

# BRIEFING PAPER

## Diverging Tendencies of Competitiveness

by

**Gustav A. Horn**



Institut für Makroökonomie  
und Konjunkturforschung

Duesseldorf  
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## **Executive Summary**

The paper outlines the still heterogeneous labour cost situation in the Euro area. Instead of the expected convergence there is divergence. In particular German economic policy follows a strategy of continuous real depreciation. This is not a sustainable situation. Two exit scenarios are outlined, one is benign but unlikely, the other one involves severe hardship and is more likely. As the ECB is only able to manage aggregate developments, it can only try to avoid negative aggregate side effects by either avoiding inflation in the benign case and deflation in the worst case. It is mainly the task of fiscal policy and the wage formation to settle the problem of divergence

## **1. Introduction**

The introduction of the currency union fundamentally changed the competitive environment for the member states. Before the emergence of pegged or managed exchange rate systems divergences in competitiveness of different economies were only relatively short-lived. As soon as firms of one country managed to achieve a significant competitive advantage an appreciation of the exchange rate diminished it or even wiped it out. Germany was almost always in that position, whereas the UK and Italy mostly faced competitive disadvantages that needed to be compensated by a corresponding depreciation of their currencies. Those kinds of adjustment processes occurred in 1992, when the UK had to leave the EMS and in 1995 when Italy faced an unsustainable disadvantage. Consequently the two currencies strongly devalued against the German mark causing turbulences in the currency markets.

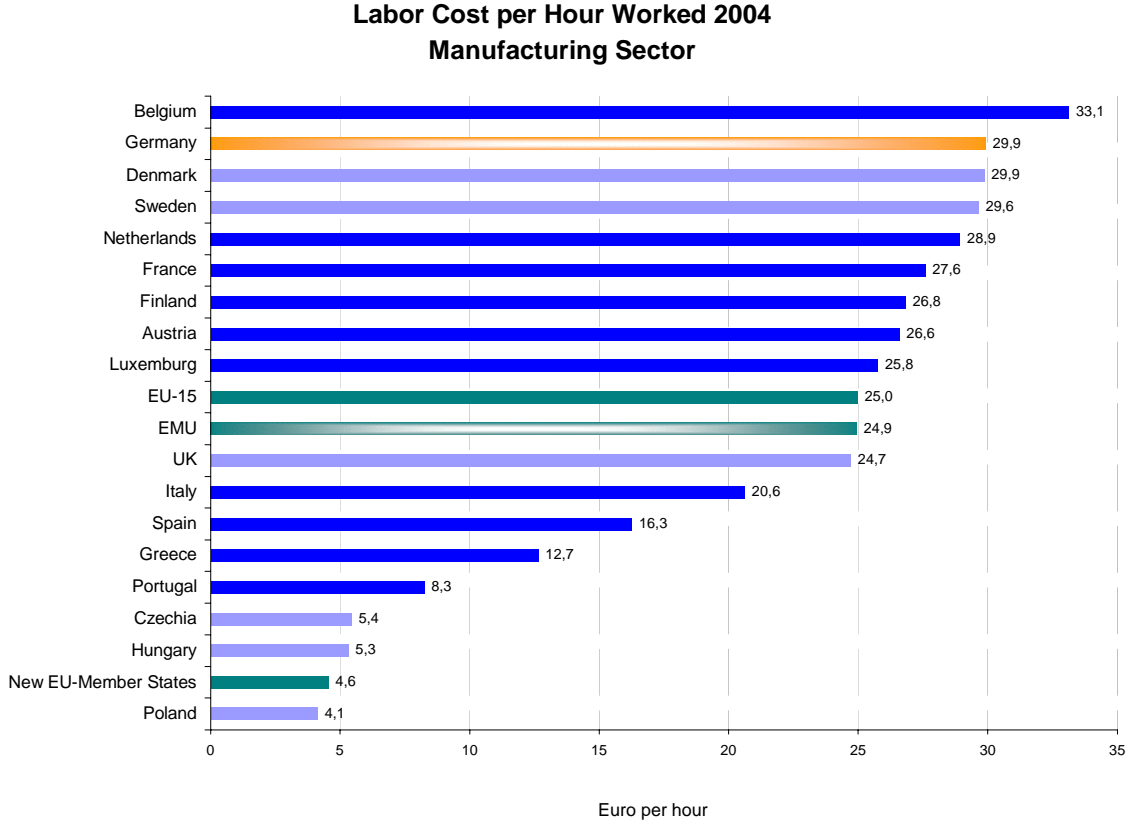
At the root of these movements were not only divergences in the innovative power of the respective economies but rather nominal tendencies. Wage and price formation in many European countries were such that inflationary tendencies prevailed. The consecutive devaluations enhanced these tendencies leading to severe growth distortions in many countries. One reason to establish the currency union was to overcome these tendencies by importing a culture of stability that resembled the German approach. With the introduction of the currency union the previously frequently used adjustment channel of nominal exchange rate changes was closed for those countries that joined the currency union. In an ideal setting, from now on competitive differences would only emerge when there were innovative advantages leading to relatively higher productivity growth. That would be a desirable effect since it determines a strong incentive for innovations. On the other hand nominal processes like wage and price formation would converge across the currency union in a way that price stability is observed everywhere and growth could unfold undistorted. Even if the ideal did not come true and still some divergences prevailed no serious problems would have to be expected. A gain (loss) in competitiveness would lead to external trade surpluses (deficits) and thus growth differentials. Those countries with surpluses would have higher and those with deficits lower growth with the respective consequences for employment. In due course wage increases would be higher in surplus countries and lower in countries with deficits thus correcting the divergences in competitiveness by so called adjustments of the real exchange rates.

