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Research Report

Monitoring competitiveness in the European Economic and Monetary Union

IMK Study, No. 44

Provided in Cooperation with:

Macroeconomic Policy Institute (IMK) at the Hans Boeckler Foundation

Suggested Citation: Hallwirth, Volker (2015) : Monitoring competitiveness in the European Economic and Monetary Union, IMK Study, No. 44, Hans-Böckler-Stiftung, Institut für Makroökonomie und Konjunkturforschung (IMK), Düsseldorf, <https://nbn-resolving.de/urn:nbn:de:101:1-201602195139>

This Version is available at:

<https://hdl.handle.net/10419/148242>

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Volker Hallwirth¹

Monitoring competitiveness in the European Economic and Monetary Union

The aim of the European Union's Macroeconomic Imbalance Procedure (MIP) is to prevent and correct macroeconomic imbalances before they get out of hand. The President's of the EU and Euro area institutions recommend in their report on "Completing Europe's Economic and Monetary Union" to strengthen this procedure. A euro area system of Competitiveness Authorities is recommended, which should "assess whether wages are evolving in line with productivity and compare with developments in other euro area countries and in the main comparable trading partners". Along these lines it is analysed below how well MIP has worked in the past and how it could make a more effective contribution to preventing and correcting divergences in competitiveness.

¹Dr. Volker Hallwirth, 61, works for the Federal Ministry of Economics and Energy. The views expressed in this paper are the author's personal opinions.

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Contents

1. THE INHERENT FLAWS OF EMU GOVERNANCE	3
2. DIVERGENT WAGE AND PRICE TRENDS	6
3. COMPETITIVENESS: IDENTIFYING THE REQUIRED ACTION	9
4. THE CAUSES OF COMPETITIVENESS PROBLEMS	14
5. CURRENT FAILINGS IN COMPETITIVENESS MONITORING	16
6. COMPONENTS OF A PROCEDURE FOR MONITORING COMPETITIVENESS AT EUROPEAN LEVEL	18
EXCURSUS: BEGGAR-THY-NEIGHBOUR POLICIES IN A MONETARY UNION	28
7. CONCLUSION	30

In March 2014, an assessment carried out by the European Commission concluded that Germany's current account surplus constituted an imbalance.² The Commission called on Germany to increase investment in order to strengthen domestic demand, thereby reducing its surplus and aiding the current rebalancing taking place within the eurozone. The German government's response expressed relief that the European Commission saw no grounds for opening an excessive imbalance procedure. Whilst conceding that there was a need to make improvements, particularly with regard to public investment, it stressed the fact that the competitiveness of German businesses was one of the cornerstones of the entire eurozone. It added that relatively low prices only played a lesser role in explaining the growth in the German trade balance, concluding that the principal reasons for Germany's strong export performance were its workforce, its competitive economy and its globally successful products.³

For quite some time, current account imbalances and divergences in competitiveness within the eurozone have been regarded as one of the key causes (or contributing factors) of the eurozone crisis. Introduced back in 2011, the European Union's Macroeconomic Imbalance Procedure (MIP) is one of the measures that have been taken to address this issue. The MIP is aimed at facilitating the early detection and correction of macroeconomic imbalances. The abovementioned dialogue between the European Commission and the German government, which came about as a result of the MIP process, highlights a number of questions: What are the causes of the divergent trends in the eurozone? To what extent have they contributed to the eurozone crisis? What are the reasons for Germany's particularly strong competitiveness? What role do price and non-price competitiveness factors play in this phenomenon? What role does economic policy play? How can competitiveness be measured? What progress has already been achieved in terms of the rebalancing process within the eurozone? How much more rebalancing is still required? Can the MIP prevent future divergences in competitiveness? Can and should it be more effective?

1. The inherent flaws of EMU governance

The European Economic and Monetary Union (EMU) restricts the macroeconomic management policies that member states are able to implement at a national level. In particular, important macroeconomic policy instruments are not at their disposal:

- exchange rates as an instrument for protecting or restoring competitiveness,
- monetary policy in order to stabilise or stimulate their domestic economy,
- monetisation of public debt .

In a monetary union, the loss of some national autonomy with regard to macroeconomic policy is accompanied by increasing economic interdependence. As a result, the macroeconomic policies of one member state can have

² See http://ec.europa.eu/deutschland/press/pr_releases/12144_de.htm.

³ Federal Ministry for Economic Affairs and Energy (BMWi): National Reform Programme 2014 of the Federal Government of Germany, published 15.4.2014, <http://www.bmwi.de/DE/Mediathek/publikationen,did=635360.html>.

(unintended) repercussions for others. Macroeconomic shocks and interventions at the level of the union as a whole can have asymmetric effects on different member states, which implies a formidable challenge with respect to economic policy coordination. Prior to the introduction of EMU, there was a universal consensus regarding the fundamental need for such coordination. However, the architecture and practical implementation remained highly controversial and in a state of permanent adjustment.

Art. 121 of the Treaty on the Functioning of the European Union (TFEU, formerly Article 103 of the Maastricht Treaty) stipulates that Member States shall regard their economic policies as a matter of common concern and shall coordinate them. The Maastricht Treaty introduced the “broad guidelines of the economic policies of the Member States and of the Union” as a key economic policy coordination instrument. The content of the guidelines is formulated in consultation with the member states, the European Parliament and the social partners based on a draft version produced by the European Commission. Following referral to the European Council, the guidelines are adopted by the Council. The European Commission and the Council monitor the compatibility of member states’ economic policies with the Broad Economic Policy Guidelines. Should a member state fail to comply with them, the Council can recommend the relevant corrective measures.⁴

The following key recommendations regarding the content of the macroeconomic policy mix, including wage developments, were formulated in the Broad Economic Policy Guidelines in the run-up to the introduction of the euro:

- independent stability-oriented monetary policy. The more the task of monetary policy to maintain price stability is supported by appropriate budgetary policies and wage developments, the more likely it is that monetary conditions will be favourable to growth and employment. ;
- sustained effort to consolidate the public finances nominal wage trends consistent with the price stability objective;⁵
- Structural policies (especially competition and industrial policy, labour market policy, education, research and innovation policy, deregulation and measures to curb bureaucracy) should take full advantage of the potential for job creation and strengthen long-term growth potential.

⁴ The 1992 Maastricht Treaty thus sets out the basis for coordination of the macroeconomic policy mix at European level, including wage developments. In the foreword of Commission Vice-President Henning Christophersen to the first guidelines published in December 1993 (http://ec.europa.eu/economy_finance/publications/publication_summary7951_en.htm), all the “key players” are addressed, in particular the social partners. The foreword states that macroeconomic coordination is necessary. Lack of such coherence “constitutes a major macroeconomic obstacle to growth because it overburdens monetary policy and, obliges the pursuit of the stability objective by means of high interest rates.” Wage and fiscal policy are addressed immediately afterwards.

⁵ This three-pronged approach based on monetary, fiscal and wage policy appears for the first time in the 1995 guidelines. This common macroeconomic strategy which has since been a regular feature of the guidelines – with only minor variations – aims at ensuring that wage developments are consistent with the goals of price stability and productivity growth. It is recommended that real wage increases should be kept below the rate of productivity growth insofar as this is necessary to strengthen investment, employment and competitiveness.

Established under the German presidency in 1999, the “Macroeconomic Dialogue” brought about a significant improvement in the institutional structure of macroeconomic coordination. The goal of the Macroeconomic Dialogue is to create a growth- and stability-oriented macroeconomic framework in order to promote growth and employment whilst maintaining price stability. The Dialogue does not seek to formulate binding rules for the relevant policy areas (“ex-ante macroeconomic policy coordination”). Instead, it aims to facilitate an exchange of views between the Council, the Commission, the ECB, a representative of a non-euro area central bank and the social partners in order to identify any divergences from the recommendations of the Broad Economic Policy Guidelines as early as possible so that joint solutions can be developed (as such, it constitutes a “soft form of economic policy coordination” in which the responsibilities of the different players remain clearly defined). The dialogue provides participants with a regular platform for expressing fully autonomous and independent views concerning how they can contribute to dynamic, non-inflationary growth and what expectations they have of the other macroeconomic actors in this regard. In so doing, the macroeconomic actors help to monitor the extent to which the member states’ economic policies are consistent with the Broad Economic Policy Guidelines. With this theoretically sound governance structure in place, there was a great sense of optimism among the eurozone countries as they embarked on their journey towards a single currency. Right across Europe, the politicians responsible for the project proclaimed their conviction that a single currency would bring peace and prosperity to Europe. The ECB’s first President, Wim Duisenberg, promised the people of Europe that the introduction of the euro would generate additional growth of one percentage point a year.

When it came to the practical implementation of the architecture, however, not all aspects of economic policy coordination and monitoring of compliance with the guidelines received the same level of attention during the first 10 years of EMU. Following the European Council meeting in Lisbon in June 2000, if not before, the actual focus was primarily centred on the reform agenda. In other words, the eurozone’s macroeconomic policy was mainly geared towards ensuring price stability and improving the sustainability of the public finances. When looking back at this period, it is often forgotten that until the onset of the global financial and economic crisis in the autumn of 2008 – a crisis for which Europe was not to blame – the eurozone had actually achieved some notable successes in this area. During the first few years of EMU, price stability was maintained (across the eurozone as a whole), while fiscal policy was able to deliver major overall improvements in the long-term sustainability of the public finances. Moreover, a convergence process was initiated that would provide above-average growth for those member states with a below-average per capita income. Far too much is made both of the fact that Greece fudged its budget deficit figures for 2001 and of the alleged weakening of the Stability and Growth Pact in 2005. Any role these factors may have had in causing the eurozone crisis from 2010 onwards is marginal at most.

2. Divergent wage and price trends

On the other hand, macroeconomic stabilisation and competitiveness were largely left up to market forces, with the adoption of a laissez-faire economic policy clearly in contradiction to the recommendations of the Broad Economic Policy Guidelines. Although lip service was frequently paid – especially within the European Macroeconomic Dialogue – to optimising coordination of monetary policy, fiscal policy and wage developments in order to achieve the macroeconomic goals set out in Art. 3 of the Treaty on European Union, in practice this was not something that was ever demanded or implemented with any real conviction. Consequently, after the introduction of the euro, major divergences emerged with regard to wages and prices and thus ultimately also competitiveness within the euro area. This in turn led to serious economic imbalances within the eurozone that were a major contributing factor to the eurozone crisis. In Germany, low inflation and wage increases were accompanied by exceptionally sluggish domestic demand, high unemployment and difficulty in complying with the terms of the Stability and Growth Pact. The combination of weak domestic demand and continuously improving competitiveness led to growing current account surpluses. Despite rising exports, aggregate demand remained subdued for some considerable time. Market forces failed to provide the necessary stimulus to correct this imbalance.

