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Article

Restoring Competitiveness: What Has Gone Right, What Has Gone Wrong?

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Panel 1

Introduction

RESTORING COMPETITIVENESS: WHAT HAS GONE RIGHT, WHAT HAS GONE WRONG?

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Introduction

Seven years after the onset of the great financial crisis and about 5 years after this financial crisis mutated into the euro crisis, the countries in the euro area's periphery are still struggling with a challenging combination of high debt, high unemployment and sluggish growth. The difficulties encountered by Greece in jumpstarting growth are the most visible expression of this general malaise. This contribution addresses one key aspect of the problems in the periphery, namely the importance of changes in competitiveness during both the boom and the bust period. This analysis does not tackle important aspects of the crisis, such as the debt overhang. But even this important issue becomes easier to address once growth returns, and a restoration of competitiveness is widely held to be the key.

There is now a widely accepted answer to the question: what caused divergences in competitiveness (prior to 2008)? What has by now become conventional wisdom is a combination of two elements:

1. Wage moderation in Germany
2. Divergences in productivity

The conclusion to be drawn from this conventional wisdom is clear. Adjustment in the periphery requires a combination of Teutonic wage restraint, coupled with

structural reforms to increase productivity. However, the evidence that these two elements were the key driving forces behind differences in competitiveness is surprisingly weak. More specifically, it seems that wage restraint in Germany did not result from economic policy, but was the outcome of a labour market that reacted naturally to high unemployment.

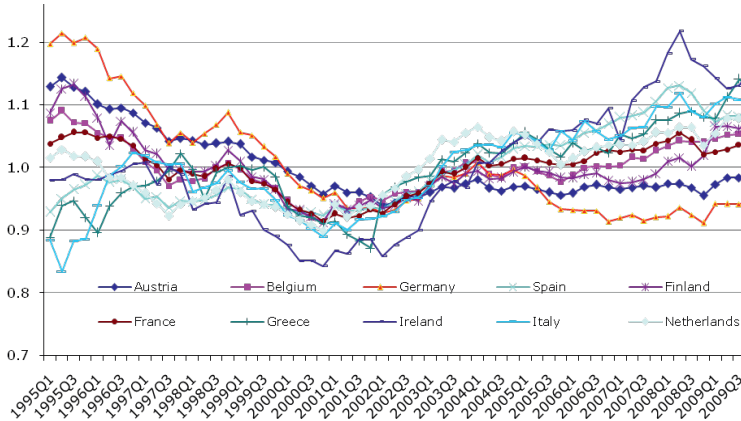
Looking at other countries also shows that the drivers of competitiveness have been more macro than micro in nature. Moreover, the link between productivity and competitiveness is also affected by macroeconomic mechanisms and the correlation between the two was the opposite of what could normally be expected. The final leg in the conventional story line is that an improvement in competitiveness is also not strongly supported by the data.

This article starts with some simple considerations on how to benchmark competitiveness. The second section examines the German labour market and suggests that there was no politically-inspired wage restraint during the early years of monetary union. The third section then asks the apparently simple question of whether an increase in productivity should lead to an improvement in competitiveness (and finds that this has not been the case). The fourth section looks at the macroeconomic drivers of competitiveness, at least those that were preponderant during the boom years, followed by the fifth section, which asks to what extent competitiveness has been a driver of trade performance and again finds some surprising relationships. The final section offers a few concluding remarks.

Benchmarking competitiveness

It is now conventional wisdom that the first decade of the euro was associated with a significant divergence in competitiveness. The evidence adduced is usually some variant of the chart shown in Figure 1 below. However, it is not actually all that easy to tell whether the movements observed represent a divergence away from an equilibrium, or a convergence towards a new equilibrium. This essentially depends on the choice of the base year. It is often implicitly assumed that the

Figure 1
Real harmonised competitiveness indicator measured in terms of unit labour cost (ULC) in total economy deflated



Note: ECB EER-21 group of currencies and euro area 16 country currencies (FR, BE, LU, NL, DE, IT, IE, PT, ES, FI, AT, GR, SI, AU, CA, CN, DK, HK, JP, NO, SG, KR, SE, CH, GB, US, CY, CZ, EE, HU, LV, LT, MT, PL, SK, BG, RO). Index re-scaled by using long-term (1995–2010) average.