Those relatively positive expectations were disappointed. Instead relatively persistent divergences prevail. The question is what went wrong and why.

## 2. Divergences in Competitiveness

The relevant divergences in competitiveness are still nominal ones. As outlined above it had been expected that they would more or less have vanished in a currency union. In the following it will be shown that this has not been the case. The decisive factor that determines competitiveness is the wage development. So in line with many theories of foreign trade one would expect some tendencies of convergence for these figures. However, wage rates within the euro area are still very divergent.

Figure 1



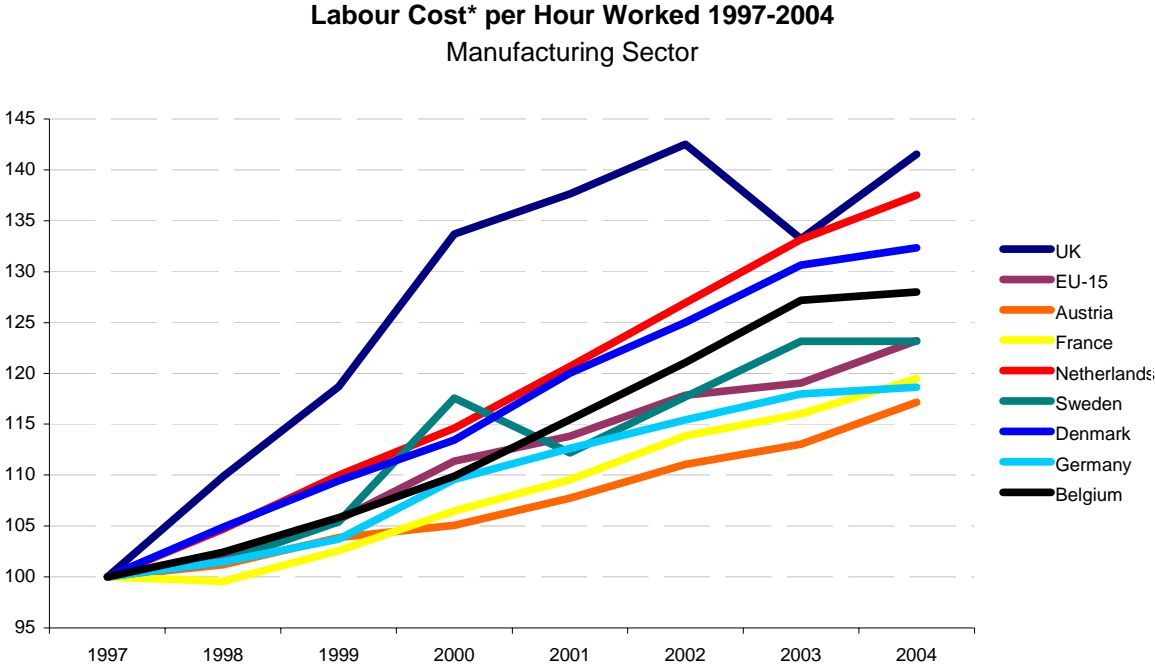
Source: Eurostat.



Figure 1 shows labour costs in the manufacturing sector of the EU. The figures include all wage and non wage labour costs such as contributions to social security. Data for manufacturing are often used because they reflect wage rates in the sector that seems to be more exposed than any other to international competition by trade. Hence the impact of the currency union should primarily occur here. The figure shows that there are still huge differences even within the monetary union. The highest labour costs are paid in Belgium followed by Germany and the Netherlands. In Portuguese labour costs in the manufacturing sector are the lowest, only about 1/8 of those in Belgium.