Conversely, excessively high wage and price increases in other member states initially had a positive impact on growth and employment. Nominal interest rates in these eurozone countries fell in consequence of the introduction of the euro, since there were no longer concerns about currency depreciation. and, at least to begin with, solvency. Another factor that should not be underestimated is that almost all the experts explained the high economic growth in these countries by high structural growth potential, i.e. as a long-term phenomenon. International organisations such as the IMF, OECD and European Commission also deemed these countries to have extremely high potential growth rates.⁶ In some instances, the adjustment of nominal interest rates in the boom countries resulted in negative real interest rates that boosted domestic demand, thereby also pushing up wages and prices. Excessive speculation became widespread, particularly in the real estate markets of countries such as Spain and Ireland. The euro thus provided a huge boost to growth in countries with overly high wage increases and inflation, in some cases even allowing them to achieve substantial budget surpluses. The strong growth in domestic demand meant that it took quite some time before the decline in their price competitiveness, which was getting worse with every passing year, and their growing current account deficits would become matters of urgency. Once again, endogenous market correction mechanisms failed to make any real difference.

These discrepancies in growth and inflation within the EMU left the eurozone's macroeconomic actors facing a series of virtually insurmountable challenges. Since the ECB has to base its policy on the average for the eurozone as a whole, the

⁶ Nonetheless, the possibility cannot be ruled out that the convergence in the interest rates of the eurozone countries' government bonds was linked to the subsequently confirmed expectation that the EU Treaty's "no-bailout clause" would turn out to be toothless when push came to shove.

single monetary policy was too expansionary for the high-inflation countries and too restrictive for those countries where inflation was lower. This already became apparent just two years after the introduction of the euro, when external stresses (the bursting of the “new economy bubble”, geopolitical tensions, the rise in oil prices and the recession in the US) led to a slowdown in Europe’s economic growth. Unlike the US Fed, the ECB only relaxed its monetary policy gradually because inflation rates in some of the eurozone countries were well above the ECB’s target. The euro appreciated by around 20% between 2002 and 2004 (trade-weighted average exchange rate). The double whammy of the global economic downturn and the appreciation of the euro hit Germany particularly hard because of its strongly export-oriented economy. In addition, the low wage settlements agreed for a two-year period as part of the Alliance for Jobs initiative meant that domestic demand in Germany was substantially weaker than in the rest of the eurozone. Germany entered a recession in 2001, leading to lower government revenue, increased unemployment benefit payments and rising social security contribution rates. This ultimately caused it to exceed the 3 percent deficit limit. The Stability and Growth Pact and the ECB’s restrictive monetary policy thus forced Germany to adopt a restrictive, procyclical policy during the 2001-2003 downturn. It was not even possible to take full advantage of the automatic stabilisers in order to cushion the impact of the recession. The fact that Germany was prevented from implementing the necessary economic policies to counter the recession resulted in a deeper and longer downturn, which in turn also damaged its future growth prospects.

This example illustrates the fact that when major divergences occur within the EMU, the eurozone’s macroeconomic actors are unable to provide an optimal response. One particularly disastrous consequence was that it proved impossible to maintain a common level of competitiveness within the eurozone. Instead, persistent inflation rate differences led to the development of significant macroeconomic imbalances between the eurozone countries. When added to the economic and fiscal policy consequences of the global financial and economic crisis, this resulted in major tensions within the EMU that have posed a threat to its very existence since the onset of the eurozone crisis in May 2010.

One of the principal causes of the growing competitiveness gap within the eurozone prior to the start of the global economic crisis involved wage policy developments associated with the asymmetric demand and price shocks caused by the introduction of the euro. The euro’s critics therefore see it as the root of the problem.⁷ However, if the Broad Economic Policy Guidelines – including the wage policy recommendations – had been followed, the eurozone would have been spared both major current account imbalances and their inevitable consequence of excessive foreign debt in the less competitive countries. Rather than the euro itself, it is the ongoing divergence of wage developments and the resulting macroeconomic imbalances that have brought the eurozone to the brink of the abyss. However, in no way does this interpretation place the blame on workers and the organisations that represent them, since even in the boom countries they were

⁷ The proponents of this view ignore the fact that, with the right economic policy coordination, the euro would have been – and can still be – a huge success story.

unable to protect their income levels during the period in question. Instead, the finger should be pointed at the striking lack of economic policy coordination within the eurozone. If market mechanisms fail to correct obvious imbalances in the eurozone, it is up to economic policymakers to counter these imbalances by implementing a coordinated macroeconomic policy. This is precisely what the macroeconomic actors, including the social partners, are tasked with doing by the Broad Economic Policy Guidelines. Accordingly, in order to prevent similar imbalances from occurring in the future, or at least to ensure that they are detected as early as possible, and in order to make sure that – for the good of Europe as a whole – the euro does not collapse, it is urgently necessary to improve macroeconomic policy coordination within the EMU.

It is not without reason that the guidelines' definition of the recommended range for wage increases is based on the ECB inflation target and medium-term productivity gains and is not linked to the current national inflation rate. This recommendation unquestionably implies that, under certain circumstances, workers may miss out on wage increases that are potentially achievable in their national market. In other situations, however, it could actually strengthen their bargaining position. Ultimately, though, it is the Community interest that provides the guidelines' wage policy recommendations with their legitimacy. The improvements in the eurozone's macroeconomic trends that would be expected to occur if the recommendations were followed would benefit employees and employers alike. Complying with these recommendations and abandoning procyclical wage formation would have been by far the most reliable way of preventing the current imbalances. Within the narrow constraints of the Stability and Growth Pact, it might have been possible to employ fiscal measures in order to counter the divergences in the eurozone. However, fiscal policy cannot act as a substitute for the correction of wage policy imbalances. Success can only be guaranteed through coordinated action on behalf of all the players.

In general, it can therefore be said that the primary cause of the macroeconomic imbalances in the eurozone crisis was not a lack of rules or a lack of transparency in the rules, but rather that the rules were not complied with and that there were no consequences for failing to comply with them. This led to the introduction of the MIP, which sets out the monitoring rules in greater detail, in 2011. In principle, wage policy recommendations can also be made as part of the MIP process. Other new aspects include the use of precisely defined indicators for monitoring purposes (e.g. unit labour costs and real effective exchange rates), the explicit definition of macroeconomic imbalances and when they should be classed as "excessive" and a detailed description of the "in-depth review" procedure (corrective arm).

This overhaul of the Maastricht/Lisbon architecture – as a result of (sadly long overdue) insight into the harmful effects of neglecting macroeconomic coordination – undoubtedly constitutes a step in the right direction. It is under the auspices of the MIP that the European Commission decided to address Germany's current account surplus in March 2014. The resulting in-depth review identifies significant wage moderation in Germany compared to other member states as one of the causes of

the imbalances. In the report “Macroeconomic Imbalances – Germany 2014”⁸ which was published in March 2014, the European Commission also attaches particular importance to wage developments and income distribution. In 2015 Germany once again was subject to an in-depth review by the European Commission. The European Commission concluded that “reinvigorating Germany’s aggregate demand would raise growth domestically and have the additional benefit of supporting the euro area recovery.” According to the European Commission “there is scope to strengthen Germany’s performance and at the same time contribute to foster growth dynamic and tackle downwards price pressures in the euro area as a whole.”⁹ The MIP can thus be regarded as a fundamentally suitable instrument for improving the surveillance of the broad guidelines’ wage policy recommendations, thereby making a substantial contribution to overcoming the eurozone crisis. Nevertheless, in its current incarnation the MIP falls a long way short of guaranteeing the level of macroeconomic coordination required by the EMU. As well as suffering from a number of significant flaws that need to be remedied, it still falls short of the mark in terms of macroeconomic coordination.

3. Competitiveness: identifying the required action

Any process aimed at preventing and correcting macroeconomic imbalances, especially with regard to competitiveness, requires a transparent procedure for diagnosing imbalances together with as broad as possible a consensus on the appropriate economic policy responses for areas identified as requiring action. In a recent report for the Federal Ministry for Economic Affairs and Energy¹⁰, the Kiel Institute for the World Economy (IfW-Kiel) adopts the extreme view that the term ‘macroeconomic imbalance’, which is of fundamental importance to the MIP, is in fact a very vague expression and that the concept of national competitiveness is extremely problematic. According to the IfW, apart from in the realm of financial sector regulation, it is hard to conceive of any international contagion effects that would require a macroeconomic surveillance procedure.¹¹ Any harmful cross-border effects (e.g. falls in growth and employment) resulting from wage and price adjustments should simply be accepted as long as they do not impair the functioning of the common market.¹² According to the IfW, the term ‘competitiveness’, which is addressed by the MIP-Regulation EU No 1176/2011, cannot meaningfully be applied to economic areas.¹³ In other words, the Kiel Institute argues that any attempt to monitor divergences in competitiveness within the eurozone is doomed from the outset to be either a waste of time or potentially

⁸ See European Commission: Macroeconomic Imbalances – Germany 2014, European Economy, Occasional Papers, No. 174, http://ec.europa.eu/economy_finance/publications/occasional_paper/2014/op174_en.htm.

⁹ http://ec.europa.eu/europe2020/pdf/csr2015/cr2015_germany_en.pdf, S. 52

¹⁰ IfW Kiel study (in German): Das europäische Verfahren zur Vermeidung und Korrektur makroökonomischer Ungleichgewichte - Auswertung der bisherigen Erfahrung und mögliche Reformansätze, 2014, <http://www.bmwi.de/BMWi/Redaktion/PDF/S-T/studie-das-europaeische-verfahren-zur-vermeidung-und-korrektur-makroekonomischer-ungleichgewichte,property=pdf,bereich=bmwi2012,sprache=de,rwb=true.pdf>

¹¹ Ibid. p. 109.

¹² Ibid. p. 108.

¹³ Ibid. p. 110.

even harmful. This paper takes the opposite view, arguing that this surveillance is in fact essential to the long-term survival of any monetary union.

Nonetheless, one thing the Kiel Institute is right to criticise is the fact that the MIP fails to provide a clear framework for analysing competitiveness. No fewer than five of the MIP scoreboard indicators (current account balance, net international investment position, export market shares, nominal unit labour cost, real effective exchange rates) are connected with competitiveness. However, the indicators fail to clarify how competitiveness problems should be identified, their extent and their causes and which economic policy measures can be used to correct them.

A confusing picture emerges when different real effective exchange rates (REERs) are used as an indicator of competitiveness. This is illustrated in Figures 1 – 3, where the various competitiveness indicators are attributed a value of 100 in the baseline year of 1999. The REER 42 indicator used in the MIP scoreboard (Fig. 1, trade-weighted consumer price indexes compared against 42 countries), for instance, fails to point up any major issues for Greece throughout the entire period, even though this country has in fact been suffering from serious current account problems. On the other hand, the 2008 score for Ireland appears to highlight an extremely alarming situation, whereas Ireland actually had no major current account problems during the period in question. However, unlike Fig. 1 which shows deviations in relation to a baseline period, the MIP scoreboard only looks at upper and lower thresholds for rates of change over a three-year period. In Germany's case, the indicator value for 2012 that points to an improvement in competitiveness of almost 9% turns out to be a false alarm. The indicator for 2004, on the other hand, mystifyingly suggests 7.5% deterioration in Germany's competitiveness. Different price competitiveness indicators also give different signals regarding the rebalancing progress achieved since 2008. In contrast to the MIP's REER 42 indicator, the unit labour cost-based indicators REER 37 (Fig. 2) and REER EA-18 (Fig. 3) indicate that significant rebalancing progress has already been achieved.

