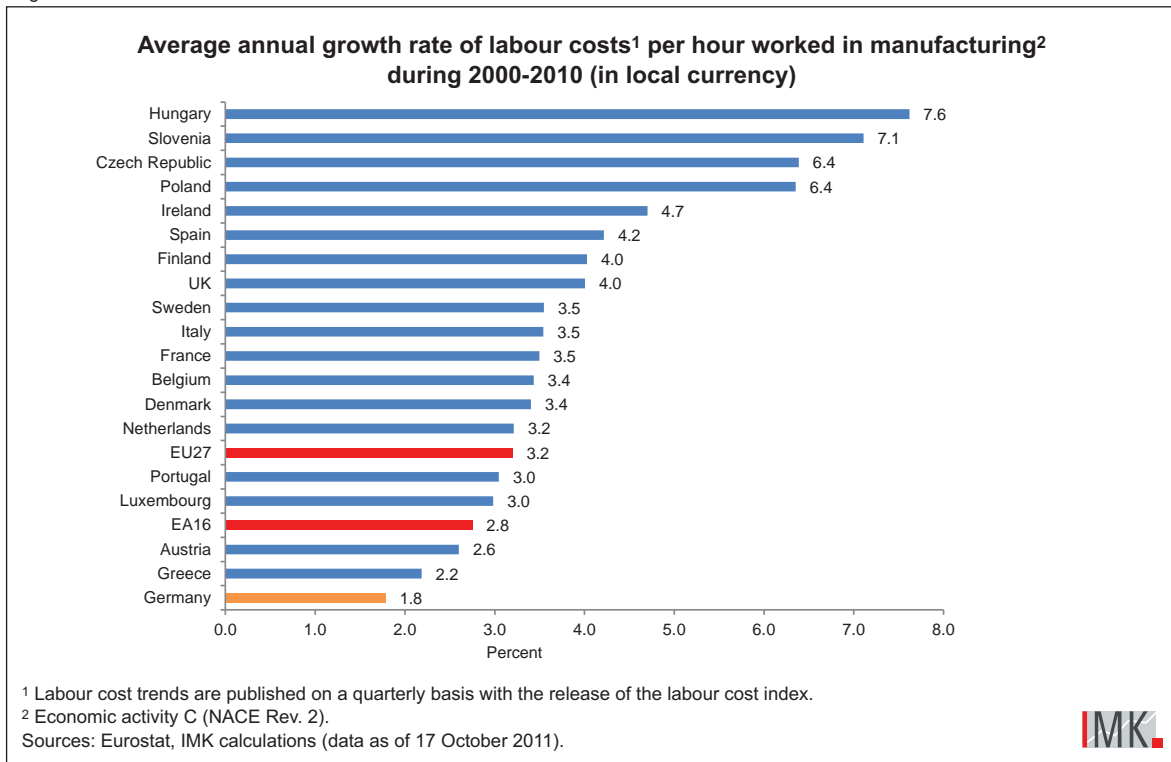
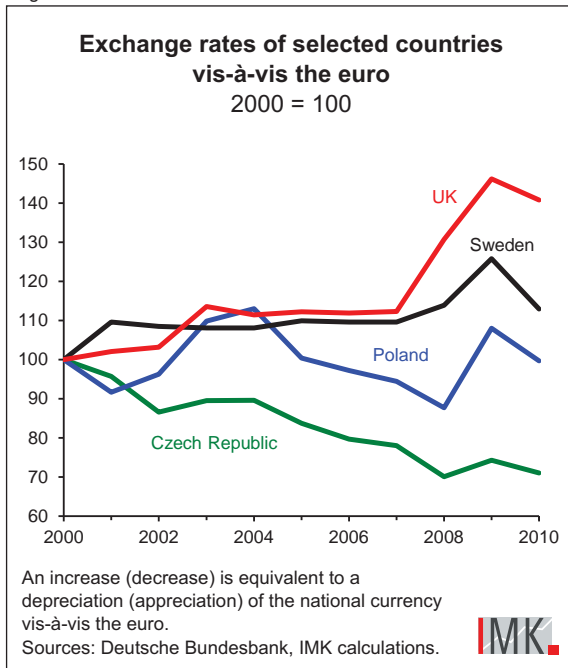


Figure 5



In what follows unit labour costs are analysed for the majority of euro area countries as well as two benchmark countries outside the euro area (Poland, United Kingdom). The calculation of unit labour costs is based on Eurostat data. All data are in euros. As the competitiveness of Poland and the United Kingdom vis-à-vis the euro area is still affected by exchange rate fluctuations, these countries' exchange rate movements are illustrated in Figure 5. During the crisis the currencies of both countries depreciated strongly. In 2010 there was a slight appreciation again. By now the pound sterling has lost 40 % of its value of 2000 vis-à-vis the euro, whereas the Polish zloty has just returned to its initial rate.

Figures 6 and 7 show the evolution of the components of unit labour costs, i.e. compensation of employees and productivity. Whereas France, Austria and also Belgium and Italy have recorded increases of compensation of employees close to the euro area average since 2000, the German increases have remained far below the average. The crisis countries, but also Finland as one of the surplus countries, and in particular Greece and Ireland have seen high wage increases before the onset of the crisis in 2008. Over the whole period Poland, which was hardly affected by the crisis, has recorded the sharpest increase of compensation of employees of all countries in this group<sup>4</sup>.