If one analyses how labour costs have developed since 1997 (Figure 2), when the ERM II was adopted, it turns out that dynamics have indeed been very different in the individual countries.<sup>1</sup>

Figure 2



\*On ECU/Euro-basis.

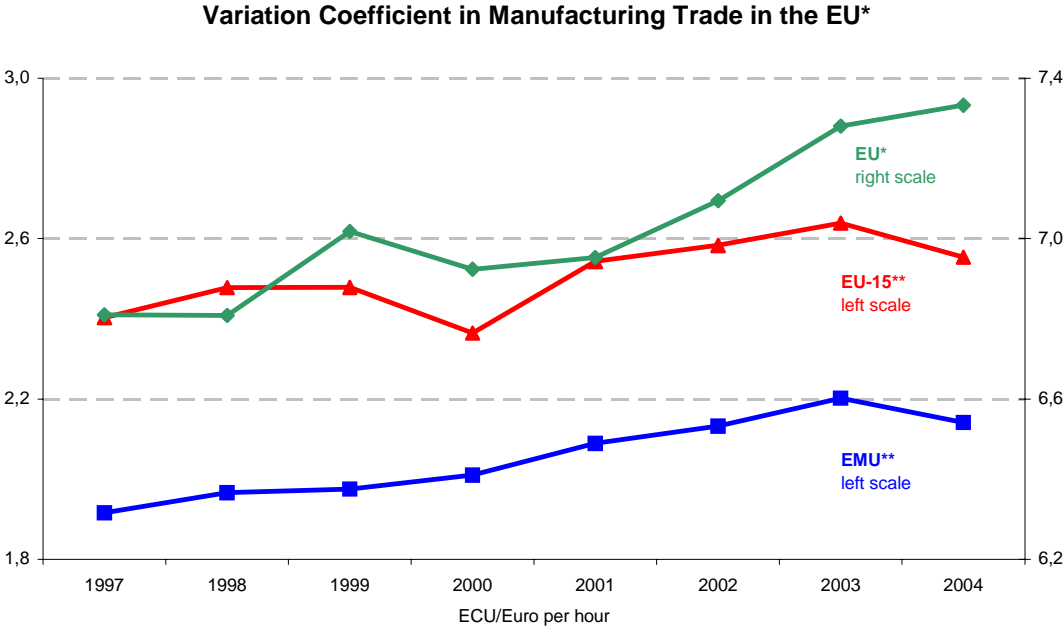
Source: Eurostat.



<sup>1</sup> All wage data mentioned in this paper is published in IMK- Report 11/June 2006. Download : [www.imk-boeckler.de/veroeffentlichungen](http://www.imk-boeckler.de/veroeffentlichungen).

Germany having one of the highest levels of labour costs in manufacturing shows one of smallest increase since 1997. On the other hand Belgium, where costs were even higher than in Germany, experienced wage growth well above the euro area average. Convergence should have lead to slower wage rises in Belgium.

Figure 3



\* Belgium, Czechia, Denmark, Germany, Estonia, Greece (GR), Spain, France, Italy, Cyprus, Latvia (LV), Lithuania, Luxemburg, Hungary, Netherlands, Austria, Poland, Portugal, Slovenia (SI), Slovakia, Finland (since 2000), Sweden (SE), United Kingdom. No data for Ireland and Malta.

\*\* Without Ireland.

Source: Eurostat, Calculations by the IMK. For GR, LV, SI und SE: approximation for labour cost per hour for 2004.