Source: ECB Statistical Warehouse; own computation.

start of EMU is the best base, but this does not seem to be the case. Figure 1 shows the evolution of unit labour costs in euro area countries, as is often the case. However, to avoid the bias induced by the choice of a single year as the base, the index (unit labour costs, as provided by the ECB) has been re-scaled dividing it by its average over the period 1995–2010. This approach assumes that unit labour costs have, on average, been in equilibrium over the 15 years up to 2010.

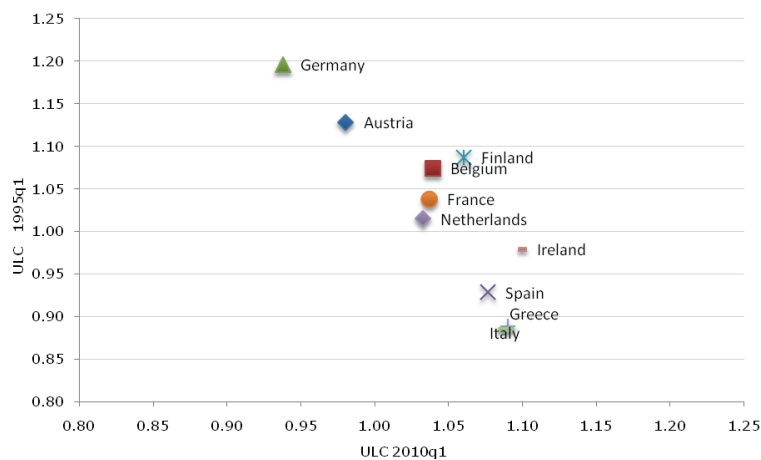
Interestingly, the chart shows the existence of a node in 2003, rather than in 1999/2000. This highlights the fact that 1999/2000, which is usually taken as the base year, might not have been an equilibrium itself. The year 2003 appears to be the year of the smallest cross country differences if one takes the long-term average as the equilibrium concept. Prior to 2003, Germany appears to have been ‘uncompetitive’ and, after 2003, some countries like Ireland and Spain, where bubbles started to emerge, experienced a significant loss in competitiveness. Choosing the base period carefully is important. Most analyses that use 1999/2000 as the base conclude that the divergence of the countries now in difficulties amounts to 25–30 percent loss in terms of unit labour costs relative to Germany. Using 2003 as the base

year yields a substantially smaller estimate of the divergence, namely about 15 percent. The purpose of these simple considerations was not to show that 2003 is unambiguously the proper base year, but simply to show how difficult it is to measure divergences in competitiveness in practice.

Moreover, there is some evidence that the divergences in the competitiveness indicators observed until the onset of the euro crisis constitute a mirror image of the divergences that existed during the early 1990s. Figure 2 shows a scatter plot of the competitiveness indicator of euro area member

countries in 1995 and in 2010. There is clearly a strong correlation between the two. Countries that had a high (relative) labour cost indicator (notably Germany and Austria) in 1994 experienced a strong increase in competitiveness (a fall in their relative unit labour costs); while those countries with the best position in 1994 now have the highest costs. This way of looking at the data implies that the case for the popular narrative that the introduction of the euro was to blame for the following problems is not as strong as widely believed. Even after these considerations concerning the base from which to measure divergences in competitiveness, the key question that remains is what determined these movements.