In Spain, Portugal and France the trend of labour productivity was similar to that of the euro area as a whole. By contrast, Germany, the Netherlands and also the United Kingdom show a markedly better evolution before the crisis, but then began to converge towards the euro area average. Above average increases of labour productivity occurred in Finland, Poland and – since the beginning of the crisis – Ireland. Austria's trend is slightly below. Until the onset of the crisis Greece exhibited high productivity growth. Since then, however, there has been a negative trend. Labour productivity rose by less than the euro area average in Belgium. The situation is even worse in Italy, where labour productivity has stagnated since the start of the monetary union.

An analysis of the evolution since the beginning of 2008 reveals that labour productivity decreased in many countries in 2008/09 as a consequence of the underutilisation of capacity during the crisis. Since then it has recovered again except in the United Kingdom and particularly in Greece. The reasons for the recovery are the renewed increase of capacity utilisation on the one hand and lay-offs or diminishing employment

and includes the effects of cross-sector production. Whenever labour costs are lower in the sectors providing production inputs than they are in manufacturing this lowers the actual labour costs in this sector. However, this also implies that the cost-saving effect is limited when labour costs are roughly equal in manufacturing and in the private service sector. In Germany labour costs in the private service sector are 18.7 % below those in manufacturing. In the rest of the euro area countries labour costs in the service sector are either much closer to those in manufacturing or they even exceed them (Table 1). As a consequence, the cost-saving effect is particularly high in Germany.

### Unit labour costs and price competitiveness

It is not sensible to assess the price competitiveness of a country exclusively on the basis of the level of its labour costs, as labour productivity also plays a vital role. This is so, because labour cost increases do not necessarily make a product more expensive. Simultaneous productivity growth may compensate or even overcompensate for the labour cost increases. If productivity has risen, higher production is possible with the same labour input. This is why costs per unit do not rise proportionally. Therefore, it makes more sense in the context of price competitiveness to use unit labour costs, as their calculation takes labour productivity into account. Unit labour cost trends relative to those in other countries are thus a good indicator of the change in an economy's competitiveness position.

<sup>4</sup> However, an interpretation of the figures has to take into account that, particularly due to the increasing share of part-time work, average wage increases are usually much higher per hour than per person.

Table 1

Labour costs per hour in euros by kind of economic activity in 2010 (rank)							
	Private sector <sup>1</sup>		Private service sector <sup>2</sup>		Manufacturing <sup>3</sup>		Public service sector <sup>4</sup>
Belgium	38.2	(1)	38.3	(2)	39.5	(1)	
Denmark	37.6	(2)	38.7	(1)	36.2	(3)	
Sweden	36.0	(3)	35.9	(3)	37.2	(2)	
France	33.1	(4)	33.0	(5)	33.6	(4)	29.7
Luxembourg	32.8	(5)	35.6	(4)	30.0	(9)	
Netherlands	30.4	(6)	29.8	(6)	31.1	(7)	34.8
Germany	29.1	(7)	26.7	(8)	32.9	(5)	28.6
Finland	28.9	(8)	27.5	(7)	31.4	(6)	28.7
Austria	27.9	(9)	26.5	(11)	30.1	(8)	
Ireland	27.9	(9)	26.6	(10)	29.8	(10)	34.4
Italy	26.2	(11)	26.7	(8)	25.4	(11)	
Spain	20.0	(12)	19.4	(13)	21.6	(12)	22.5
UK	20.0	(12)	19.5	(12)	20.9	(13)	20.6
Greece	17.5	(14)	17.3	(14)	16.6	(14)	15.4
Cyprus	16.2	(15)	16.8	(15)	13.0	(16)	25.6
Slovenia	14.1	(16)	15.0	(16)	13.5	(15)	17.5
Portugal	12.1	(17)	13.2	(17)	10.4	(18)	14.5
Malta	11.5	(18)	11.7	(18)	11.8	(17)	
Czech Republic	9.9	(19)	10.3	(19)	9.3	(19)	9.9
Slovakia	8.0	(20)	8.1	(20)	7.7	(20)	7.5
Estonia	7.7	(21)	7.9	(21)	7.2	(21)	7.6
Hungary	7.3	(22)	7.5	(22)	6.9	(22)	6.9
Poland	7.0	(23)	7.1	(23)	6.3	(23)	8.3
Latvia	5.7	(24)	6.0	(24)	5.0	(25)	5.2
Lithuania	5.3	(25)	5.5	(25)	5.1	(24)	5.9
Romania	4.3	(26)	4.6	(26)	3.5	(26)	4.0
Bulgaria	3.1	(27)	3.4	(27)	2.6	(27)	3.5
EA16	27.0		26.5		28.5		
EU27	22.5		22.6		22.8		

<sup>1</sup> Economic activities B to N; B-F: Industry and construction; G-N: Services of the business economy.  
<sup>2</sup> Economic activities G to N; G: Wholesale and retail trade; repair of motor vehicles and motorcycles; H: Transportation and storage; I: Accommodation and food service activities; J: Information and communication; K: Financial and insurance activities; L: Real estate activities; M: Professional, scientific and technical activities; N: Administrative and support service activities.  
<sup>3</sup> Economic activity C: Manufacturing.  
<sup>4</sup> Economic activities O to S; O: Public administration and defence; compulsory social security; P: Education; Q: Human health and social work activities; R: Arts, entertainment and recreation; S: Other service activities.  
Sources: Eurostat, IMK calculations (data as of 17 October 2011).

on the other hand. The latter applies particularly to Spain and Ireland (cf. Figure 8).