Figure 1

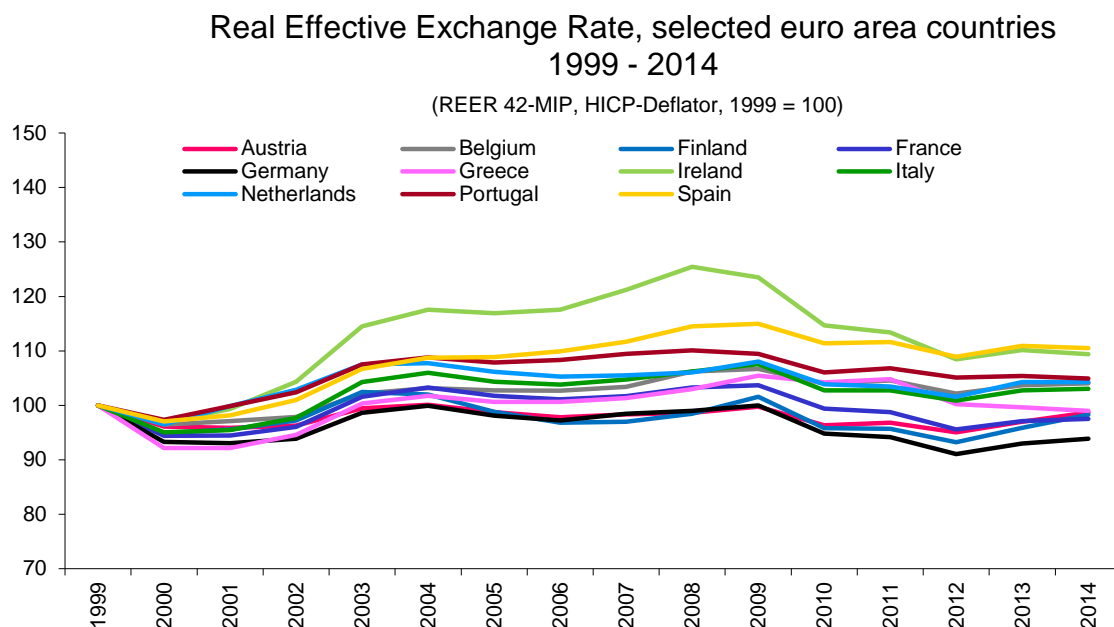


Figure 2

Real Effective Exchange Rate, selected euro area countries
1999 - 2014

(REER 37 ULC-Deflator, 1999 = 100)

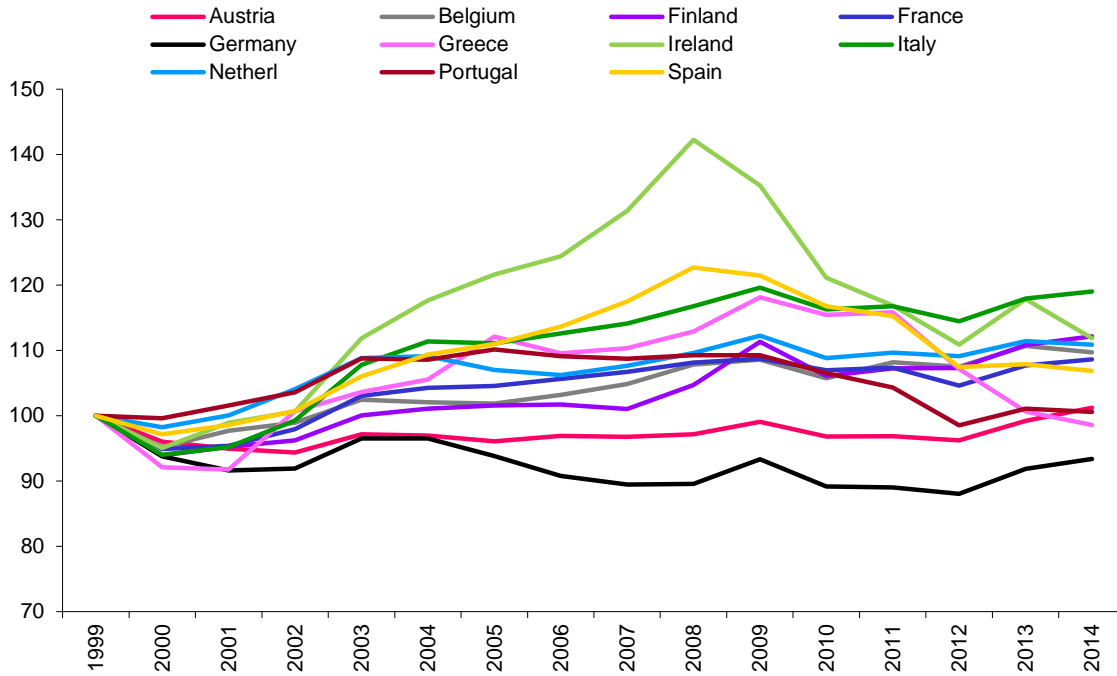
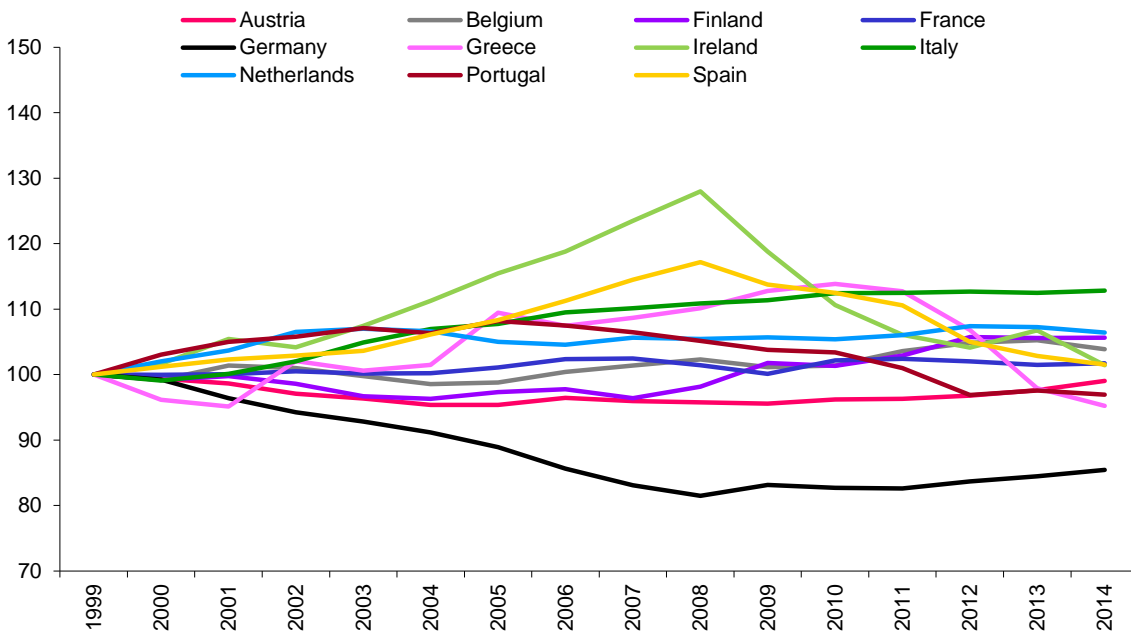


Figure 3

Real Effective Exchange Rate, selected euro area countries
1999 - 2014

(REER EA18 ULC-Deflator, 1999 = 100)



All three indicators shown here for illustrative purposes are in fact unsuitable for recording quantitative deviations from competitiveness targets. The choice of 1999 as a baseline year is completely arbitrary. For example, if 1995 were to be taken as the baseline year, the divergences would be significantly higher. So when was the level of competitiveness in fact broadly similar among all the eurozone countries – was it 1995 or 1999? The simple answer is, of course, that it was neither 1995 nor 1999, nor indeed any other year. The choice of a baseline year will always be arbitrary. Even if there was a year when the competitiveness of the different countries was comparable, shifts in non-price competitiveness could have since altered the equilibrium competitiveness levels of the eurozone countries. Whatever real effective exchange rates we use, they will never provide us with an objective basis for evaluating competitiveness imbalances. Without a clear reference value for measuring competitiveness, it is impossible to accurately determine either the extent of the progress already made on rebalancing or any remaining rebalancing requirements. Indeed, it is even impossible to tell whether changes in the indicators point to a positive rebalancing or an increased need for corrective action.

In view of the above, it is hardly surprising that the experts differ significantly in their assessment of the extent of competitiveness rebalancing required in the eurozone. At the beginning of 2013, H.-W. Sinn was still advocating a real devaluation of 25-35% in Spain, Portugal and Greece, 15-25% in France and 5-15% in Italy. However, Sinn also claimed that this would only be enough to realign competitiveness if it was accompanied by a real revaluation of 15-25% in Germany.¹⁴ On the other hand, the Bundesbank¹⁵, the German Council of Economic Experts¹⁶ and the Institute for Economic Research¹⁷ were all far more optimistic even at that point in time, owing to the rebalancing progress that had already been achieved. The differences between these assessments can largely be attributed to the use of different real effective exchange rates and baseline years. H.-W. Sinn builds his conclusions primarily on price competitiveness indicators based on the price trends of the aggregate value added (GDP deflator), taking 1995 as his baseline year. The Bundesbank and the Institute for Economic Research place greater emphasis on unit labour cost-based indicators and take 1999 as their baseline year. Meanwhile, the German Council of Economic Experts, which also takes 1999 as its baseline year, takes an approach somewhere between the two positions outlined above, arguing that the actual level of rebalancing in the eurozone is overstated by unit labour cost-based (ULC-based) indicators and understated by GDP deflator- or consumer price-based indicators.¹⁸

Indicators based on the GDP deflator suffer from certain drawbacks. In addition to unit labour costs, the GDP deflator also incorporates corporate financing costs and

¹⁴ See H.-W. Sinn: Austerity, growth and inflation: Remarks on the Eurozone's unresolved competitiveness problem, in: *The World Economy*, Volume 37, 2014, pp. 1 – 13.
<http://onlinelibrary.wiley.com/doi/10.1111/twec.12130/pdf>.

¹⁵ See Deutsche Bundesbank (in German): Zum Abbau der Leistungsbilanzdefizite in den Peripherieländern des Euro-Raums, *Monatsbericht der Deutschen Bundesbank*, November 2012, pp. 22-30.

¹⁶ German Council of Economic Experts Annual Economic Report 2013/14, pp. 44 – 59.

¹⁷ J. Matthes: “Rebalancing der Leistungsbilanzdefizite in den Peripheriestaaten des Euroraums”, (in German), in: *IW-Trends* 1/2012, pp. 1 – 19.

¹⁸ German Council of Economic Experts Annual Economic Report 2013/14, p. 54.

profits, as well as indirect taxes minus subsidies. However, since the V.A.T. on exports is refunded, V.A.T. increases do not harm price competitiveness, but possibly internal demand. In crisis countries that have raised V.A.T. rates there is a certain quantitative impact, albeit not a terribly important one. It would, on the other hand, unquestionably be surprising if higher corporate profits were to have the same effect on an economy's price competitiveness as higher wages. Higher profits, especially in the export sector, can in fact also be a consequence of improved competitiveness. Temporarily higher profits can strengthen competitiveness if they alleviate companies' financing problems and enable higher levels of investment.