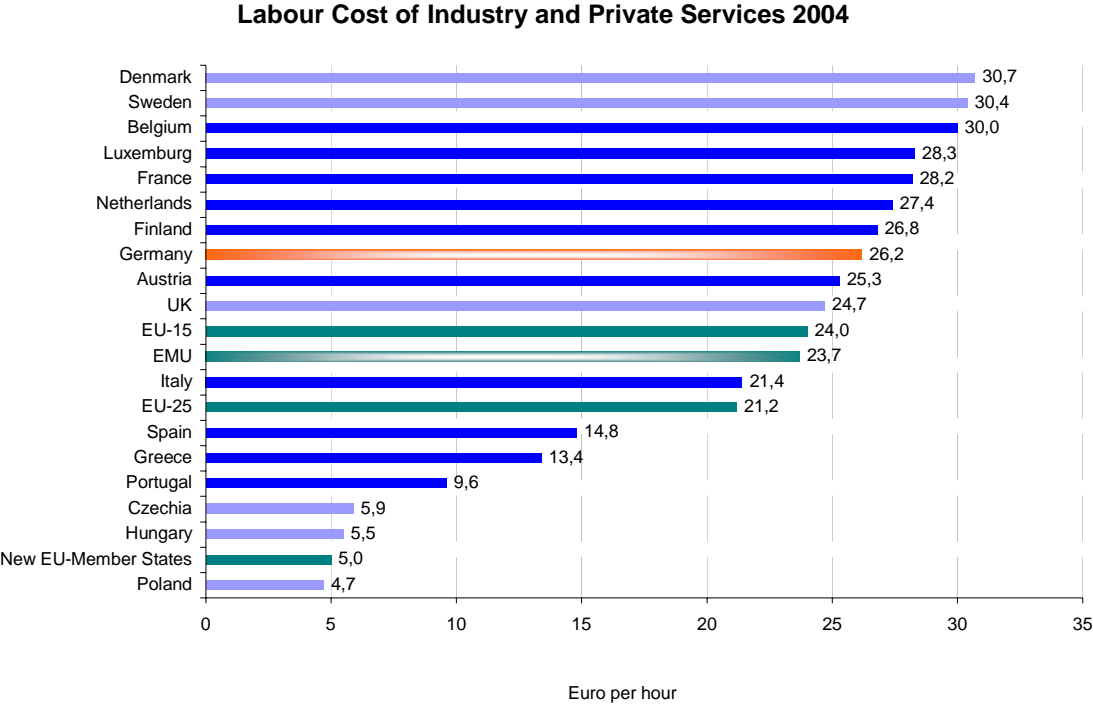


The coefficient of variation (Figure 3) measures the differences between wage rates at a point of time in relation to their mean. In case of convergence the coefficient should decline over time. The contrary is the true. Differences have increased rather than diminished. This finding does not only apply to the EU as a whole, where new member countries add a lot of divergence, but also to the euro area, where one would clearly expect the opposite.

There are some problems with the labour cost data used. The competitiveness of an economy cannot just be measured by labour costs in the manufacturing sector. Although exports of most countries are still dominated by industrial products, services play an increasing role - both directly and indirectly - for exports. Firstly services

account for an increasing share in exports. Secondly the production of industrial goods includes a growing service content. Therefore competitiveness also relies on a competitive supply of domestic services. In order to capture these effects labour cost of manufacturing plus private sector services are analysed (Figure 4).

Figure 4



\*For Sweden and Greece the numbers relate to 2003. No data for Ireland.

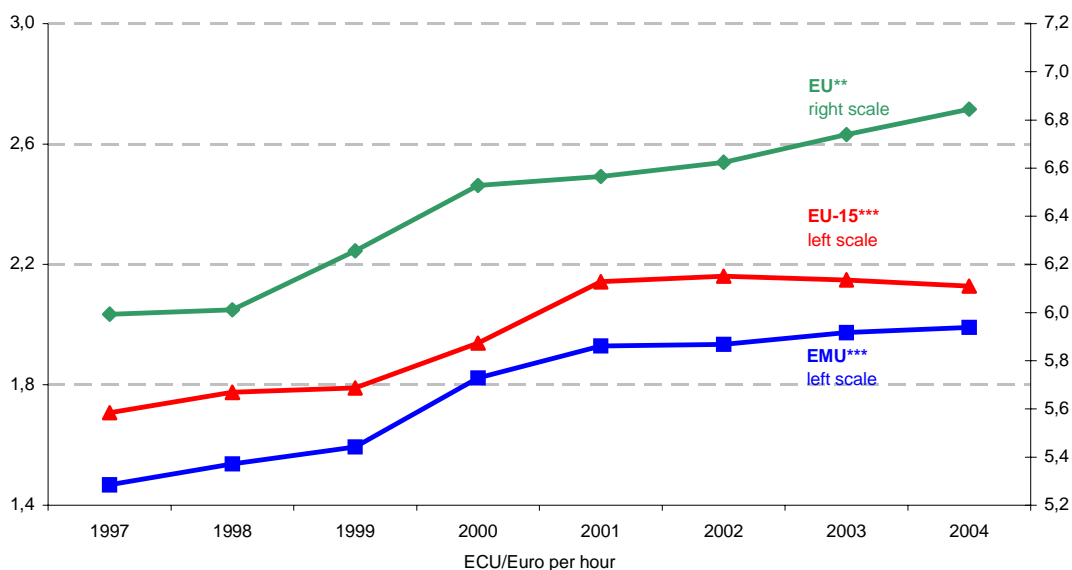
Source: Eurostat.