Figure 2
Unit labour cost in 1995 and in 2010

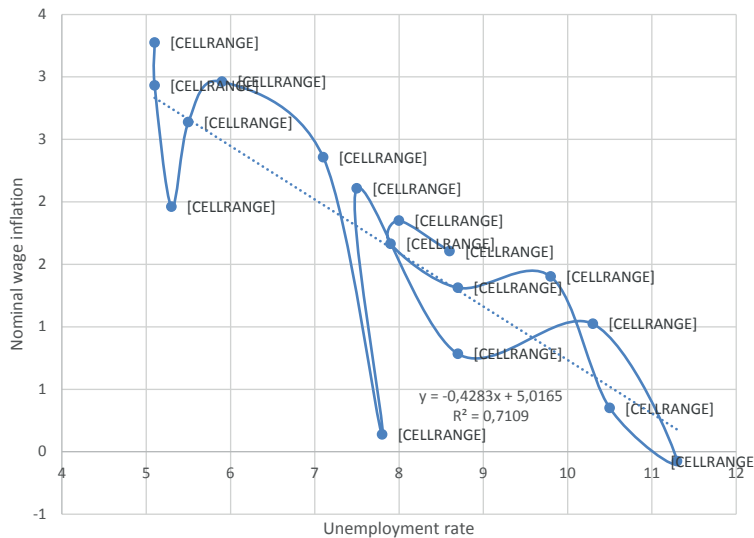


Note: ECB EER-21 group of currencies and euro area 16 country currencies (FR, BE, LU, NL, DE, IT, IE, PT, ES, FI, AT, GR, SI, AU, CA, CN, DK, HK, JP, NO, SG, KR, SE, CH, GB, US, CY, CZ, EE, HU, LV, LT, MT, PL, SK, BG, RO). As in Figure 1, the original ULC index has been re-scaled by using its long-terms (1995–2010) average.

Source: ECB Statistical Warehouse; own computation.

Figure 3

Phillips curve of Germany after EMU



Source: Own calculations based on AMECO data.

Wage moderation in Germany: policy or the market?

A key part of the conventional narrative is that Germany supposedly entered EMU with excessively high wages. The evidence for this is that, at the time (i.e. 1999/2000) Germany had a current account deficit and a higher unemployment rate than the euro area. But during the years that followed Germany's wages (and unit labour costs) declined relative to its partners. It is often argued that this was due to a political choice. But the evidence suggests that, in reality, this was a market-driven phenomenon in the sense that the Phillips curve did work in Germany, as shown in the figure below, which shows the link between (pan) German wage increases and the unemployment rate. There is a rather close relationship with only one outlier (2009), when the fear of a long lasting recession produced agreements without wage increases. But the recession proved to be short-lived (for Germany), and unemployment did not increase, partly because of the specific provisions for temporary short-term work.

The key implication of this relative stability of the Phillips curve in Germany is often overlooked: the stability of the link between unemployment and inflation implies that a policy of wage moderation was not re-

sponsible for low wage growth. The real driver of Germany's competitiveness gains was the high unemployment rate during the early part of the 2000s. A politically-inspired push for competitive wage deflation would have shown up in (nominal) wage increases lower than warranted by the Phillips curve. But this was not the case. During most of the period 2000–2008 actual wage increases were very close to (and sometimes higher or lower) than those predicted by the Phillips curve.

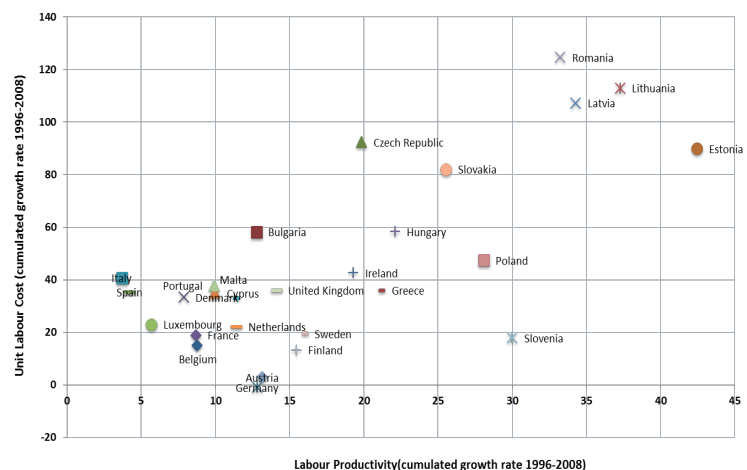
A Phillips curve can only represent some correlation between two variables. But more in depth investigations, which take into account factors like inflation, import and export prices and productivity essentially confirm this finding. This result already suggests a key conclusion: namely that changes in competitiveness might be determined by macroeconomic variables.

Productivity as a driver for competitiveness?

A further key element of the conventional narrative is that the periphery needs to become more productive. Higher productivity growth should lead to higher 'competitiveness'. In other words, higher productivity growth should, in theory, lead naturally to lower relative unit labour costs. But the reality seems to be dif-

Figure 4

Labour productivity (cumulated growth rate 1996–2008)



Source: ECB Statistical Warehouse; own computation.