The ratio of compensation of employees over labour productivity yields unit labour costs (cf. methodological annex to Niechoj et al., 2011 – in German). In what follows, unit labour costs are shown both for the total economy and for industry. As the industrial sector receives inputs from the rest of the economy and thus price trends of the whole economy also affect export prices, it is reasonable to invariably analyse the developments in the total economy in addition to those in industry.

Concerning unit labour cost trends in the total economy there has been a trichotomy during the most recent decade (cf. Figure 9). One group of countries,

including France, the Netherlands, Belgium, Finland, and, with considerable qualifications, Austria, is close to or slightly above the euro area average. A second group consisting of the crisis countries Greece, Portugal, Ireland, Italy and Spain, has recorded increases of unit labour costs considerably above the euro area average. The third group of countries consisting of Germany and the United Kingdom, by contrast, remains clearly below the average, this being largely due to the depreciation of the pound vis-à-vis the euro in the case of the United Kingdom. On the other hand the developments in Poland can rather be called erratic. Here, too, exchange rate movements clearly affect unit labour cost trends.

## Database for the calculation of unit labour costs

In what follows the trends of unit labour costs and their individual components are presented in terms of their relative changes since the start of the monetary union in order to analyse the (diverging) trends of the individual countries since the introduction of the euro. In part the data used in the calculation of unit labour costs are only available for the period from 2000, in part the time series start even later. As a consequence, the first quarter of 2000 was usually chosen as the base period and starting point set to 100. The series then reflect the changes compared to this starting point. Time series usually end in the second quarter of 2011. Partly, time series for the Netherlands and Poland had to be excluded due to missing data. Whenever available, data per hour were used. Otherwise data per person were resorted to. The data used in the calculations are classified according to NACE 1.1. Unit labour costs in industry comprise the economic activities C, D and E of NACE 1.1 (Details are given in the methodological appendix – “Methodischer Anhang” – to Niechoj et al. 2011, in German).

To improve the clarity of the presentation two groups of countries were formed. The first includes the countries of the euro area, which, due to the euro area debt crisis, have been in the focus of attention during the past 1 ½ years and still are: Greece, Portugal, Ireland, Spain and Italy. For the purpose of comparison this group was complemented by Poland, a country outside the euro area with a low level of labour costs like Greece and Portugal, but keeping a flexible exchange rate. Besides Germany, the second group of countries is made up of four smaller open economies with current account surpluses – Belgium, Finland, Austria and the Netherlands – as well as France as the second largest economy in Europe and the United Kingdom as a European reference country outside the euro area.

The exclusive focus on the period since early 2008 reveals, that in most countries unit labour costs increased between 2008 and 2009 before entering stagnation. By contrast, the crisis countries Portugal and Greece as well as Spain and particularly Ireland show a trend remaining clearly below the average. This is strongly linked to the trend of labour productivity, which is in turn affected by the strong decline of the number of employed persons in these countries due to the crisis.

The comparison of unit labour cost trends in industry with those in the total economy does not reveal any substantial differences. However, there are some individual peculiarities (cf. Figure 10). For instance, in Germany, France, the Netherlands, Belgium, Austria and Finland unit labour costs in industry have risen more slowly than in the total economy during the whole period of analysis. Nevertheless, the increases in these countries remain close to or below the euro area average. In the crisis countries unit labour cost trends in the total economy and in industry are similar with the exception of Ireland, which exhibits a drastic decline of unit labour costs in industry.

It is remarkable that unit labour costs in the German industrial sector rose most sharply after the onset of the crisis in 2008, but converged towards the euro area average again soon afterwards. This reflects the decline of labour productivity at the beginning of the crisis. Unlike in most other countries, many companies

in Germany used instruments of internal flexibility, i.e. above all the reduction of surpluses in working time accounts and short time work schemes. This helped to save jobs, but labour productivity growth remained below that in other countries for some time and, consequently, unit labour costs initially rose at an above-average pace. However, this was merely a technical reaction, which masks a great success of labour market policies: Unlike in the euro area the number of employed persons hardly decreased during the crisis and has even grown again since February 2010 (cf. Figure 8). In the course of this recovery the unit labour cost increases reversed. Apart from this crisis-induced and temporary overshooting of unit labour costs an increasing divergence of unit labour cost trends and consequently of price competitiveness has become apparent within the euro area since the start of the monetary union. The crisis has resulted in a temporary reduction of the imbalances and stopped a further divergence of price competitiveness for the time being. Despite the recovery following the financial and economic crisis since mid-2009 there has not been any appreciable increase of unit labour costs until the end of 2010 or early 2011. Two countries have even succeeded in slowing or even reversing the increases in unit labour costs both in the total economy and in industry: Greece and to an even larger extent Ireland. However, this came at an enormous cost for the population and in terms of economic growth.