Again one sees significant divergences for the year 2004. But the order is somewhat different from that in Figure 1. Now the Scandinavian countries are ahead of Belgium. Interestingly Germany, which was second in manufacturing, is only in the midfield, when services are taken into account. In Germany wages in the service sector are particularly low compared to those in the manufacturing sector. The difference between the country with the lowest private sector labour costs in the Euro area, (Portugal) and that with the highest (Belgium), is not as large as in the manufacturing sector. Portuguese costs are roughly 1/3 of those in Belgium. That cannot be interpreted as evidence of convergence either. This impression is corroborated by the coefficient of variation, although to a lesser extent than in the manufacturing sector.

Figure 5

### Variation Coefficient<sup>1</sup> of Labour Cost in the EU\*



\* The variation coefficient is the variance divided by the mean.

\*\* Czechia, Denmark, Germany, Estonia, Greece (GR), Spain, France, Italy, Cyprus, Latvia (LV), Lithuania, Luxembourg, Hungary, Netherlands, Austria (AT), Poland, Portugal, Slovenia (SI), Slovakia, Finland, Sweden (SE), United Kingdom. No data for Ireland, Belgium and Malta.

\*\*\*Excludingt Belgium and Ireland. Source: Eurostat, partly own approximation for labour cost per hour for 2003 (AT) and 2004 (GR, LV, SI and SE) and calculations by the IMK.

Source: Eurostat, Calculations by the IMK. For GR, LV, SI und SE: approximation for labour cost per hour for 2004. For AT: approximation for 2003.



While labour costs show an increasing divergence in the EU, the matter is less clear for the Euro area. This is not very surprising since the new member states are still catching up, which makes the EU a very heterogeneous economy. Therefore, one would not expect convergence in the short run.<sup>2</sup> However, the coefficient has also increased for the euro area – albeit only slightly. This seems mainly the result of different reactions to shocks occurring in 2000/2001. Nevertheless it is not the picture one would expect in case of convergence.

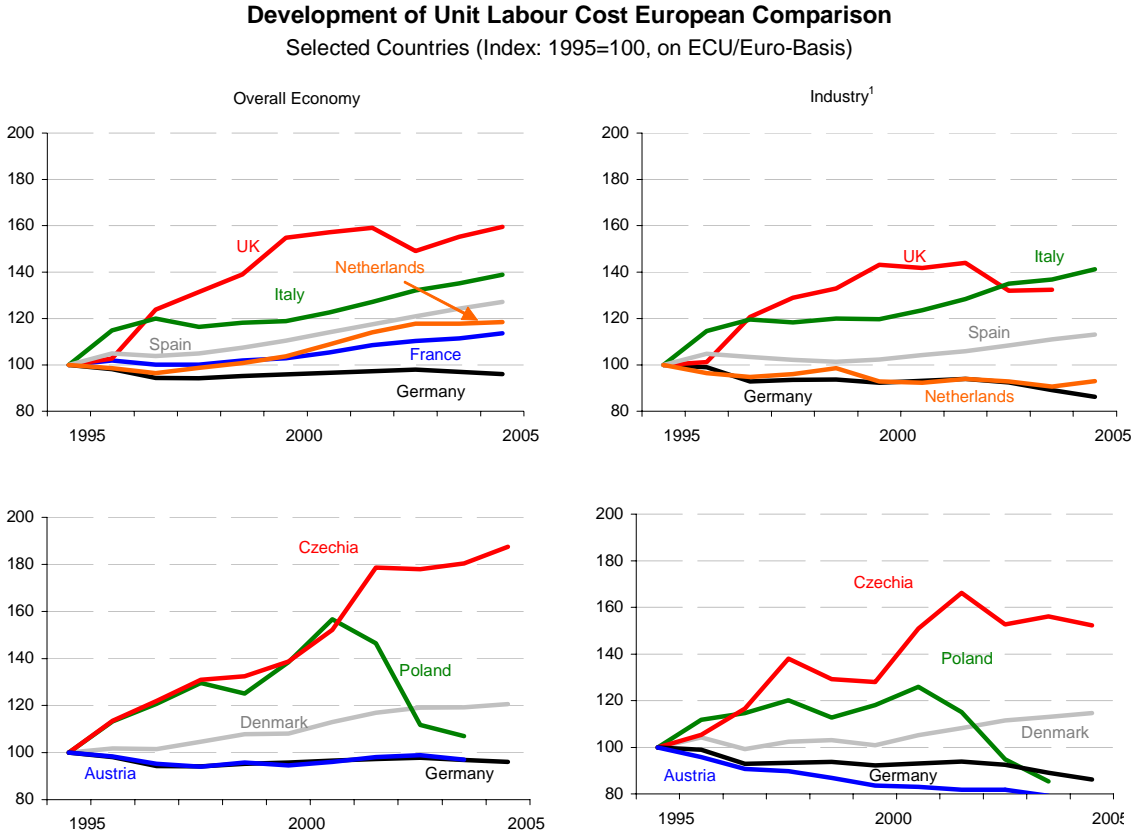
Both indicators presented suffer still from a major drawback. They focus on absolute labour costs. What is more decisive for firms is labour costs in relation to productivity. The assumption that productivity is the same everywhere is very extreme. Education, infrastructure and industrial relations still tend to differ among different countries and this has to be taken into account when measuring competitiveness. Unit labour costs