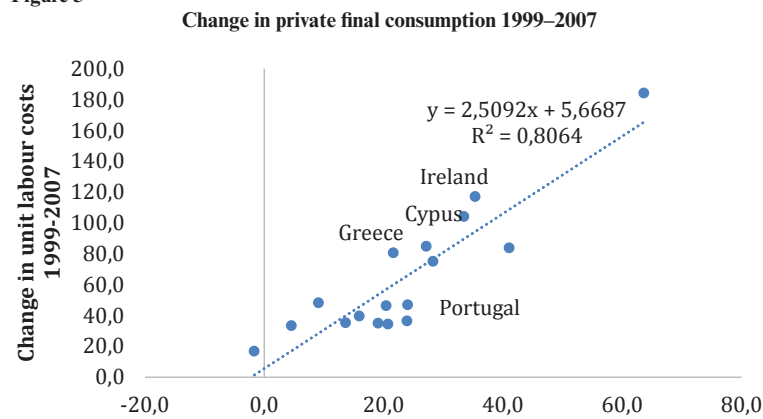
ferent. The data from the boom period until 2008 show higher productivity associated with higher unit labour costs.

Figure 4 also shows that the measured labour productivity was higher in some peripheral countries, including Greece, than in Germany during the boom years. What would be the concrete economic mechanism by which an increase in labour productivity leads to higher unit labour costs? This can obviously only happen if wages increase by more than productivity. But this is possible, indeed likely if the increase in productivity also leads to an increase in demand and thus, *via* a tightening of the labour market, to higher wages.

A concrete example illustrates how this can come about: consider a country that experiences an (exogenous) increase in the rate of growth labour productivity. If this shock is expected to be permanent, the permanent income of workers will increase. This implies that the population will feel richer and want to consume more. Higher consumption would lead to a tighter labour market and thus potentially, *via* a Phillips curve relationship, to wage increases outstripping, at least initially, the gain in productivity. The increase in demand due to the perceived gain in permanent income might also lead to stronger housing demand and higher house prices, which strengthen domestic demand further, as in the case of Ireland and Spain. Moreover, an increase in overall productivity (TFP growth) would make investment in the country more attractive and foster capital inflows. The counterpart to these inflows would be current account deficits. This mechanism seems to have operated particularly effectively in the new member states.

The fact that the correlation between productivity and competitiveness (ULCs) was positive during the boom years (and the opposite of assumptions based on conventional wisdom) does not, of course, imply that an increase in productivity will always lead to a loss of competitiveness. During the boom years (up to 2007 and 2008) workers (and enterprises) were more likely to consume and invest more than they could afford to based on their current income (which is based on current productivity), because financial markets were more likely to provide the financing necessary for con-

Figure 5



Source: ECB Statistical Warehouse; own computation.

sumption and investment expenditure to outstrip growth in current income.

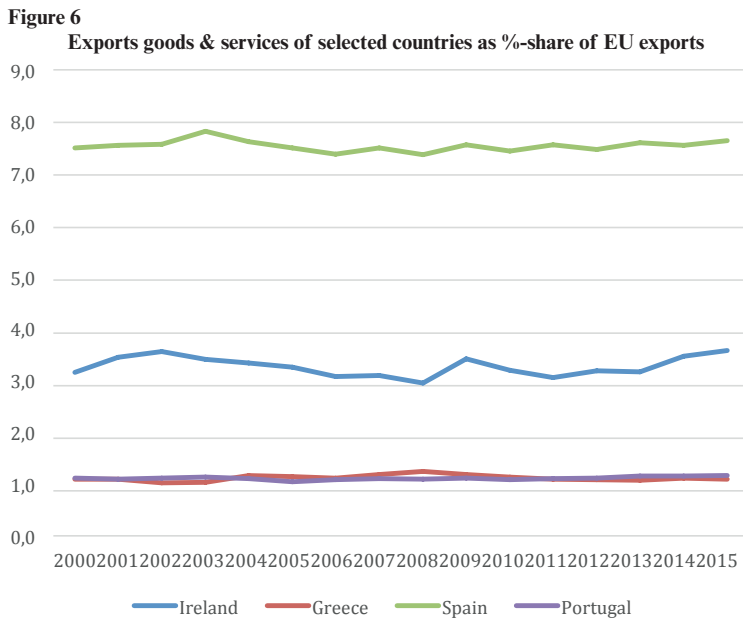
Macroeconomic drivers of competitiveness

The preceding section demonstrated that the correlation between productivity and competitiveness actually has the opposite sign than expected and the section before it showed that a macroeconomic variable like unemployment drove wages in Germany. This seems to be the case more generally. Figure 5 illustrates that there was a strong positive correlation between private consumption growth and loss in competitiveness (ULC) prior to the crisis.

