CEPS COMMENTARY
Thinking ahead for Europe

Competitiveness Pact: Flawed Economies

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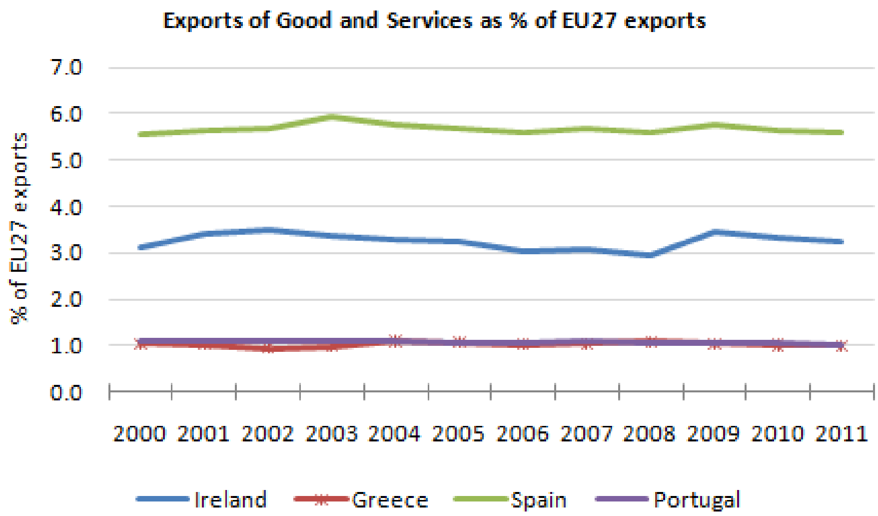
The economic philosophy behind the Competitiveness Pact now before the European Council seems to be quite simple. It can be summarized by two hypotheses:

1. If we fix (relative?) wages, no external imbalances can arise since relative costs determine export performance.
2. Higher productivity always means more 'competitiveness', and is thus always useful to reduce divergences.

At first sight, both theses seem to make sense, but on closer inspection, neither corresponds to reality. I will address each one in turn, starting with hypothesis I:

The (relative) unit labour costs of GIP(S) countries Greece, Ireland, Portugal and Spain) have increased: this is the fundamental cause of their problems as export performance must have been bad, pushing them into large current account deficits.

Unfortunately, however, the data do not support this hypothesis. The figure below shows the share of the exports of goods and services of these four countries in overall EU27 exports (also of goods and services). It is apparent that all lines are essentially flat and not downwards sloping, as one would expect if a loss of competiveness had had a strong impact on exports.



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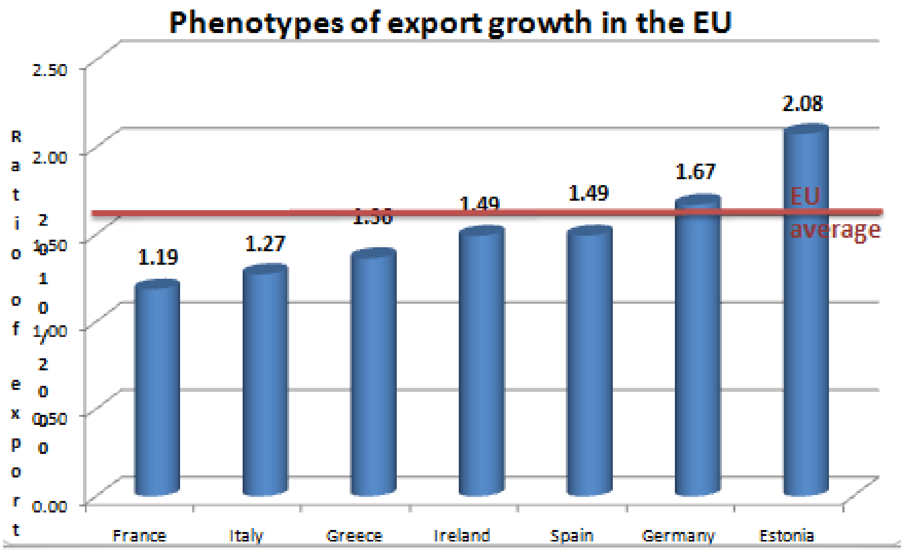
Competitiveness indicators by themselves are thus of very limited value in predicting export performance. One might of course turn the reasoning around and use export performance as an indicator of competitiveness. The figure below shows the compound rate of growth of the exports (of goods and services) of the seven euro area countries over the last 10 years, which the vagaries of alphabetical order have put close to each other in the statistics of the Commission.

The best performer on this scale is Estonia, which had the largest increase in relative unit labour costs in the entire euro area. The runner-up is no surprise, Germany, which had the largest fall in relative unit labour costs. But what is surprising again is that Greece, Ireland and Spain are all doing better on this measure than both Italy and France. The latter seems to be a rather poor performer, although it has never been singled out on the usual competitiveness hit parades based on unit labour costs.[1].