<sup>2</sup> The data for new members were included right from beginning of the time periods analysed in order to avoid a break in the data. So the divergence cannot result just from the inclusion of new member states.



exactly measure the respective relation. Changes in unit labour cost are known to affect changes of the price level, which bring about changes in competitiveness. Therefore, one should look at the change of unit labour costs to assess how competitiveness has developed in the currency union.

Figure 6



<sup>1</sup> Manufacturing Industry including mining, power and water supply (C, D, E).

Source: Reuters EcoWin (Eurostat); Calculations by the IMK; Value added in Industry for France available since 2000 only. Calculation of unit labour cost on the basis of persons since data of hours worked is not available for all countries.



Figure 6 shows an interesting picture. As for the aggregate economy, since the beginning of the currency union, Austria and Germany have strongly gained in competitiveness vis-à-vis all other member states. Taking industry alone Austria has improved its competitiveness more than any other country in the EMU; Germany and the Netherlands follow. What is most striking is that the pattern is very clear cut. It does not change over time. Every year Austria and Germany have gained and the others have lost. In other words, Germany and Austria have followed an economic policy strategy of permanent real depreciation. However, the same strategy shows

different effects in large resp. small countries. In large countries where domestic demand is more important than exports whereas in small countries it is the other way round. In the end small countries like Austria and the Netherlands indeed benefit from such a strategy whereas large ones like Germany do not.

The currency union thus led to a fundamental change in intra European trade relations. The occasional at times drastic nominal depreciation of currencies has been replaced by a quite persistent real depreciation. Whilst the nominal depreciations served to restore the lost competitiveness the purpose of real depreciations is a permanent improvement of an already existing competitive advantage. Where this leads to will be shown in the following section.

### **The Effects of Persistent Real Depreciations**

To assess the impact of such a strategy one has to keep in mind that the Euro area is a currency union with a common target for price stability.<sup>3</sup> This means that the ECB has to conduct its monetary policy in a way to achieve this target for the euro area as a whole. If each member country shows roughly the same inflation rate in line with the inflation target, there is no problem. If e.g. a country shows a better record in productivity growth, wages and real incomes should correspondingly rise faster leading to relatively higher wealth in the country with better productivity performance without harming any other country or violating aggregate price stability. Neither is there any problem with temporary divergences resulting from diverging business cycle positions. In this case a country in a slump may revive economic activity back to normal while those in a boom loose steam and avoid overheating.

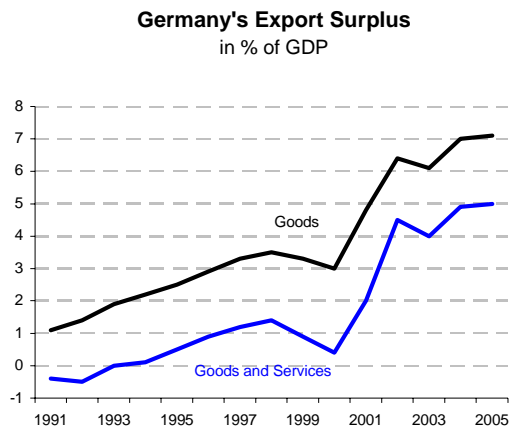
But as shown above the euro area presently faces a persistent real depreciation by two countries. Comparisons with different regions in the US show that such tendencies are unusual within a currency union.<sup>4</sup> The consequences are severe.

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<sup>3</sup> Price stability is defined by the ECB in a manner that the inflation rate should be close to but below 2 percent.