The evidence to date suggests that the divergences in competitiveness up to 2007 were not primarily due to a German policy of wage restraint and low productivity in the periphery. The key driver seems to have been relatively strong domestic demand growth in the periphery (compared to Germany), which led to tight labour markets and thus, high wage and price increases. There is not enough space in this paper to delve deeper into the reasons for the strong increase in domestic demand in the periphery. But it seems that, in some cases, strong domestic demand was actually a result of high productivity.

Competitiveness as a driver of trade performance?

An implicit element in the conventional narrative is that competitiveness is a key driver of trade performance. But the evidence for this proposition is also surprisingly weak. There does, however, seem to be a reasonably strong link between the external adjustment and competitiveness.



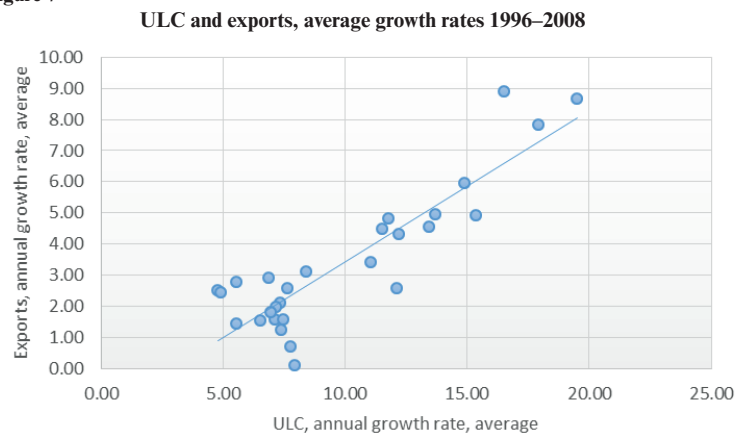
Time series evidence for the periphery

It is usually argued that the combination of a domestic boom and high wage growth made the exports of the peripheral countries uncompetitive, and resulting in large current account deficits. However, the raw data does not bear out this view. *A priori* one would expect the peripheral countries to lose market share until about 2008 to 2010, and then gain some market share once wages started to fall after the onset of the euro crisis. However, the data presented in Figure 6 does not support this view. This figure shows that for Greece and Portugal, the shares of national exports (of goods and services) in overall EU exports (which constitute a rough measure of market share) were essentially flat during the boom years. For Spain and Ireland only a very small reduction was seen, which is surprising in view of the major changes in competitiveness over this period. It is also interesting that the euro crisis did not lead to and major changes either.

Cross section evidence

Looking at cross section evidence (instead of the time series presented above) yields an even more surprising picture: higher (unit labour) costs were associated with higher export growth! Why would a gain in competitiveness (i.e. a fall in relative unit labour costs) be associated with lower export growth? The general explanation

Figure 7

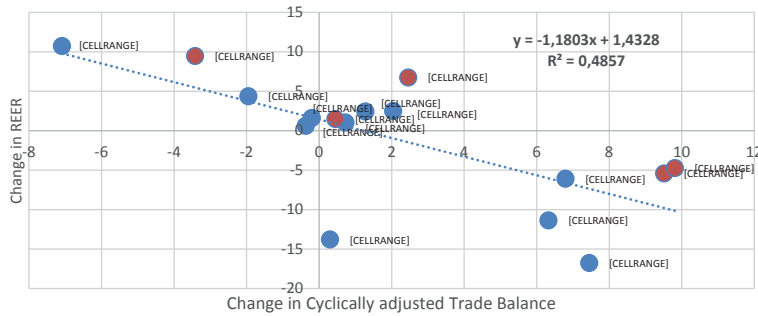


for the surprising correlation found in Figure 7 is that any partial relation between a quantity and the price can be either a positive or a negative sign, depending on the dominant source of disturbances during the period of observation. When the demand curve is stable, but the supply curve shifts, there is often a negative slope; and *vice versa* if supply is stable and demand shifts around.