Figure 6

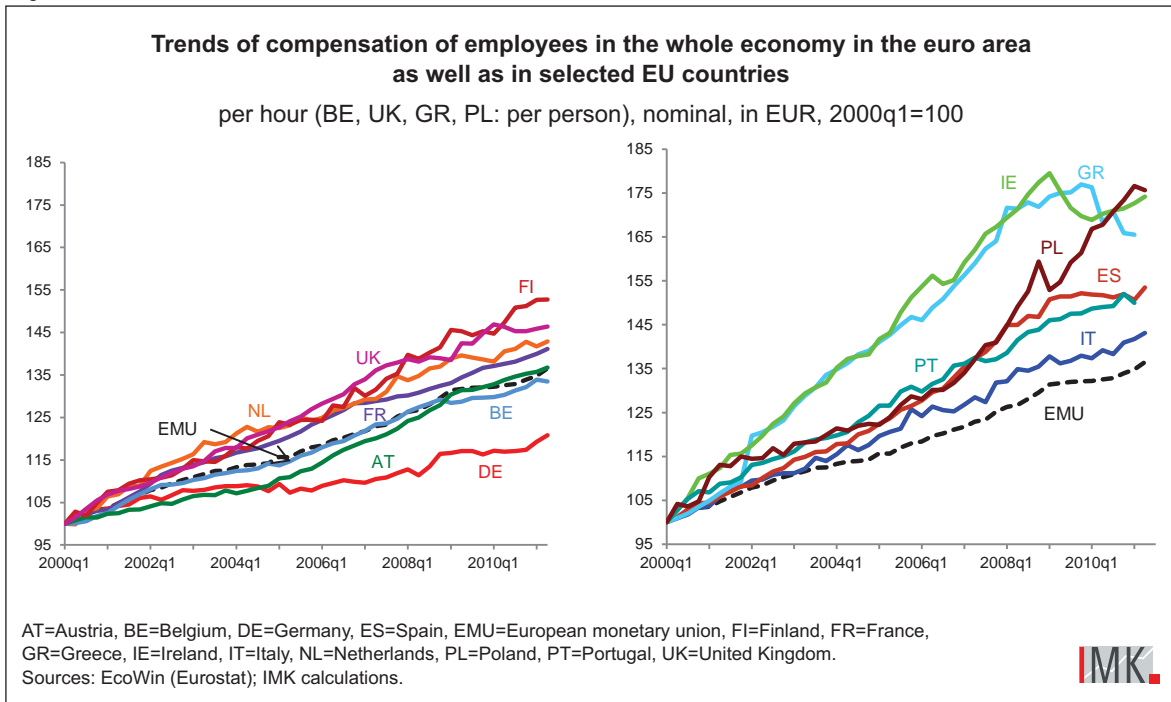


Figure 7

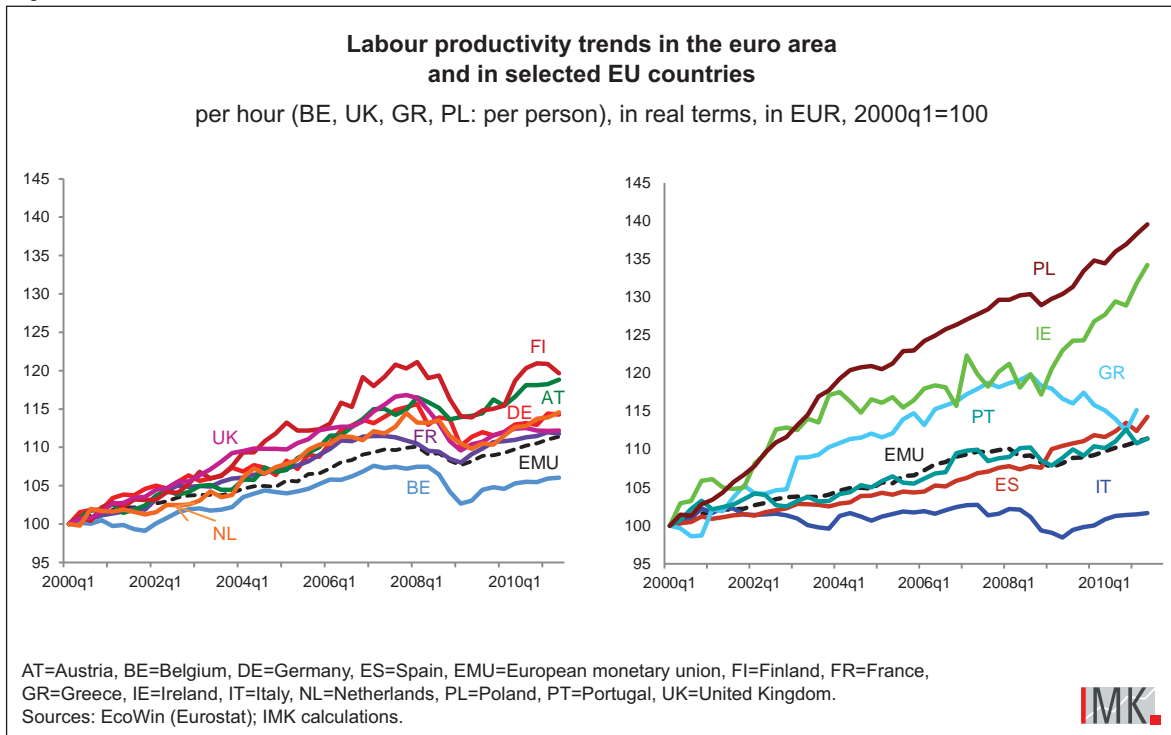