<sup>4</sup> See IMK-Report 1 /August 2005. Download: [www.imk-boeckler.de/veroeffentlichungen](http://www.imk-boeckler.de/veroeffentlichungen).

Figure 7



Source: Reuters EcoWin (Eurostat);  
Calculations by the IMK.

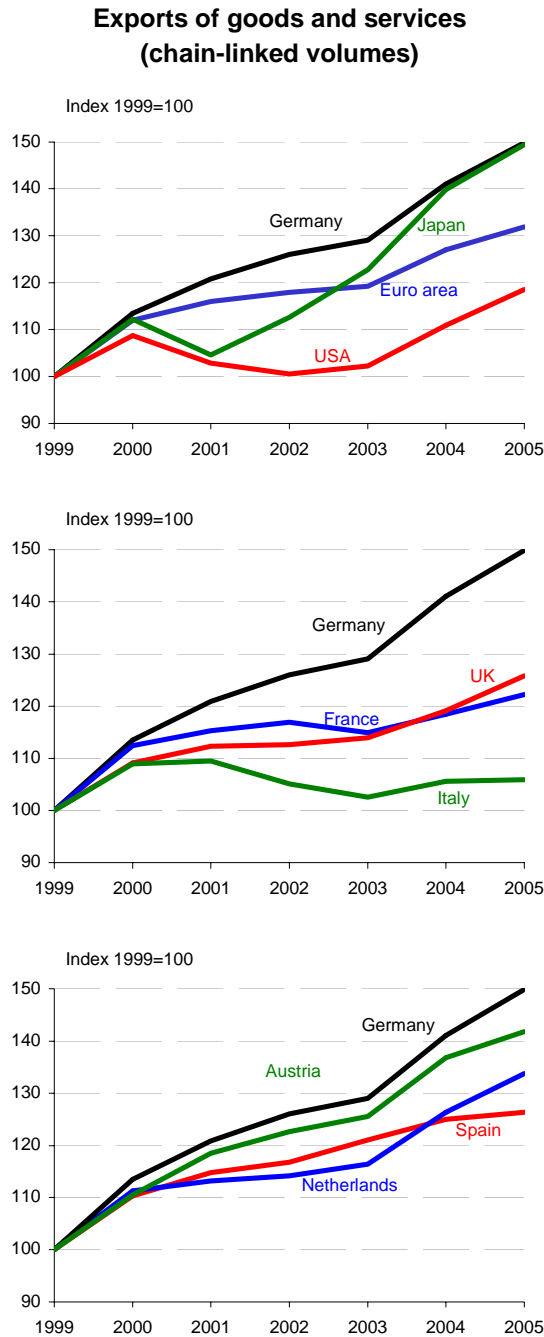


Germany has increased its exports since the beginning of the currency union more than any other member country of the euro area, followed by Austria the other country showing a persistent real depreciation.

Consequently Germany has acquired a significant trade surplus, which is still increasing. This is the immediate result of the improved competitiveness. The surplus is now higher in terms of percentage points of GDP than the worrying trade deficit of the US economy. Figure 7 illustrates the strength of Germany's export performance. The trade surplus of the German economy is accumulating at an accelerating pace. A surplus in Germany corresponds to a deficit in other countries. Especially those countries where the inflation rate was significantly higher over recent years like Spain and Italy lost competitiveness and accordingly accumulated high deficits in their external balances. What can be observed with respect to foreign trade is a growing divergence instead of a convergence within the euro area.

These findings also have a domestic dimension. The real depreciation by wage restraint has led to a severe consumption crisis in Germany.