H.-W. Sinn avoids using ULC-based real effective exchange rates as indicators of competitiveness because they would erroneously suggest an increase in competitiveness if only unproductive businesses exit the market because of the crisis and unproductive workers are made redundant (this phenomenon is known in German as 'Entlassungsproduktivität' or 'dismissal productivity'). However, the value of a company's capital stock can also fall as a result of the crisis, offsetting any productivity gains resulting from headcount reductions. Productivity does in fact tend to follow a procyclical pattern, falling during a crisis and increasing during an investment- and innovation-based upturn. This pattern can also be observed in Greece, for example, where productivity rose by 20% during the dynamic growth phase from 1998 to 2004 and fell by 8.5% during the recent crisis. This drop in productivity is causing additional damage to Greek competitiveness in its own right. Seen in this light, it could be argued that the improvement in Greece's competitiveness since 2010 may if anything have been underestimated. In any case, the improvement in Greece's productivity suggested by ULC-based indicators is more than just a statistical artefact caused by the 'dismissal productivity' phenomenon. On the other hand we are still faced with the problem that – whatever deflator is used – the indicators remain unable to tell us whether an adequate level of competitiveness has already been reached or the extent of any rebalancing that may still be required. Ultimately, the debate about what constitutes the "right" deflator for real effective exchange rates isn't all that important. What really matters is to have meaningful reference values for competitiveness so that robust assessments can be made both of rebalancing progress and of any remaining rebalancing requirements. Although general trends can be identified if a sensible baseline period is chosen, as we have already seen, a relatively wide range of conclusions can be reached depending on the baseline year selected.

The analysis undertaken as part of the Independent Annual Growth Survey 2015 (iAGS report 2015)¹⁹ constitutes a significant advance with regard to this issue. On the basis of what are deemed to be stable and sustainable international investment positions, the authors calculate the amount of rebalancing still required by selected eurozone countries using GDP deflator-based real effective exchange rates. The iAGS report comes to the conclusion that, with the exception of Greece, the

¹⁹ Independent Annual Growth Survey, Third Report 2015, pp. 165 – 189.

<http://www.socialistsanddemocrats.eu/de/publications/independent-annual-growth-survey-third-report-iags-2015>.

realignment of the crisis countries' competitiveness has already been completed. Ireland, Italy and Spain are once more in need of a revaluation, while Portugal is the only country where there is still a slight devaluation requirement. Furthermore, the need for rebalancing in Greece only exists if, in addition to balancing its current account, the country is required to achieve a significant improvement in its international investment position within the next 20 years. If Greece were only required to achieve a sustainable international investment position by some much later deadline, it too would already require a revaluation. The iAGS study identifies a significant revaluation requirement for Germany and the Netherlands and a devaluation requirement for Belgium and Finland, notwithstanding the fact that these two countries are not – at least for the time being – crisis countries.

In principle, there is no reason why the MIP could not employ a similar analytical approach to the iAGS report in order to identify measures for correcting divergences in competitiveness and support their implementation. In practice, however, it falls a long way short of this goal, not least because there is no consensus at European level regarding the real causes of Europe's competitiveness problems.

4. The causes of competitiveness problems

In its National Reform Programme 2014, the German government observes with some satisfaction that “competition on price only plays a lesser role in explaining the growth in the German trade balance”. Moreover, a study by staff members of the German Council of Economic Experts²⁰ reveals “that the price elasticity of German exports is relatively low; German exports tend to react more to changes in global demand”.²¹ In 2012, the European Commission published a comprehensive analysis of the causes of the current account imbalances in the EU and the eurozone. The principal conclusion of this study is that wage developments did not play a significant role.²² The Commission identifies the main cause of the current account imbalances in the eurozone as being demand effects driven by the convergence in interest rates due to the introduction of the euro. It also cites demographic trends and non-price factors as having a certain role. It argues that demand effects following the introduction of the euro caused country-specific endogenous (market-driven) wage and price adjustments.²³ To exaggerate only slightly, the Commission's reasoning in its analysis of the current account balances is more or less as follows: since there were no notable exogenous wage shocks in

²⁰ See S. Breuer, J. Klose: Who gains from nominal devaluation? An empirical assessment of Euro-area exports and imports, Working Paper, No. 04/2013, German Council of Economic Experts; http://www.sachverstaendigenrat-wirtschaft.de/fileadmin/dateiablage/download/publikationen/arbeitspapier_04_2013.pdf.

²¹ See Federal Ministry for Economic Affairs and Energy (BMWi), loc. cit., p. 9.

²² See European Commission: Current account surpluses in the EU, European Economy 9/2012: “Overall, there is no evidence that wage developments are at the root of surpluses”, loc. cit., p. 91.

²³ In the specific case of Germany, the study comes to the following conclusions: “However, the ULC response may be the endogenous response to low demand and output growth rather than the consequence of exogenous shifts in labour supply.” (ibid, p. 84). “The impact of interest rate convergence on the trade balance operates mainly through the reduction in domestic demand and activity, which via lower factor demand also translates into a reduction in labour costs.” (p. 87). In the analysis of the trade balance to GDP ratio, wage restraint is considered to have made only a moderate contribution to the trade surplus. The principal causes of the trade surpluses are cited as interest rate convergence and external shocks (p. 88).

the EMU and since economic policy exerted very little influence on wage developments, wage developments did not make a major contribution to the macroeconomic imbalances. In other words, they were a symptom rather than a cause. The Commission believes that since the endogenous wage responses during the period in question would not be expected to differ significantly from previously observed response patterns, there must be deeper-rooted explanations for the current account and wage trends.

This is in line with the Commission's renowned and deeply-held conviction that economic policy should not intervene unnecessarily in macroeconomic developments. Instead of drawing the obvious conclusion that endogenous wage adjustments can significantly strengthen and perpetuate macroeconomic imbalances within the EMU, it prefers to conclude that – from an economic perspective – wage developments cannot be the cause of the imbalances. According to this interpretation, there is no need even to ask – let alone answer – the key economic policy question of whether a better economic outcome might have been achieved through appropriate macroeconomic coordination incorporating wage developments.

German Council of Economic Experts staff members S. Breuer and J. Klose calculated the long-term effects of wage and price adjustments on foreign trade imbalances. They found the long-term export and import elasticities of the eurozone countries to be surprisingly low. France and Portugal were the only countries where the sum of the estimated absolute values for export and import elasticities was greater than one, thereby meeting the Marshall-Lerner condition for “normal” foreign trade responses to changes in the real exchange rate (i.e. an improvement in the balance of trade if the exchange rate falls and a deterioration if it rises). In terms of economic policy, this would mean that wage and price adjustments are of little if any use for correcting current account imbalances.

Even though the data should always have the final say, there is no denying that these findings appear implausible, to put it mildly.²⁴ If the Marshall-Lerner condition is not met over the long term, a country could raise the price of its exports as much as it liked while still continuing to increase its balance of trade surplus. This would amount to the invention of an economic perpetual motion machine. One possible explanation for the low estimates could be the high degree of interdependence between domestic demand and wage developments. Weak domestic demand (leading to lower demand for imports) results in downward pressure on wages. Conversely, low wage increases also cause domestic demand to slow down. In econometric terms, this makes it difficult to separate the influence of these two factors on trade and current account balances.

So, for the purposes of the MIP, what preliminary conclusions can be drawn with regard to competitiveness? The crises that have occurred since 2008 have demonstrated that persistent current account imbalances can pose a major threat to the stability of the international financial markets, especially against a backdrop of

²⁴ The authors themselves describe it as a “puzzling result” that is partly “in contradiction to theory”, S. Breuer, J. Klose, loc. cit., p. 17.

growing uncertainty about the sustainability of foreign debt. This highlights the importance of the economic policy goal of pursuing balanced current accounts over the longer term. But how can competitiveness problems and rebalancing requirements be identified, and how can these problems be prevented or corrected? Current account balances can be temporarily distorted by demand fluctuations, meaning that the balances themselves are not a good short-term indicator of competitiveness. It is likely that slumps in domestic demand have played a significant part in the rebalancing that has been observed since 2008 in particular. A return to stronger economic growth could well be accompanied by a sharp rise in imports, potentially causing another rapid build-up of current account deficits. Consequently, it is important to use an appropriate price competitiveness indicator in addition to current account balances. It is also absolutely essential to ensure that changes in non-price competitiveness are properly taken into account.

5. Current failings in competitiveness monitoring

Competitiveness imbalances among the member states could have been prevented if wage developments in the eurozone countries had been monitored more effectively and corrected as soon as possible in accordance with the recommendations of the Broad Economic Policy Guidelines. However, monitoring divergences in competitiveness solely on the basis of the guidelines' wage policy recommendations (which state that unit labour costs should rise in line with the ECB's inflation target) may not be the ideal solution either. The guidelines' wage policy recommendations would only serve to adequately monitor competitiveness under two conditions:

- If a country had the same level of competitiveness as all the other eurozone countries at the baseline time point, i.e. when they joined the EMU.
- If the equilibrium real effective exchange rate – i.e. the REER that is compatible with a balanced current account over the long term – were to continue to evolve in parallel across all the eurozone countries.

Neither of these two conditions was met in the past, and they are unlikely to be met in the future either. Instead, several countries with substantially overvalued or undervalued currencies have joined the eurozone. In addition, it can be assumed that the equilibrium real effective exchange rates have diverged since the EMU was established. Depending on the size of these effects, more or less serious imbalances in the eurozone countries' competitiveness could still have occurred even if the guidelines' wage policy recommendations had been strictly complied with. It is therefore highly advisable to monitor other aspects of competitiveness over and above wage developments.

However, one of the key weaknesses of the MIP is that its main indicators for monitoring competitiveness are based purely on rates of change rather than on deviations from targets or reference values. The result is that, at least at the level of the indicators, it is currently unclear whether any observed changes should be interpreted as tending towards the establishment of a balance or towards causing an imbalance. While the in-depth reviews may well turn up additional information, they also make the process somewhat more arbitrary and less transparent.