Figure 8

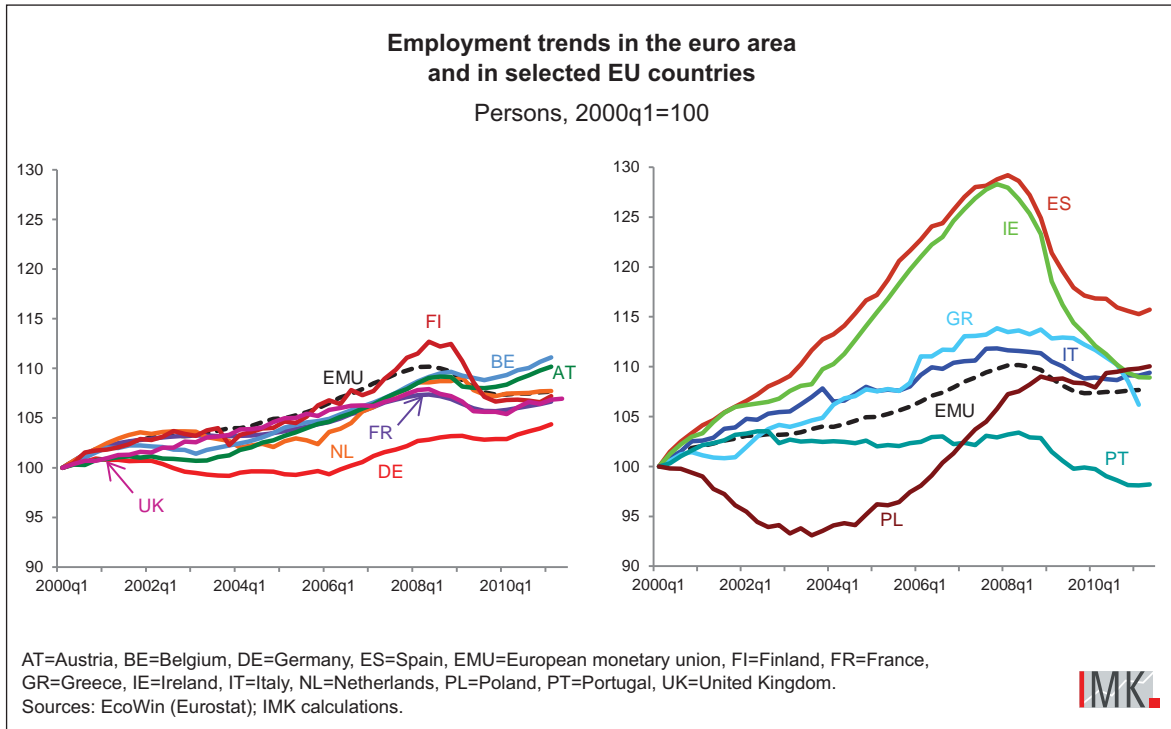


Figure 9