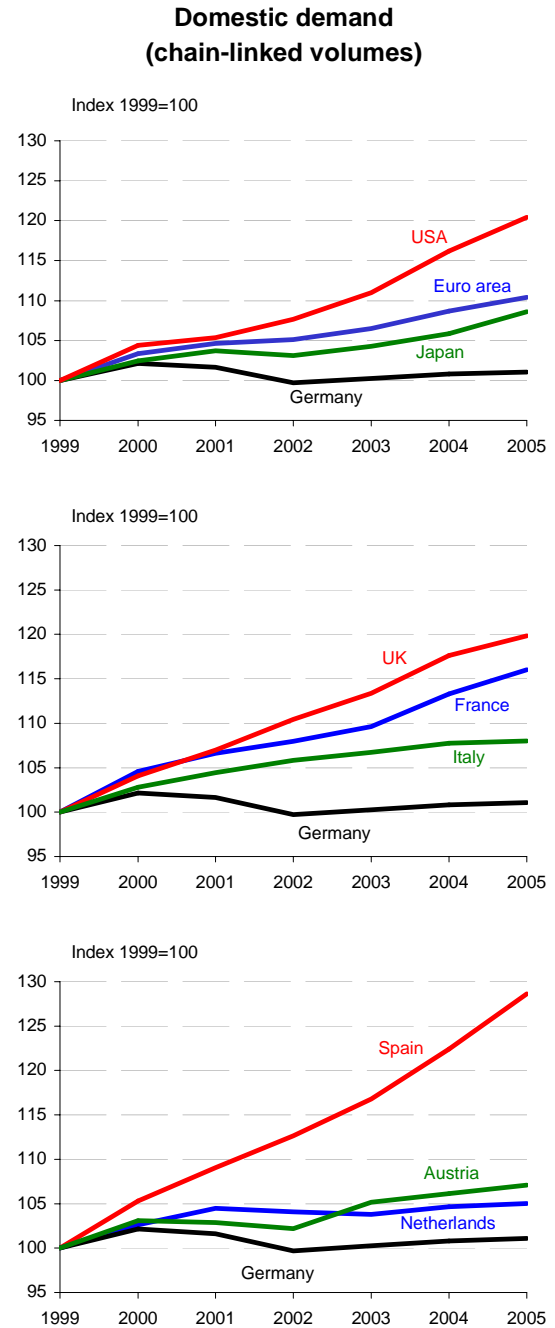
Figure 8



Source: AMECO database of the European Commission.



Figure 9



Source: AMECO database of the European Commission.



Domestic demand in Germany until the end of 2005 was weaker than in any other major industrial country, including deflation-plagued Japan. On the other hand, economies like Spain and France had a significantly higher domestic demand. In Spain the high inflation was a cause and a result of the domestic dynamics at the same time. Spain paid a price in terms of lost exports. France achieved a better domestic performance without any excessive inflationary pressure. Thus the loss of export share was not as strong as for Italy and for Spain. Nevertheless even France faces increasing difficulties in export markets against cheaper German products.

The present situation within the Euro area is not sustainable. There are basically two scenarios for future development. The first scenario is that the real depreciation for German products comes to an end. This would either be the case, if the competitive advantages finally lead to a strong German recovery. In the course of this recovery wages and in particular unit labour cost would rise faster than in the rest of the euro area, so that the real depreciation would turn into an appreciation. In order to avoid negative side effects this development is only possible if wage increases in the rest of the euro area slow down. Otherwise aggregate price stability in the euro area would be endangered and the ECB would be urged to raise interest rates. The same result can be achieved if the economic upturn is supported by a more expansionary economic policy stance than in the past. Then trade imbalances should diminish over time. This scenario implies a major change of economic policy that should stop slowing down domestic demand. The probability of this scenario is rather low. Even given the present acceleration of economic activity in Germany there are no signs of wage movements that could lead to a real appreciation. While wage increases in Germany continue to be subdued below productivity, those in the rest of the euro area are still higher.

The second scenario is that German real depreciation continues for the time being. In this case trade imbalances will grow until economic activity in those countries that appreciate slows down. This may even lead to a euro area wide recession. Then wages in these countries will rise more slowly than in Germany. Again in order to avoid additional negative side effects aggregate wage movements have to be taken into account. If German wages do not accelerate at the same time there is the danger of deflation causing potentially long term damage to the euro area.

Both scenarios imply an end to the real depreciation strategy of the German economic policy. The first scenario is a benign one, but clearly lacks probability. The second one is a harsh one and seems to be much more likely.

What could the ECB do under these difficult circumstances? Not much, since the ECB is basically in charge of an aggregate policy that cannot deal with regional differences within the Euro area. The ECB can only try to avoid negative aggregate side effects outlined in both scenarios. In the benign scenario it means to strongly signalise all countries but Germany to curb down wage increases. If this advice is not followed higher interest rates are unavoidable. In the second scenario early reductions of interest are necessary to avoid a deflation. Since from today's perspective the second scenario is more likely the ECB should be prepared to do as soon as it starts to become reality.

In order to solve the basic problem of diverging competitiveness within the Euro area the wage formation process in the different countries has to converge. This does not mean it should be equal everywhere, but it should be such that there would be no systematic differences in inflation and the resulting inflation rate should be the price stability target of the ECB. If this is not possible in the short run, fiscal policy should at least try to compensate the divergence by being more restrictive in those countries where inflation is relatively high and more expansionary where inflation is relatively low. But given the present political circumstances the probability of this to happen is rather low. Hence destabilization of the Euro area will continue for the time being.