Other serious weaknesses in the MIP include the following:

- Indicators provide an early warning of macroeconomic imbalances when certain thresholds are exceeded. However, some of these early warning thresholds are asymmetrically structured. For instance, in the “current account balance” indicator, the threshold value for current account deficits is 4% of GDP, whereas it is 6% for current account surpluses. If it is assumed that the eurozone as a whole wishes to pursue the economic policy goal of maintaining a balanced current account in relation to the rest of the world, then the countries with surpluses need to balance out the countries with deficits. Accordingly, current account surpluses need to be assessed just as critically as deficits. There is therefore absolutely no justification for the asymmetry in the “current account balance” indicator thresholds, either in theoretical or in economic policy terms. Indeed, they devalue the MIP and pose a threat to its acceptance.
- The MIP fails to draw a clear distinction at the indicator level between competitiveness problems within the eurozone and competitiveness problems between eurozone countries and countries outside of the eurozone. The latter can be corrected through adjustments to the euro’s nominal exchange rate, using either a free floating or managed floating approach. However, this option is no longer available for correcting divergences within the eurozone, making it much more difficult to correct such divergences. Consequently, the MIP should pay particular attention to the prevention and, where necessary, correction of these divergences from an economic policy perspective.
- Substantial imbalances may already have built up before the indicators signal the need for action. For instance, the MIP scoreboard “real effective exchange rate” indicator only raises the alarm if the rate of change is 5% or more after a period of three years, while the threshold is 6% or more over five years for the “export market shares” indicator. The upshot is that smaller but longer-lasting imbalances may only be identified very late in the day, if at all.
- The MIP only recommends corrective action to those countries for which it has identified macroeconomic imbalances. However, within the meaning of Art. 121 of the TFEU, measures to correct macroeconomic imbalances are of common concern to all of a monetary union’s member states. It is therefore the fundamental responsibility of all the actors to jointly correct any imbalances. It is necessary for all the eurozone countries to work together in order to optimise the rebalancing, i.e. to minimise negative impacts on growth and employment and, if necessary, to ensure that the burden of the rebalancing is fairly distributed among them. It can be problematic, particularly in terms of competitiveness, to place the entire rebalancing burden on the less competitive countries. And it is in any case difficult to clearly pin the blame on individual countries if we wish to apply the principle that those responsible for the problem should also be responsible for dealing with it. Current account deficits can of course arise if wages and prices rise excessively in a particular country. However, they may equally come about as a result of wages and prices in other countries falling or not rising fast enough. In any event, the costs of the rebalancing process are a far more important issue than who is to blame. In

order to restore their competitiveness, less competitive countries may in some cases be faced with the risk of deflationary processes. The macroeconomic costs of the resulting recessions and unemployment can potentially be extremely high. If rebalancing measures are shared between competitive and less competitive countries, on the other hand, it should prove possible to significantly reduce if not completely prevent the overall negative impacts of the rebalancing on growth and employment.

- The corrective action recommended by the MIP includes both macroeconomic and structural measures. This makes the process unnecessarily cumbersome. Structural reforms aimed for example at boosting productivity growth are very rarely an appropriate tool for correcting macroeconomic imbalances. They generally take a long time to implement and their impact is usually only felt over the longer term. In the main, their effectiveness is not tied to the state of the economy at any given time. Reforms to foster efficiency, productivity and growth potential should be on the agenda regardless of whether there are any macroeconomic imbalances. However, they are not suitable for managing demand and competitiveness across the economy as a whole. For instance, it makes little sense to recommend that an EMU member state should deregulate the liberal professions in order to strengthen domestic demand. If regulation creates inefficient structures, then it still needs to be reformed even if domestic demand is strong. Only macroeconomic policy is capable of managing both aggregate national demand and the measures needed to correct macroeconomic imbalances. As described in the Broad Economic Policy Guidelines, in a monetary union this requires cooperation between the union's macroeconomic policy actors. This is by no means to suggest that structural reforms have no impact on macroeconomic developments. Supply-side reforms promote long-term growth and employment. In the short term, however, they may actually have a negative impact on growth and employment. When devising macroeconomic policies, it is therefore especially important to take account of the interactions between concrete reforms and economic development. In other words, the formulation and implementation of growth- and stability-oriented macroeconomic policies should take the current reform agenda into account. However, structural reforms themselves should not be included in the MIP process.

6. Components of a procedure for monitoring competitiveness at European level

The aspects that should ideally be addressed by a European-level process for preventing and correcting divergences in competitiveness can be summarised as follows:

1. The process should be based on objectives for the sustainable development of current accounts. At the very least, it should clearly define the current account developments and net investment positions that are considered to be unsustainable. Unsustainable current account surpluses should be regarded just as seriously as unsustainable current account deficits. Moreover, large,

long-term current account imbalances between the eurozone and the rest of the world pose global risks and should therefore also be avoided.²⁵ In contrast to the current incarnation of the MIP, there should be a clear distinction at the indicator level between the competitiveness of the eurozone as a whole and the divergences in competitiveness within the eurozone. The indicator should be specifically geared towards the surveillance of divergences in competitiveness within the euro area.

2. The next step should be to estimate the degree of price competitiveness realignment required in order to restore sustainable net investment positions and current account trends whilst at the same time minimising the costs of the rebalancing and ensuring that they are fairly distributed. In a monetary union, where this rebalancing cannot be delivered through nominal revaluations and devaluations, it could in principle come about as a result of wage and price adjustments, different rates of productivity growth and changes in non-price competitiveness. Over the longer term, productivity and non-price competitiveness can be strengthened through structural reforms. However, such reforms are extremely slow to take effect and it is very difficult to quantify their impact reliably. Where potential structural reforms are identified, it makes sense to implement them regardless of a country's current competitiveness. For these three reasons, they should not be included as part of the rebalancing process. Any reforms implemented by the eurozone countries in these areas should result in a corresponding change to the identified wage and price adjustment requirements, measured as a quantitative deviation from a clearly defined reference value. Wage and price adjustments should only be used to address those imbalances that cannot be corrected through short- to medium-term supply-side reforms.
3. The third step would involve formulating, implementing and monitoring compliance with recommendations for wage and price developments in order to deliver the price competitiveness adjustments identified as being necessary.

This process should be kept as simple and transparent as possible. It would be advisable to begin by evaluating different analytical approaches and estimation methods in order to establish which are most suitable. However, it is important to recognise that there will always be a degree of uncertainty surrounding any assessment of rebalancing requirements. In order to ensure the necessary acceptance, the methods used should ideally be simple, robust and theoretically and empirically well-founded. However, even more important than sophisticated estimation methods is the need for a policy consensus regarding the nature of the relevant rebalancing requirements. Any decisions taken at European level concerning which estimation methods should be used could of course be modified in the light of new findings. The next section takes a more detailed look at the three requirements outlined above:

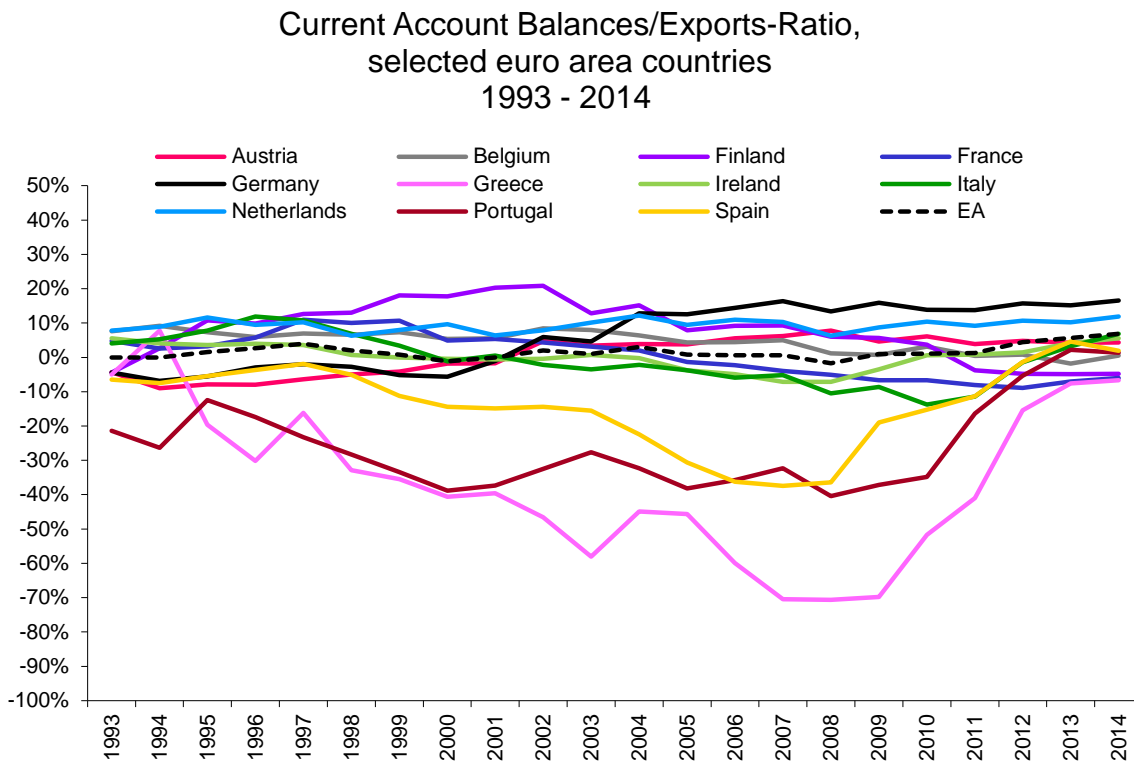
²⁵ In the short term, the strong devaluation currently being experienced by the euro can help to mitigate the eurozone crisis by boosting foreign trade. However, this is a less-than-ideal strategy for overcoming the crisis, since it effectively sows the seeds of new global imbalances and future crises.

Point 1: The following fundamental considerations should form the basis for assessing competitiveness rebalancing requirements in the eurozone. The ratio of current account balance²⁶ to export levels (Fig.4) can be expressed as the deviation of the current real effective exchange rate from (unknown) long-term equilibrium values:

$$(1) \quad \frac{CA}{EX} = c (REER - REER^*)$$

where CA = current account balance
 EX = exports
 $REER$ = real effective exchange rate
 $REER^*$ = equilibrium real effective exchange rate²⁷

Figure 4



Over the longer term, the focus on exports serves to eliminate effects caused by the trend for the growth in global trade (as a rule, global trade grows somewhat faster than global value-added). Demand effects that are independent of global trade are indirectly captured through the macroeconomic wage and price ratios. This approach is based on the “working hypothesis” that there is a close reciprocal relationship between domestic demand and wage developments. An alternative to focusing on the deviation

²⁶ Current account balances should also include foreign trade with third countries, since divergences in competitiveness within the eurozone also affect external markets. In addition to receipts from trade in goods and services, international interest payments also go into the current account. These are also affected by divergences between REER and REER* in previous years.

²⁷ The European Commission regularly publishes different REER indicators, http://ec.europa.eu/economy_finance/db_indicators/competitiveness/data_section_en.htm.

of real effective exchange rates from the equilibrium value would be to set target values for sustainable long-term international investment positions to be achieved within a given period of time – this is in fact the approach taken by the 2015 iAGS report referred to elsewhere in this paper. If transfer payments are excluded, then assuming that the interest rates on financial assets are homogeneous, the current account balance is equal to the balance of trade plus interest on net foreign receivables. The international investment position is then equal to the accumulated past current account balances. In practice, however, changes in international investment positions are frequently brought about chiefly through changes in the value of foreign receivables and liabilities. Furthermore, in countries experiencing dynamic growth, high foreign debt to domestic value ratios can fall relatively quickly. For all practical purposes, it should therefore usually be sufficient to keep real effective exchange rates somewhere in the region of the values that guarantee a balanced current account over the longer term.