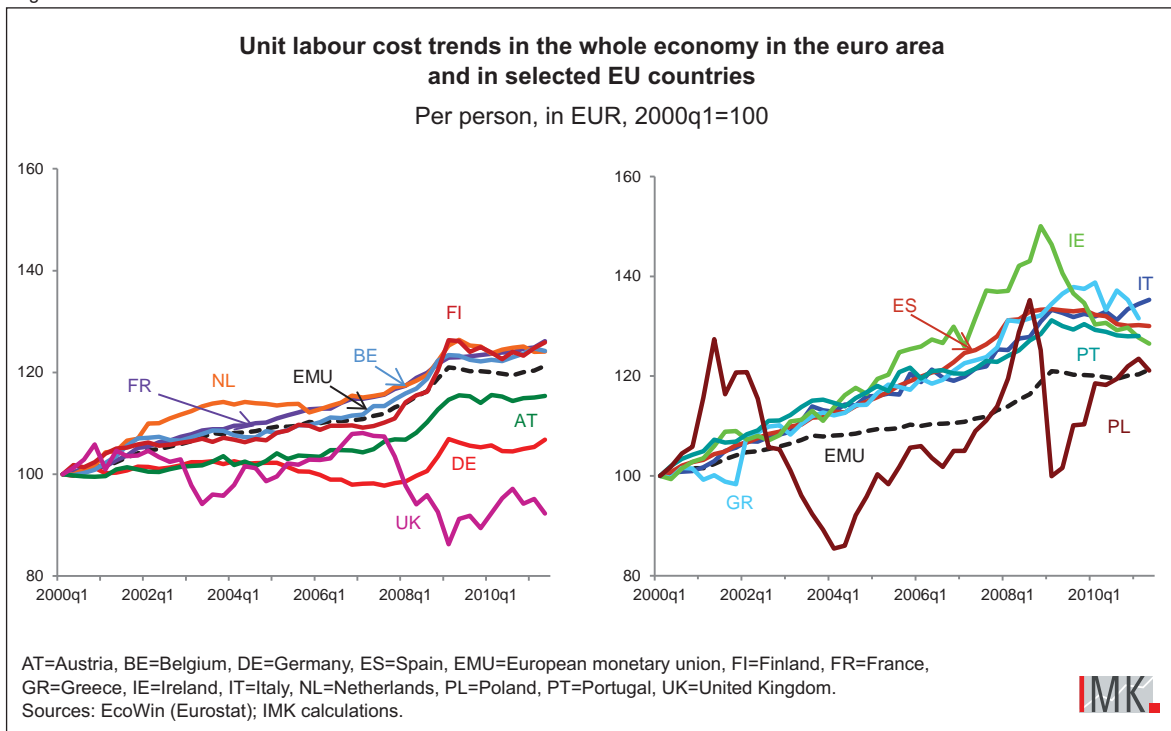
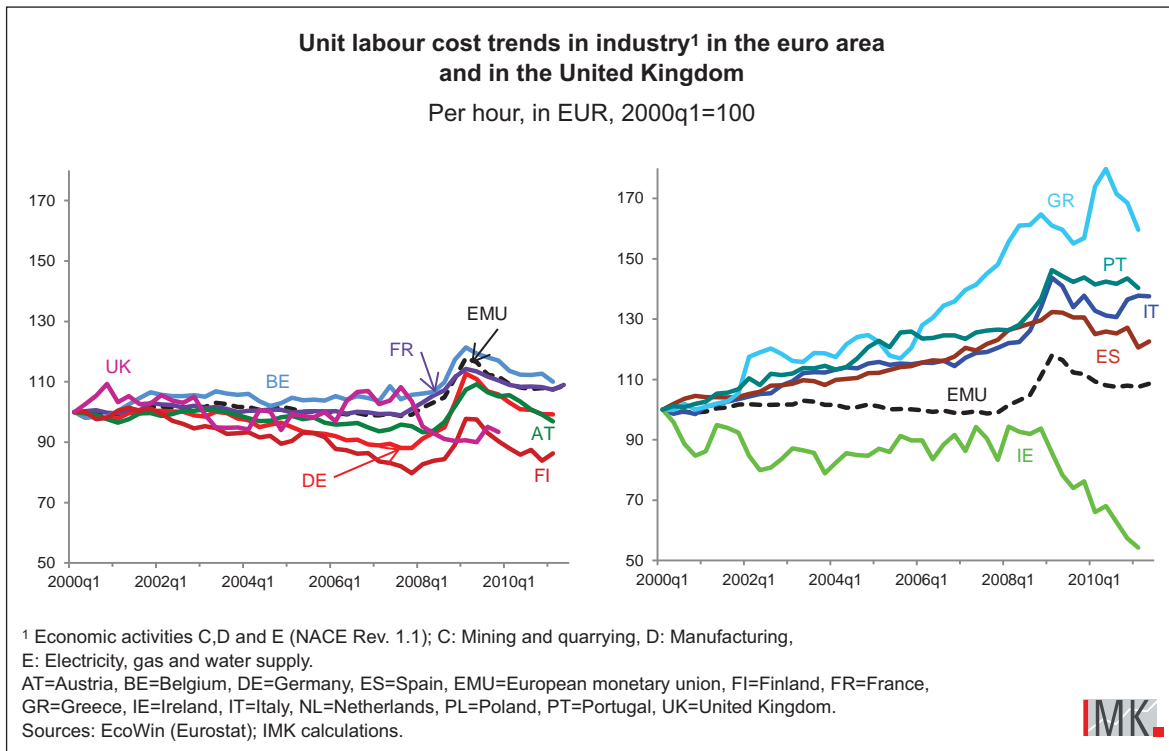