A more detailed explanation of the unexpected relationship between export growth and unit labour costs has to start with the modern theory of international trade, which implies that every

country exports an array of differentiated products whose demand, at least in the short to medium run, is not completely elastic. In the short run one can take the number of varieties or products as given. In the short run exports can thus change only if exporters slide along the demand curve for their products (this is incorporated in most empirical estimates with the so called ‘Armington assumption’). However, in the medium to long run, the number of varieties or products a country produces can increase, implying that exports can increase without any need for export prices to go down because the foreign demand curve shifts outwards as the supply in the home country expands. The most impressive example of this phenomenon has turned out to be China whose exports have increased ten-fold over the last decade, although its measured competitiveness has deteriorated as wage increases in China have been far higher than elsewhere.

Figure 8
The real exchange rate and cyclically-adjusted trade balance in the Eurozone



Source: European Commission.

Competitiveness and external adjustment

The link between the trade balance and competitiveness was (and remains) a particularly important issue for the euro area since the euro crisis was fundamentally a balance-of-payments crisis. A key question for policymakers during the adjustment process was thus whether an improvement in competitiveness could be relied upon to produce an improvement in the current account or trade balance. This seems to have been the case, although it is often argued that membership in the common currency area makes the adjustment more difficult because a large downward adjustment in domestic prices is much more costly than a simple devaluation of the exchange rate.

Figure 8 shows the relationship between the change in the real effective exchange rate (REER) and the change in the cyclically adjusted trade balance (both over the time period 2008–2013) for the euro area countries. This figure uses the trade balance corrected for the cycle because it is clear that the trade balance will improve if domestic demand and imports fall as a result. But the aim of the exercise is to look for an independent effect of competitiveness on the trade balance. The correlation coefficient is surprisingly high at close to 50 percent. But it is also apparent that Greece constitutes an outlier, as it achieved a significant improvement in its competitiveness, but a relatively small improvement in its cyclically-adjusted trade balance. Without Greece, the correlation between the change in the REER and the cyclically-adjusted trade balance increases to almost 70 percent.

Figure 8 also illustrates that the CEECs, indicated by red dots, are somewhat special in the sense that almost all of these dots lie above the trend line. This implies that their adjustment was larger than one would expect given the link between the trade balance and the real effective exchange rate for euro area countries on

average. Changes in competitiveness have thus played an important role within the euro. Surprisingly, competitiveness seems to have played a less significant role outside the euro. The correlation between changes in competitiveness and the trade balance is much lower among those EU member countries that are not part of the euro area. The case of Britain is particularly im-

portant here given the emphasis of the UK authorities on the benefits of its floating exchange rate. Britain is an outlier as much as Greece because its trade balance has not improved, despite a large gain in competitiveness.

The evidence for the proposition that an improvement in competitiveness fosters the external adjustment is thus much stronger than the evidence of a close link between exports and competitiveness – at least inside the euro area.

Conclusions

Policy discussions often suggest that countries somehow ‘chose’ to become more competitive or uncompetitive. But this does not correspond to reality. Wages and prices are set in markets. Governments have very little control over them; and there is little evidence that public sector wages, the one variable which government can at least partially control, have a significant influence on private sector wages.

Viewing competitiveness as an endogenous ‘symptom’, rather than an autonomous factor has two implications: if excessive domestic demand was the problem during the boom years, a solution should now be on its way. International capital markets have curtailed credit to all peripheral countries. The sharp fiscal retrenchment everywhere in peripheral Europe has contributed further to a sharp deceleration, and in many cases even to an outright fall, in domestic demand in these countries. If labour markets are flexible this should result in lower wages. This is the key condition: flexibility of labour markets on the way down as much as on the way up.

The appropriate policy response to a loss of competitiveness (which is judged to be ‘excessive’) should be to

focus on domestic demand, not on wage developments or specific aspects of the labour market. In the case of Spain, for example, it would have been necessary to restrain the pace of housing construction during the boom years (by auctioning only a limited number of building permits, for example), rather than trying to meddle with the labour market in the midst of a domestic demand boom.