Point 2: In principle, the proposed approach makes it possible to derive a quantitative estimate of rebalancing requirements. The equilibrium exchange rate $REER^*$ is the exchange rate that is compatible with a balanced foreign trade account over the longer term. As such, it constitutes the desired target and reference value. However, owing to the sum of the effects resulting from changes in non-price competitiveness, it is not time-invariant. In principle, the proposed approach allows the sum of import and export elasticities and the development of $REER^*$ to be estimated over time, using the following equation:²⁸

$$(2) \quad c = \eta_{EX} - \eta_{IM} + 1$$

Once valid estimates for the sum of import and export elasticities have been derived, it is possible to determine c . Equation (3) then makes it possible to estimate the development of $REER^*$ over time:

$$(3) \quad REER^*_t = REER_t - \frac{1}{c} \frac{LB}{EX}$$

We do not claim to be putting forward valid estimates for the elasticities and $REER^*$. However, estimates based on annual values using simple OLS regressions do allow the following assumptions to be made:

- After their exchange rates were pegged (in effect from around 1995 for the EMU's founding members) there was a particularly close correlation for almost all the eurozone countries between CA/EX and the ULC-based $REER$ EA-18, with the exception of the Netherlands. Figures 5 – 8 illustrate this finding for the case of Germany. The figures show the correlations between the current account balance-to-exports ratio and the ULC-based and GDP deflator-based

²⁸ η_{EX} and η_{IM} denote export and import elasticity. It is intuitively easy to understand that the current account will remain unaffected by changes in the real exchange rate if the corner solution to the Marshall-Lerner condition is met exactly, i.e. if the sum of the elasticities is equal to 1. Mathematically, this correlation follows from the partial derivative of equation (1) after $REER$, taking into account that $CA = EX \cdot REER - IM$. If c is negative, the current account reacts “normally”. This correlation only holds exactly if the current account is balanced at baseline. If $CA \neq 0$, it holds approximately.

real effective exchange rates REER EA-18 and REER 37. The explanatory power of the two REER EA-18 exchange rates is significantly higher than that of the REER 37 exchange rates (see Table 1). One possible explanation is that the REER 37 exchange rates also incorporate fluctuations in the nominal exchange rate, i.e. the ratio between the euro and the currencies of countries outside the eurozone. If nominal exchange rate fluctuations are not taken to signify permanent changes in the terms of trade, trade flows could – at least in the shorter term – react more weakly to occasional highly volatile fluctuations in nominal exchange rates than to comparatively steady changes in unit labour costs or GDP deflators.²⁹ Trade relations between the eurozone countries and countries outside the eurozone are also largely determined by divergences in competitiveness within the eurozone. The choice of deflator for the real effective exchange rates is less important. For Germany and other euro area countries, there is a clear advantage to using a ULC-based deflator approach (see Table 1). In the case of the Netherlands, there is in essence no close correlation between current account balance and real effective exchange rates for the period in question. This is presumably connected with the particular importance of energy exports in this country.

Table 1

Table 1a

Correlation of Current Account Balance to Export-Ratio (CA/EX) and ULC-based Real Effective Exchange Rates (R²)

	Austria	Belgium	Finland	France	Germany	Greece	Ireland	Italy	Portugal	Spain
REER EA18 ULC	0.88	0.48	0.45	0.49	0.9	0.46	0.76	0.44	0.64	0.88
REER 37 ULC	0.74	0.41	0.56	0.3	0.56	0.41	0.45	0.28	0.32	0.52

Table 1b

Correlation of Current Account Balance to Export-Ratio (CA/EX) and GDP-Deflator Real Effective Exchange Rates (R²)

	Austria	Belgium	Finland	France	Germany	Greece	Ireland	Italy	Portugal	Spain
REER EA18 GDP	0.58	0.47	0.11	0.54	0.84	0.3	0.56	0.5	0.13	0.7
REER 37 GDP	0.54	0.33	0.06	0.05	0.49	0.23	0.49	0.46	0	0.36

²⁹ This conclusion is supported by the previously cited study carried out by staff members of the German Council of Economic Experts, see p. 12 and p. 19 *ibid.*