Figure 10



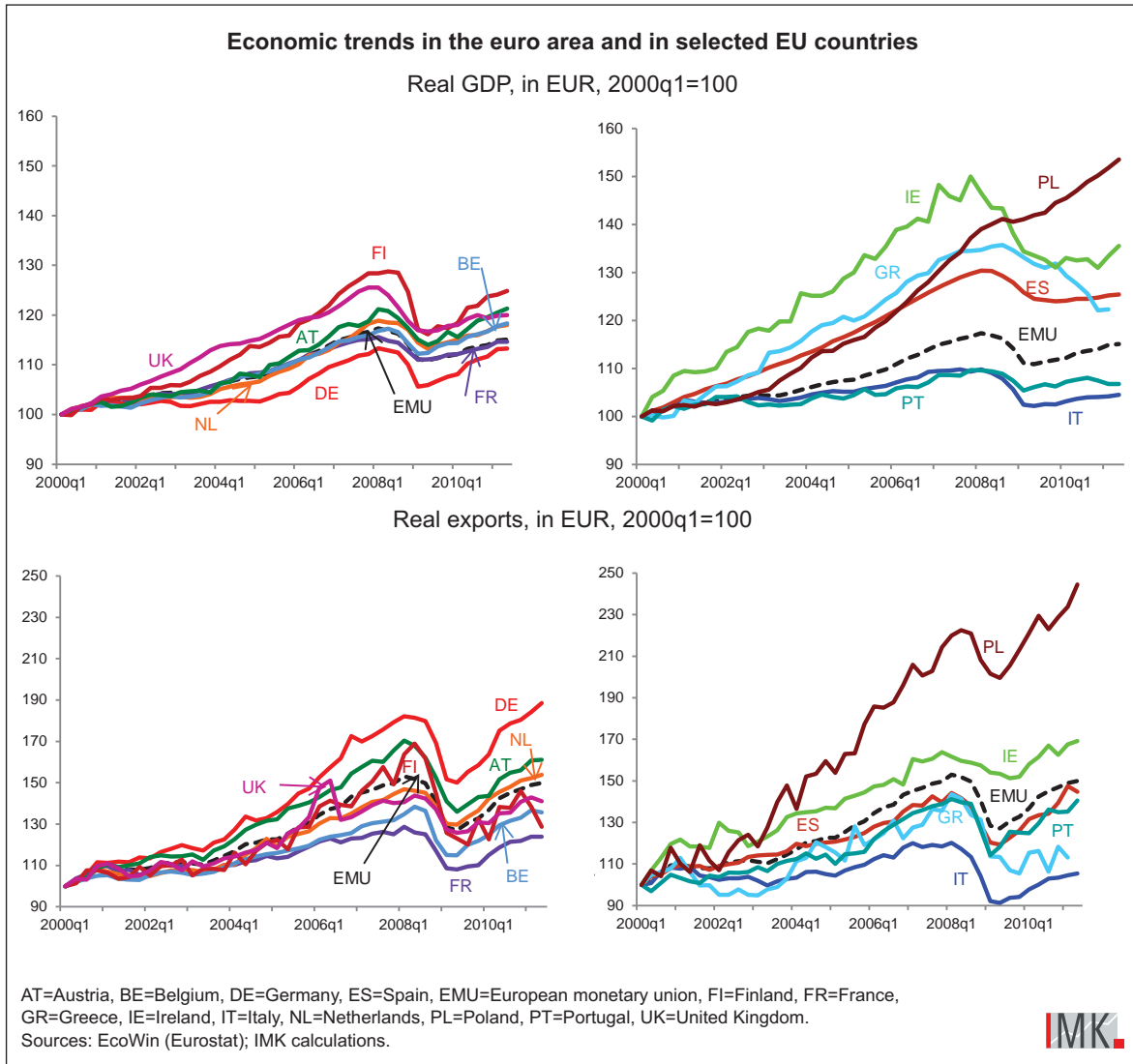
The countries exhibiting unit labour cost increases below the euro area average are also the ones that recorded a substantial growth of exports owing to their gain in price competitiveness. Particularly Germany, the Netherlands and Austria should be mentioned in this context. Until the crisis in 2008 Finland and Belgium had experienced similar export trends as the countries mentioned above (see Figure 11), but have shown a more moderate export growth since then. Ireland's export performance clearly indicates that this country has not slid into crisis because of high unit labour cost growth, but because of the financial crisis and its consequences for the banking and financial sector as well as real estate prices. Further, a comparison of Poland and the United Kingdom reveals that the mere existence of a flexible exchange rate is no guarantee for export success, although, in principle, it helps spurring exports via a depreciation of the domestic currency. Whereas Poland shows a strong expansion of exports slowed only temporarily by the crisis, the performance in the United Kingdom only just kept up with the average export growth of the euro area despite a substantial depreciation of the pound. In this context, however, it should be noted that this high average export increase of the euro area as a whole has been decisively influenced by Germany's strong export growth in the same way as the average unit labour cost trend of the euro area has strongly been biased downwards by Germany so far.

### Crisis of the monetary union and diverging labour cost trends

The escalation of the euro area crisis and the suggestions for a solution that are currently discussed should not distract the attention from the real causes of these imbalances. The latter are closely connected to labour cost trends. In financial markets pressure was exerted particularly on those countries whose relative price competitiveness had worsened continuously since the start of the monetary union. This had led to current account deficits and consequently higher external debt. Now financial markets suddenly presume that these countries can no longer ensure sufficient economic growth to service their debt without disruptions.

Since the start of the monetary union diverging trends of labour costs in the individual countries and an increase of current account imbalances have been observable. Although, at the time, among other criteria a low inflation rate was one prerequisite for admission to the common currency area, the member states merely had to meet the deficit and debt targets of the Stability and Growth Pact once they had passed the "entrance examination". Price trends in the individual countries no longer played any role as long as the euro area as a whole met the inflation target. However, this has not been without consequences. Persistent inflation differentials lead to a cumulative improvement or

Abbildung 11



worsening of the price competitiveness of the respective countries causing substantial foreign trade imbalances. In a common currency area, the latter can no longer be corrected by currency appreciations or depreciations, but only via drastic adjustments in the real economy. However, it is these real economic adjustment processes that make it more difficult to service private and public debt.