PANEL

Chairman **Paul Wallace**, European Economics Editor for *The Economist*, opened the first panel by describing EU competitiveness as a ‘compelling narrative’. Following the introduction of the euro some EU countries like Germany implemented tough reforms to streamline their economies, while others rapidly started to lose their competitive edge in global markets, noted Mr Wallace. The huge divergence in unit labour costs that resulted was exacerbated by the euro crisis, which merely served to widen the competitiveness gap within Europe. So what can be done to restore the balance and what kind of strategies does the EU need to adopt to get all of its members back on track, asked Mr Wallace in his introduction to the panel?

Martina Dalic, Vice President of the Budgetary and Finance Committee, Croatian Parliament, firstly highlighted the importance of strong public institutions, which cannot be overestimated in Southern Europe. Such institutions act as an interface between the private sector, which is supposed to produce exports and the public sector and are extremely important to the overall effectiveness of economy, explained Ms. Dalic. In her experience, problems with government can constitute a major obstacle to improvements in productivity and a source of weakness in the private sector, as illustrated by the situation in Greece. A country’s institutional set-up also basically determines its ability to implement reforms and economic policy. There is widespread disappointment with the results of recently implemented structural reforms in terms of competitiveness. Ms Dalic cited a recent IMF study that contradicts the IMF’s usual stance by claiming that labour market and structural reforms are not important to competitiveness.

For Ms Dalic, however, the real question is: how do we know whether these reforms were ever implemented? In addition to the quality of institutions, such imple-

mentation depends heavily on political will. She cited the former Latvian prime minister as an excellent example of a case of the political will to reform. In many periphery states such as Greece, however, the political environment was simply hostile to reform. “I cannot overstate the importance of the institutional set-up” concluded Ms. Dalic who speculated that the success of Germany’s Agenda 2010 was probably largely attributable to the well-known efficiency of German institutions in implementing policy.

Following on from Ms. Dalic, **Thomas Rodermann**, CEO of UBS, offered his thoughts from a banking finance perspective. In his view, the lack of structural reforms remains the key issue in Europe. Mr Rodermann identified restricted access to financing for SMEs as a central problem, as the latter are engines of economic growth and crucial to job creation. “I think the combination of economic underperformance and the lack of financing and funding is definitely one of the big issues that we have in the EU”, noted Mr Rodermann who also highlighted the need for more capital market funding in Europe. He also called for closer monitoring of the side-effects of regulatory changes on the pricing of financial services.

Quentin Peel, contributing editor at the Financial Times, asked why relative differences in productivity performance are not a good predictor of competitiveness? Ifo President Hans-Werner Sinn responded by highlighting the fact that productivity is often measured wrongly. The statistics only measure the productivity of those people who have a job, and exclude the zero productivity of the unemployed. If the latter were included in the statistics, the picture would be completely different, noted Mr Sinn. “Behind this data is the fact that countries that could borrow abroad at a low rate of interest, as the Southern European countries did, borrowed to increase their wages either directly through the government sector or indirectly through a construction boom. These were credit-financed wage increases, which then wiped out lots of low-productivity jobs, so the productivity of the remaining jobs rose”, he explained. Mr Gros agreed that productivity is a deceptive measure of competitiveness.

Ingo Friedrich, President of the European Economic Senate in Munich, cited Bavaria as an example that there are intangible factors like individual engagement that influence competitiveness and cannot be measured in figures. Mr Gros responded to this point not-

ing the key role played by the time frame when considering the effectiveness of structural reforms. “Different times require different structural reforms” he said. Boom and bust periods call for different reforms to those required by an economy struggling to improve its poor long-term performance.

Returning to the question of innovation, **Michaela Seidl**, CFO of GE Healthcare, asked how big Europe’s appetite for risk is in the future? According to Mr Rodermann, Europe’s companies often have more ideas than their US counterparts, but today’s environment in Europe is far less conducive to funding new, risky projects, partly due to banking regulations. Rodermann speculated that the US philosophy makes people more agile and open to innovation. Ms Dalic agreed that, despite the existence of EU initiatives to promote SMEs, the public sector can produce an atmosphere which, in many cases, is not conducive to entrepreneurship. Mr Wallace summed up the first panel discussion by noting that structural reforms are important, but may have been overrated as a solution in the case of Greece. Echoing Mr Gros’ comment that different reforms matter at different times, the panel’s chairman highlighted the fundamental importance of deep reforms in areas like education and speculated that the time has come for Europe to act upon the Lisbon Agenda.