Figure 5

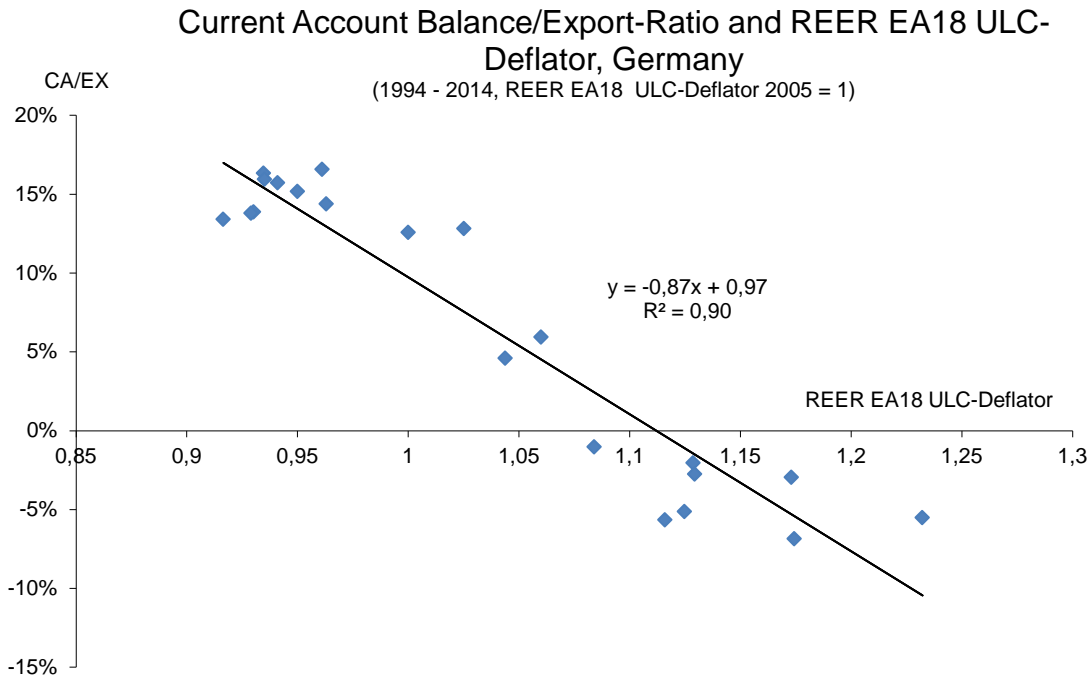


Figure 6

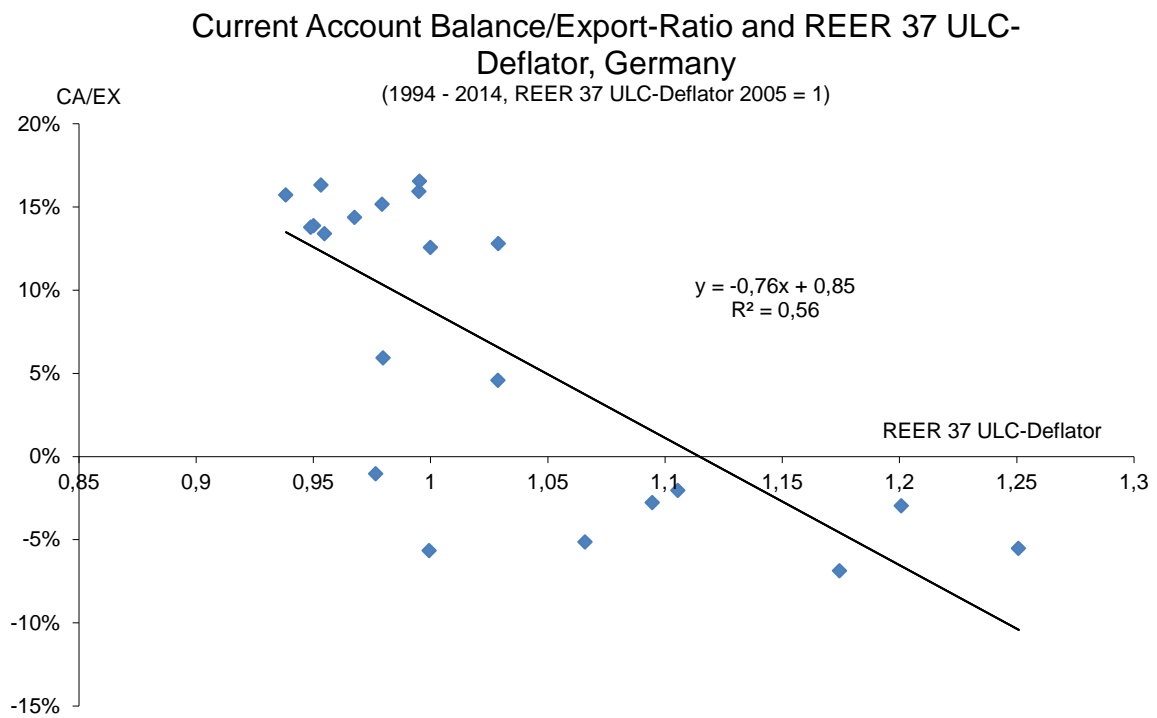


Figure 7

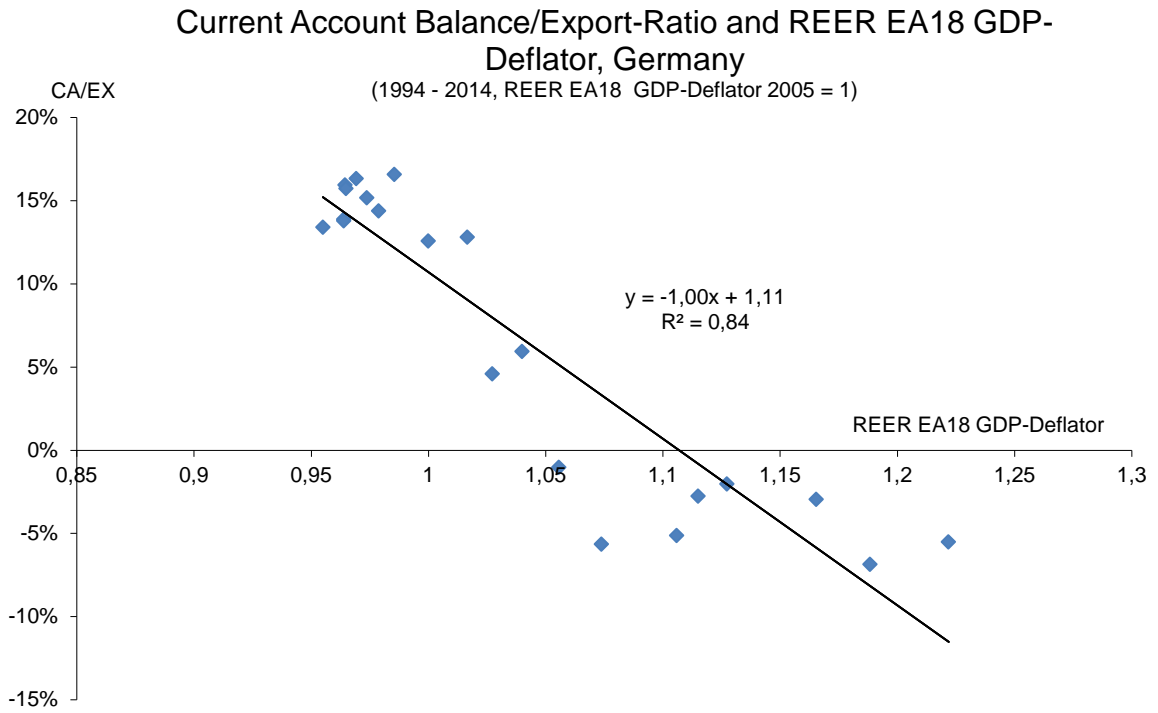
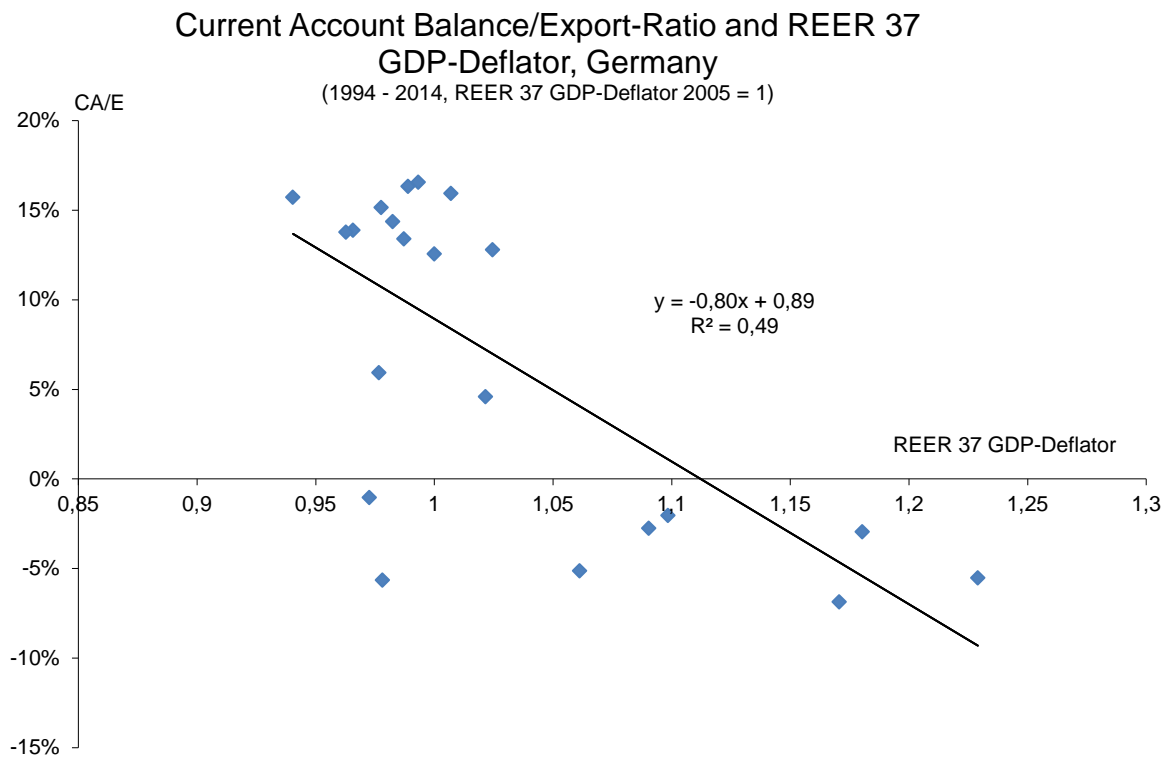


Figure 8



- The sums of the absolute values for export and import elasticities are significantly greater than one for all major euro area countries (except for the Netherlands), thereby meeting the Marshall-Lerner condition (see Table 2). Relatively low values are recorded by Ireland (1.4), and Italy (1.7), Germany (1.9) and Belgium (2.1), while Greece (2.7), Portugal (3.3) and France (6.7) are all at the upper end of the scale. With respect to France we should take into account that the variation of REER EA 18 ULC-based over the period from 1994 to 2014 is extremely small, implying increased uncertainty of elasticity estimates.

Table 2:

Table 2
Sum of export and import elasticities of major euro area countries

	Austria	Belgium	Finland	France	Germany	Greece	Ireland	Italy	Portugal	Spain
REER EA18 ULC	2.5	2.07	2.82	6.67	1.86	2.72	1.38	1.72	3.33	2.53
REER 37 ULC	1.83	1.44	2.16	1.75	1.76	2.51	1.2	1.51	2.8	1.88

- For some countries, changes in non-price competitiveness (REER*) also play a significant role. For the period 1995 – 2014 the catching-up countries of Estonia (3.9%), Latvia (3.7%) and Slovakia (3.6%) show high average annual increases in their real effective exchange rate (ULC-based REER-EA18) without detriment to their external balance. In Malta, meanwhile, the real exchange rate rose by an average of approx. 1% a year (Fig. 9). When adjusted for current account balance fluctuations,³⁰ Ireland (0.4%) and Portugal (0.2%) also show slight improvements in their non-price competitiveness for this period (average annual increase 1995 – 2014). Minor decreases are recorded in Belgium (-0.2%), Finland (-0.2%) and France (-0.1%). The remaining eurozone countries recorded no significant change over the whole period. In Germany's case, too, there was no evidence to suggest an improvement in non-price competitiveness over the period in question (see Fig. 10).

³⁰ As calculated using equation (3), based on estimated values for c and normalisation of the mean REER* value to 1.

Figure 9

Euro Area Countries with significantly improving
Non-Price-Competitiveness
(REER EA18 ULC-Deflator 1994 = 1)

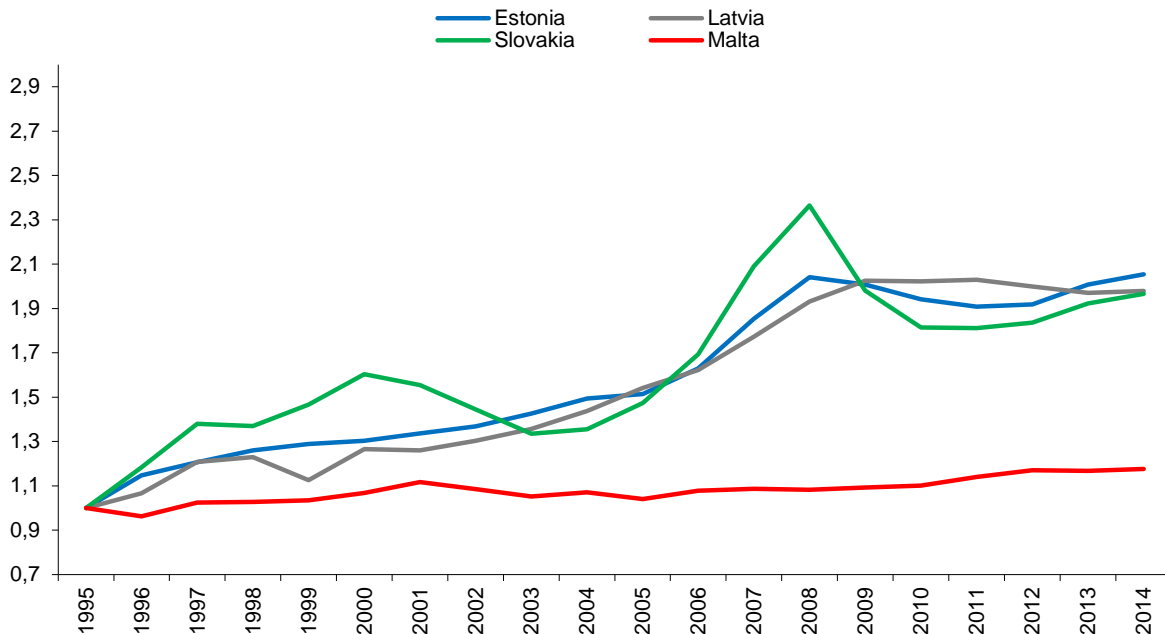
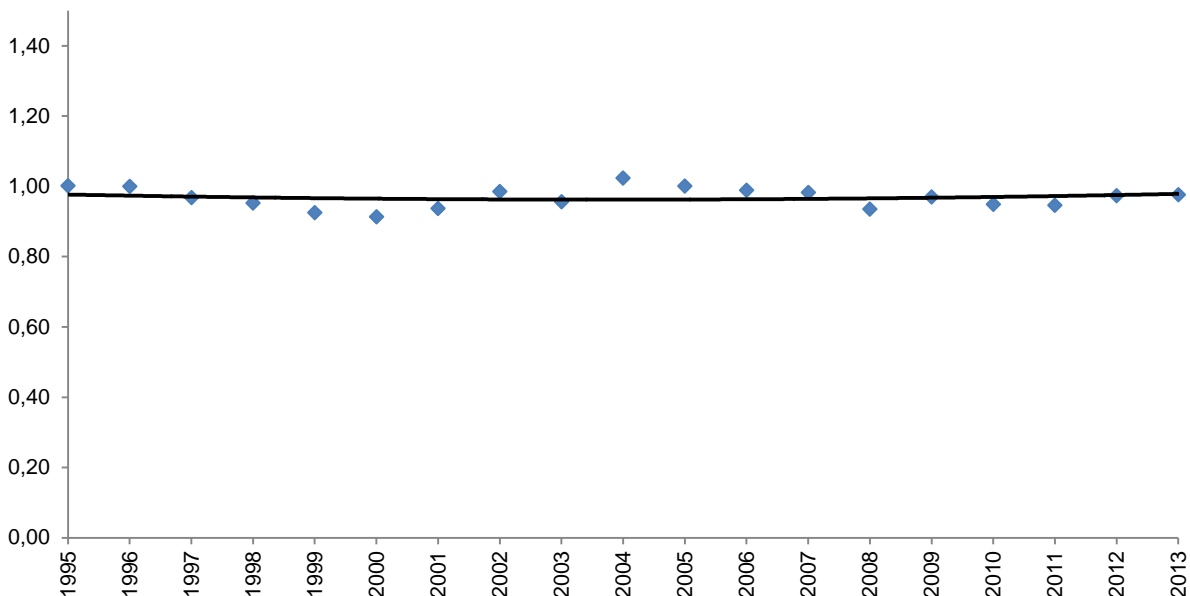


Figure 10

Estimated Equilibrium Real Effective Exchange Rate, Germany
1995 - 2014,
(REER*-EA18 ULC-Deflator 2005 = 1)



- By 2014, the remaining rebalancing requirements in terms of correcting the disparities between REER and REER* (“competitiveness gaps”) were relatively modest for all of the crisis countries. Apart from Germany and Ireland all major euro area countries find themselves within a very narrow margin (see Fig. 11). As compared to the competitiveness gap peaks of Greece (nearly 25%), Spain