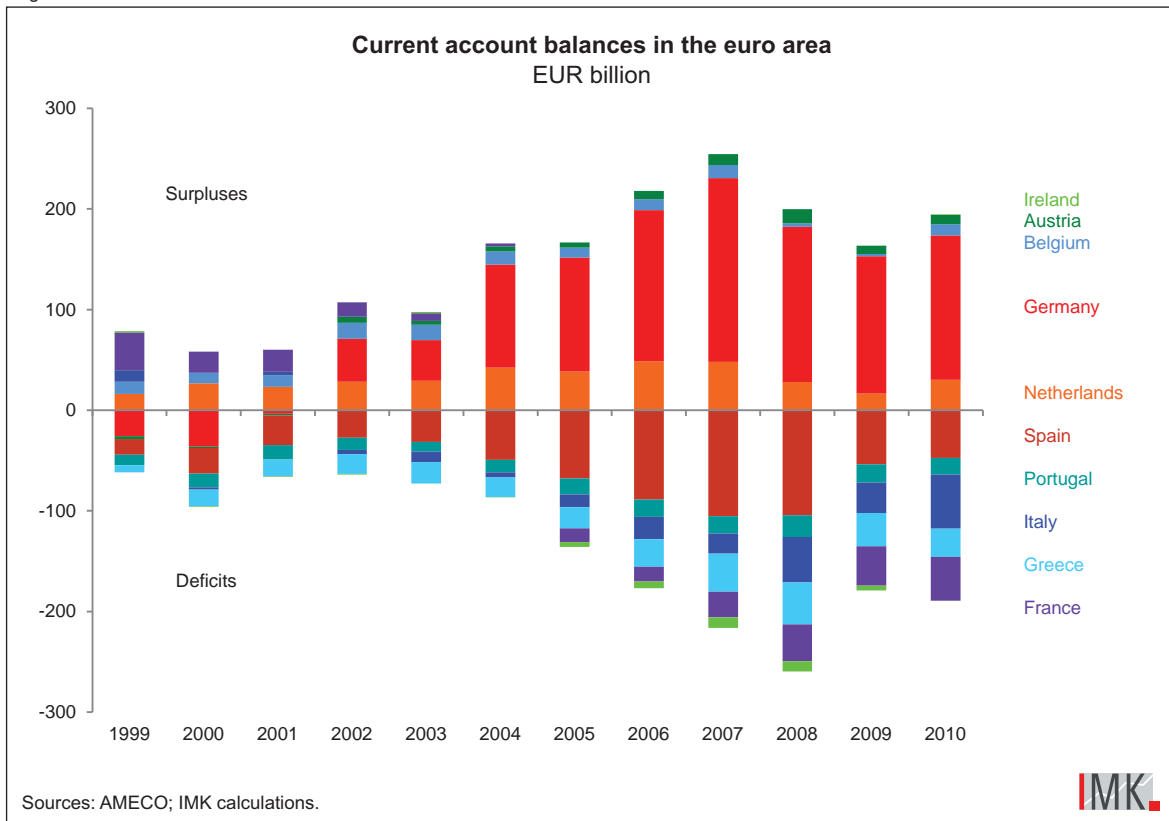
A fundamental principle of a currency union of otherwise sovereign states has been culpably neglected for more than a decade: Each individual member state must on average meet the common inflation target of the euro area of close to but below 2 %. Otherwise real appreciations and depreciations will result causing current account crises in the long run. However, meeting a common inflation target subjects the participating economies to constraints, which the

countries of the euro area do not want to expose themselves to (Horn/Mühlhaupt/Rietzler, 2005).

One of these constraints concerns the evolution of labour costs, because the latter are among the key cost factors determining the inflation rate. This is particularly true of unit labour costs. Their increase should have been compatible with the inflation target. The analysis above shows that this has not been the case. Instead, it shows that during the past 11 years a group of countries in the euro area has reported unit labour cost increases close to the EMU average, thus being consistent with the ECB's inflation target of close to but below 2 %. This group includes Finland, France, Belgium, the Netherlands and, with considerable qualifications, Austria. By contrast, Germany's average unit labour cost increase of merely 0.6 % represents a blatant downward deviation. For a growth rate of 2 %



Figure 12



which would conform to stability, labour costs would have needed to grow faster by almost 1.5 % per year in the given situation.

At the same time the picture for Greece, Italy, Portugal, Ireland and Spain reveals substantial upward deviations from the euro area average until the onset of the crisis in 2008/09. However, these have meanwhile been corrected to a significant extent (cf. Figure 9). To achieve convergence of international competitiveness, Germany will thus have to push labour costs up by much more than this group of countries has to adjust them downwards.

As, within the currency union, the crisis countries do not have the possibility of nominal devaluations, they will have to choose an adjustment path of improving their competitiveness via comparatively low labour cost increases. However, this approach is almost hopeless as long as the growth of German labour costs remains so meagre. This is because it is not sufficient for the respective countries to reach the low unit labour cost growth of Germany, as this would not help to improve the domestic competitiveness vis-à-vis Germany. Rather, it would remain as poor as before. The bilateral current account imbalances with Germany can hardly be reduced with this strategy.

In all this we must not ignore that wages are income. Weak wage growth therefore results in weak domestic demand, especially of consumers, which in turn leads to lower imports. Ultimately the massive redistribution at the expense of labour income weakened consumption expenditure in Germany. This also contributed to current account imbalances.

Preserving the European Monetary Union in its current composition and avoiding a transfer union, is only possible, if wages in Germany increase noticeably faster than they did in the past decade. To reverse the undesirable trends the increase of unit labour costs would have to exceed 2 % for several years. This would be the only way that currently uncompetitive countries could embark on an adjustment path at all, which would not end in deflation and depression as a consequence of otherwise unavoidable absolute wage cuts.

Ultimately, the rescue funds and the ECB interventions only serve to buy time. This is necessary and reasonable, if the time is used to reduce these fundamental imbalances within the euro area. Both the crisis countries and the countries exhibiting current account surpluses and below-average labour cost increases must change their behaviour. Compa-

red to a transfer union or a break-up of the euro area this solution is relatively cheap for Germany. And, at last, it gives employees a fair share in the economic gains of the past decade.

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