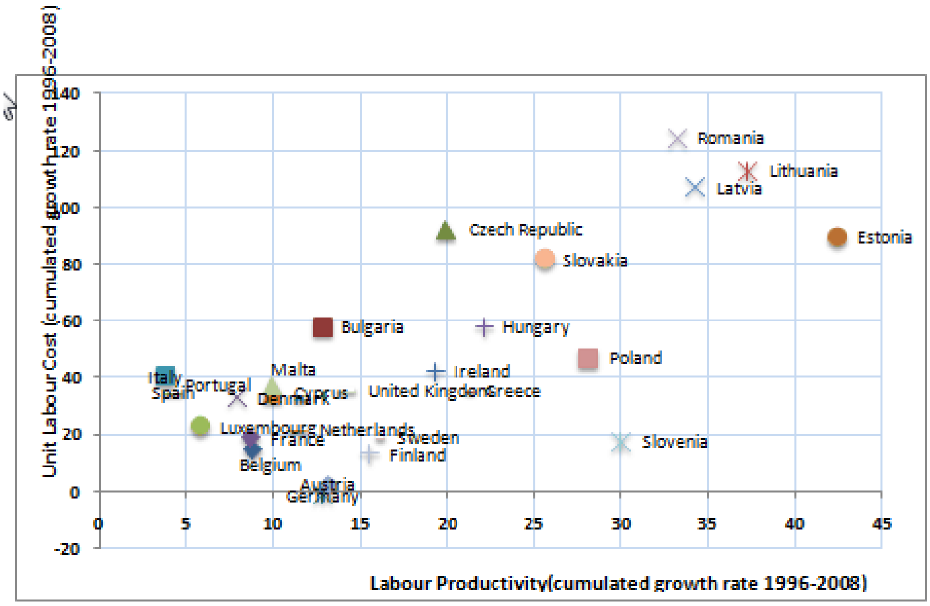
Let us continue with hypothesis II. This one seems to be a 'no brainer': Increased productivity must improve competitiveness as higher productivity should mean lower relative unit labour costs. Unfortunately, this is again contradicted by reality. As the figure below shows, the member countries with the highest growth in productivity have over the last decade also experienced the highest loss of competitiveness measured by relative unit labour costs.

[1] A brief digression for economists: There are a number of reasons why over the longer run the exports of a country can grow for reasons that have nothing to do with competitiveness.

For example, a country with a rapidly growing export supply can increase its exports without necessarily making them cheaper if the export supply comes in the form of new firms and thus new products. This is a central corollary of the Krugman/Lancaster view of trade as exchange of differentiated products. China might be the best example of how a country can increase exports (and market share) when there is structural change in this sense. The new member countries in the EU constitute another example, as will be shown below.

Another reason why export growth can be high without any change in competitiveness is that the international division of labour increases. This has been the case for example in Germany where both exports and imports have increased by more than those of its trading partners because of the increasing degree to which parts of the production process are being shifted abroad. This implies, of course, that each unit of German exports contains less and less 'German' value added (a point emphasized inter alia by H.W. Sinn). A large part of the German 'export success' in recent years has been due to this internationalization of the production process and little to do with gains in competitiveness.

Both reasons for sustained export growth without gains in competitiveness mentioned above imply that imports can also increase on a sustained basis without posing any danger to current account sustainability.



How can this be true?

The reason is quite simple: wages are endogenous and react to productivity growth. One just needs to consider a country that experiences an increase in the rate of growth in labour productivity. If this shock is expected to be permanent, the permanent income of workers will increase. The increase in perceived permanent income should lead to stronger demand, e.g. for consumption, which will lead to a tighter labour market, thus higher wages. Another reason why demand should increase in response to higher productivity is that investment should increase. Given a tighter labour market, it is possible that wage increases outpace, at least initially, the gains in productivity, leading to lower measured competitiveness. The increase often spills over into the housing market and might set off a boom there as well.

The conclusion from this short survey of the evidence is that competitiveness measures, like relative unit labour costs, are symptoms of underlying problems.

The macroeconomic imbalances of the GIP(S) countries were caused by domestic demand booms, in turn driven or simply abetted by capital flows. The countries with the strongest increases in housing investment and consumption were also those with the highest measured loss of competeviness.

A restoration of competitiveness in Southern Europe needs ultimately a macroeconomic cure: a contraction in demand leading to adjustment in wages. As capital flows are now reversing, the imbalances will anyway disappear on their own. This 'market-based' adjustment pattern needs time, but it works. It worked also for Germany between 1995 and 2005. It is difficult to see how regular meetings of the Heads of State and Government could somehow override the wage-setting process in labour markets.

The basic assumptions behind the Competitiveness Pact are thus flawed. Moreover, France and Italy are doing worse than the GIP(S) on a number of indicators, but there is little sign that reforms will be imposed on them. The real problem at present is that a debt overhang in the GIP(S) has created financial market instability. In this sense Chancellor Merkel has been right to observe that we have a 'debt crisis' not a 'euro crisis'. But the appropriate corollary should be that we should fix the debt crisis, not add another layer of policy coordination.