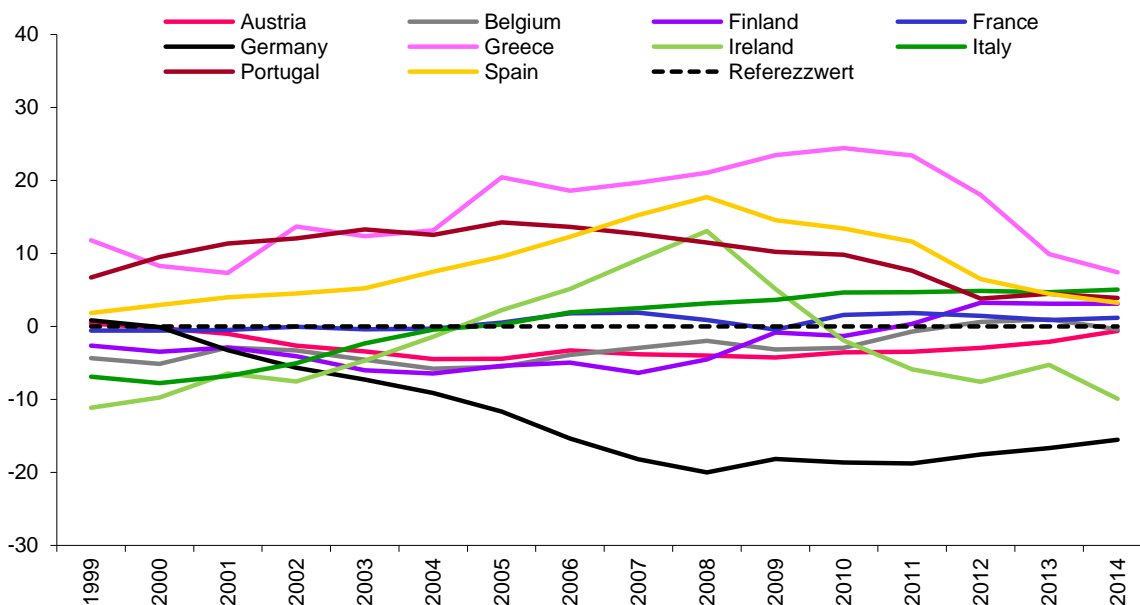
(15%), Portugal (14%) and Ireland (13%) the remaining rebalancing requirements seem to be manageable. However, the bulk of the rebalancing had already been completed by 2013. In contrast, hardly any rebalancing has occurred in Italy and Germany since 2008. Italy has so far failed to reduce its competitiveness problems, although it should be said that at present these do not appear to constitute a major threat. Although Italy has succeeded in cutting its current account deficit and in 2013 even managed to achieve a surplus for the first time in 12 years, this might be of course to a certain extent a consequence of weak domestic demand. Imports of goods and services at constant prices slumped by 8.1% in 2012 and fell by a further 2.3% in 2013. Over the same two years, exports rose by just 2.3% (2012) and 0.6 % (2013) respectively. It can thus be assumed that in the event of a strong recovery in the domestic economy, Italy's current account balance would once again deteriorate. In Germany, the rebalancing requirement for the ULC-based real effective exchange rate was minus 20.0% in 2008. Six years later, it still stood at - 15.5%. This clearly indicates that higher wage increases and somewhat higher inflation in Germany could make a significant contribution towards the as yet incomplete process of rebalancing competitiveness levels within the eurozone.

Figure 11

"Competitiveness Gap" selected euro area countries 1999 - 2014

(remaining rebalancing requirements: Divergence of REER EA-18 ULC-Deflator

from Reference in %)



Excursus: Beggar-thy-neighbour policies in a monetary union

Equation (3) illustrates how, if its equilibrium real exchange rate improves, a country can achieve a real revaluation (i.e. an improvement in its terms of trade) without jeopardising its foreign trade balance. Alternatively, if its real exchange rate remains constant, it can improve its current account balance, i.e. import more goods from abroad whilst maintaining the same level of exports. If its REER* remains stable, the country effectively follows a given price-demand curve. It could then use its real exchange rate, for example, to boost exports at the expense of a deterioration in its terms of trade. This is what is known as a “beggar-thy-neighbour policy”.

The conditions for the intertemporal exchange of domestically-produced goods against future import options depend on the elasticities. The present value of the additional financial receivables acquired in respect of other countries is equivalent to the exchange-rate-based improvement in the current account balance if the sum of export and import elasticities is equal to -2. If the sum of the elasticities is -1 (i.e. where $c = 0$), the current account balance remains unchanged and there are no additional receivables from other countries (corner solution to the Marshall-Lerner condition). However, in the event of a devaluation, the country needs to export more in real terms in order to obtain the same real quantity of imports. Seen purely in terms of international trade, this is bad business. The value of the additional foreign receivables will only be greater than the losses arising from the deterioration of the terms of trade if the export and import elasticities are relatively high (i.e. where the absolute sum of the elasticities is greater than 2). The balance looks even worse if uncertainties regarding the future reliability of foreign receivables is taken into account. If a country has to write down or completely write off its foreign receivables, it has effectively given away its exports either for free or for less than what they are worth.

The appeal of real devaluations resides solely in the additional external demand impulses and the positive side-effects that these have in the shape of increased growth and employment. However, this should only be relevant if there is something preventing the obvious alternative economic policy of seeking to strengthen domestic demand without jeopardising price stability. From a theoretical perspective, it is hard to find any good reasons for why this might be the case – while additional external demand may result in higher growth and employment, in principle the same outcome can be achieved by using monetary and fiscal policy to stimulate domestic demand. In a monetary union, however, there are restrictions on what the member states are able to do. Any measures to strengthen domestic demand without compromising stability in a monetary union will require the appropriate monetary, fiscal and wage policy coordination. Economic policy can be used to overcome demand-side limitations on growth and employment, even in a monetary union. Indeed, macroeconomic policy can do more than simply prevent underutilisation of capacity – it can also help to boost growth potential through a growth- and stability-oriented policy mix. This approach would allow all the members of a monetary union to follow consistently higher growth and employment

paths over the longer term.³¹ Thus, if the economic policy alternatives are taken into account, the only circumstances under which a beggar-thy-neighbour policy would be attractive would be if a country were unable to implement economic policies to expand domestic demand without compromising stability. The inability to do so would be due to failures in the country's macroeconomic policy and, in a monetary union, to a lack of adequate macroeconomic coordination which would in any case still be self-inflicted, to some degree.

Beggar-thy-neighbour policies have no place in a monetary union, since they are detrimental to the community interest. Indeed, there is considerable evidence to suggest that the term "beggar-thy-neighbour policy" is a misnomer, since the biggest losers are likely to be the countries that pursue such policies. Ultimately, however, the key point is that everyone will end up losing out in a monetary union where beggar-thy-neighbour policies are pursued, even if only by a substantial proportion of the union's members or just one very big country. In such a scenario, macroeconomic imbalances are inevitable. This makes it all the more important for monetary unions to identify and correct such policies as early as possible. All the eurozone countries' REER and REER* should therefore be subject to permanent surveillance. Where appropriate, economic policy measures involving a realignment of the REER should be taken in order to correct any imbalances.

Point 3: The third step involves wage and price development recommendations for all the eurozone countries. If competitiveness problems are identified in one or more eurozone countries, these should be rebalanced through wage and price adjustments. It is of course possible for these to be carried out only within the countries in question. However, since competitiveness is a relative concept, the rebalancing could in principle also be achieved through coordinated adjustments in all the other countries. In other words, Germany, the Netherlands and Austria could bring themselves closer to the eurozone average by accepting a slight rise in inflation in exactly the same way as the crisis countries are expected to achieve convergence through lower inflation or deflation. Any recommendations should be aimed at minimising the overall costs of the rebalancing and should pay appropriate attention to the relevant income distribution aspects. There is substantial evidence to suggest that lower average inflation rates during the rebalancing period result in higher rebalancing costs. Since falling prices cause the real debt burden to rise, the rebalancing costs are particularly high in an overall deflationary environment. In

³¹ See A. Watt and V. Hallwirth: "The policy-mix and policy coordination in EMU – how can it contribute to higher growth and employment?" In: *Transfer*, Volume 9 Number 4, pp. 610 -632. From a dynamic perspective, underemployment is not absolutely essential as an initial condition for expanding demand whilst maintaining price stability. In principle, an expansion of demand can increase capital stock and thus also growth potential by strengthening investment. Realistically, the scope for expanding demand without compromising stability tends to decrease the closer you get to full employment. However, in a monetary union, well-functioning macroeconomic coordination is a prerequisite for strengthening domestic demand without compromising stability.

order to support the rebalancing process, it is therefore important to make sure that inflation across the eurozone as a whole does not fall below the ECB target.

If divergences in competitiveness within the eurozone are to be prevented or corrected, it is essential for the eurozone countries' wage policies to be integrated into a eurozone macroeconomic coordination process.³² The experience of the first 10 years of EMU has clearly demonstrated that a lack of adequate wage policy coordination can result in serious and lasting divergences in competitiveness within the eurozone. The integration of wage policies into a European-level macroeconomic coordination process is therefore absolutely indispensable. Notwithstanding the undeniable difficulties associated with the practical implementation of wage policy coordination, we are therefore justified in treating macroeconomic price relationships between the eurozone countries as a policy variable – indeed we have little option but to do so.

This is not the place for an in-depth discussion of the prospects of European-level wage policy coordination succeeding or of what the institutional structure of a European-level macroeconomic coordination process incorporating wage policy might look like. However, it should not be forgotten that, as a rule, the employee side's bargaining power in wage negotiations depends not only on the relevant labour market institutions but above all on the extent of public support for employee demands. Employees will be able to push through higher pay demands if they have the backing of economic policymakers, leading economists and public opinion. By the same token, however, these same factors can also be harnessed to impose wage restraint, something of which Germany is a prime example.

7. Conclusion

The most important economic policy lesson of the eurozone crisis is that endogenous market responses can contribute to significantly strengthening and perpetuating macroeconomic imbalances within the EMU. Following the introduction of the euro, divergences in domestic demand and wage and price developments thus grew into full-blown macroeconomic imbalances. Better macroeconomic policy coordination is required in order to break this vicious circle so that imbalances can be prevented and corrected. Market forces alone cannot be expected to prevent and correct macroeconomic imbalances. Accordingly, what is needed is a comprehensive macroeconomic policy coordination process within the EMU that also incorporates wage policy. Under the current circumstances, specific interventions and rebalancing recommendations targeted at individual member states – which are the best outcome that the current MIP process can hope to deliver – will not be enough to restore and secure the full functioning of the EMU. In order to achieve the goals set out in Art. 3 of the Treaty on European Union, it will instead be necessary to undertake continuous adjustments to ensure optimal coordination of all the eurozone's macroeconomic actors, based on the permanent surveillance and, where necessary, rebalancing of macroeconomic developments.

³² For the institutional structure of a macroeconomic coordination process incorporating wage policy, see W. Koll: The new economic government arrangements and autonomous collective bargaining in the European Union, IMK-Study No. 30, March 2013.

The MIP should therefore be upgraded in order to create a comprehensive macroeconomic coordination procedure for the eurozone.

Indeed, right now there seems to be a perfect window of opportunity. The five Presidents of the EU and Euro area Institutions, Jean-Claude Juncker, together with, Donald Tusk, Jeroen Dijsselbloem, Mario Draghi and Martin Schulz – recently presented ambitious plans on how to deepen the Economic and Monetary Union. They recommend the creation of “a euro area system of Competitiveness Authorities” in order to strengthen the implementation of the Macroeconomic Imbalance Procedure. Based on a common template, all Member State shall decide on the set-up of a national Competitiveness Authority. Social partners shall “use the opinions of the Authorities as guidance during wage setting negotiations”. Let’s hope that this idea will be implemented in a reasonable way by European and national institutions in agreement with social partners as soon as possible.

Publisher: Hans-Böckler-Stiftung, Hans-Böckler-Str. 39, 40476 Düsseldorf, Germany
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IMK Study is an online publication series available at:
http://www.boeckler.de/imk_5023.htm

ISSN: 1861-2180

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