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Diverging competitiveness among EU nations: Constraining wages is the key

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The Eurozone crisis rolls on. This column argues that Europe's leaders must do more to address the gap in competitiveness between the lean north and the bloated south. The answer is as simple to say as it is difficult to do - follow Germany's example and keep wages low.

The need for troubled Eurozone nations to rein in unsustainable government finances is clear (see, for instance, Wyplosz 2011 on this site). But it is now also widely acknowledged that they must also address their lack of competitiveness, which drains economic performance, undercuts finances, and strains the fabric holding the EU together.

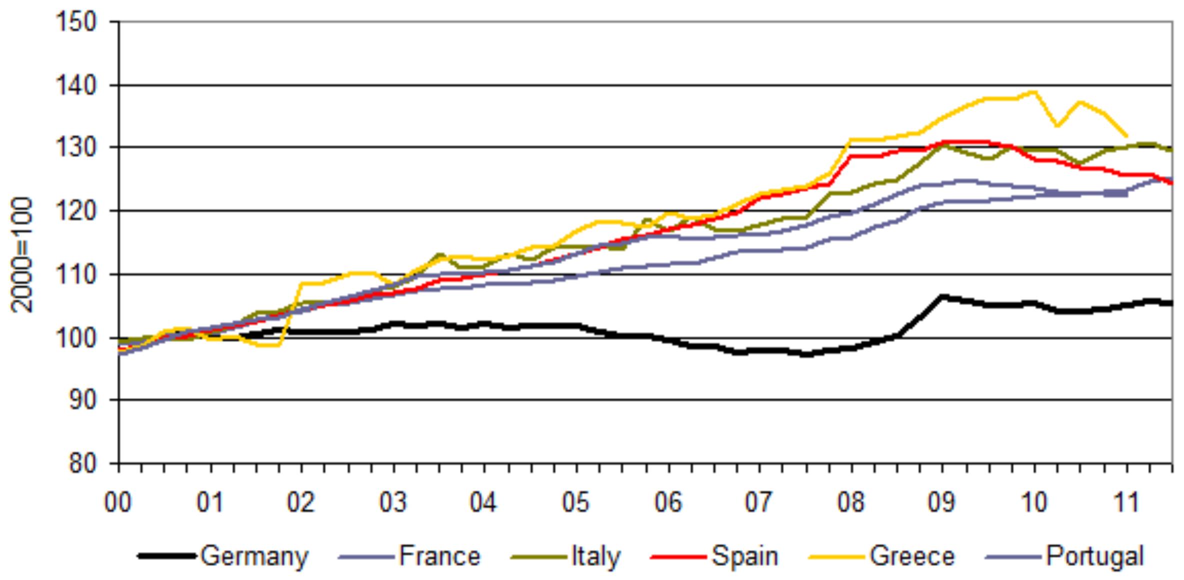
- Since unification, unit labour costs – wage compensation adjusted for labour productivity – in troubled Eurozone nations have risen dramatically faster than in Germany and other high-performing nations. The sources of these unit-labour-cost divergences are very instructive.
- Contrary to the common view, the largest source of diverging labour competitiveness in many Eurozone nations has been wage increases that exceeded productivity gains.

The policy implications are clear. Realigning real wages with productivity in Greece, Italy, Portugal, and other EU nations is as important, if not more important, than required fiscal austerity. However, this will be easier said than done.

Germany's labour policies and its trends in wages and productivity following unification provide a viable roadmap for troubled EU nations, but the political and social obstacles are daunting.

- Since 2000, productivity-adjusted wages have increased only 5% in Germany (they actually declined from 2000-2008).
- In other European nations, meanwhile, wages have increased by between 25% and 35% (see Figure 1).

Figure 1. Unit labour costs in selected EU nations



Source: Eurostat

By comparison, US unit labour costs have increased slightly faster than Germany's, driven by significantly larger labour-productivity gains and even faster wage gains. (Note that all of the figures in this column are benchmarked to 2000 and, as such, only capture relative, i.e. cross-national, changes in labour competitiveness. They do not capture the pre-existing differences in absolute levels in 2000.)

In one sense, Germany has 'benefited' from the single currency of the Eurozone relative to a stronger-currency alternative. But in reality, Germany's restrained wages amid healthy productivity gains – which reflect its government-labour union relations, labour laws and regulations compared to other EU nations – are what have distinguished the country.

The German advantage

Based on this comparative advantage, Germany's robust export growth has been the key factor driving its strong economic performance, low unemployment rate, and healthy government finances.

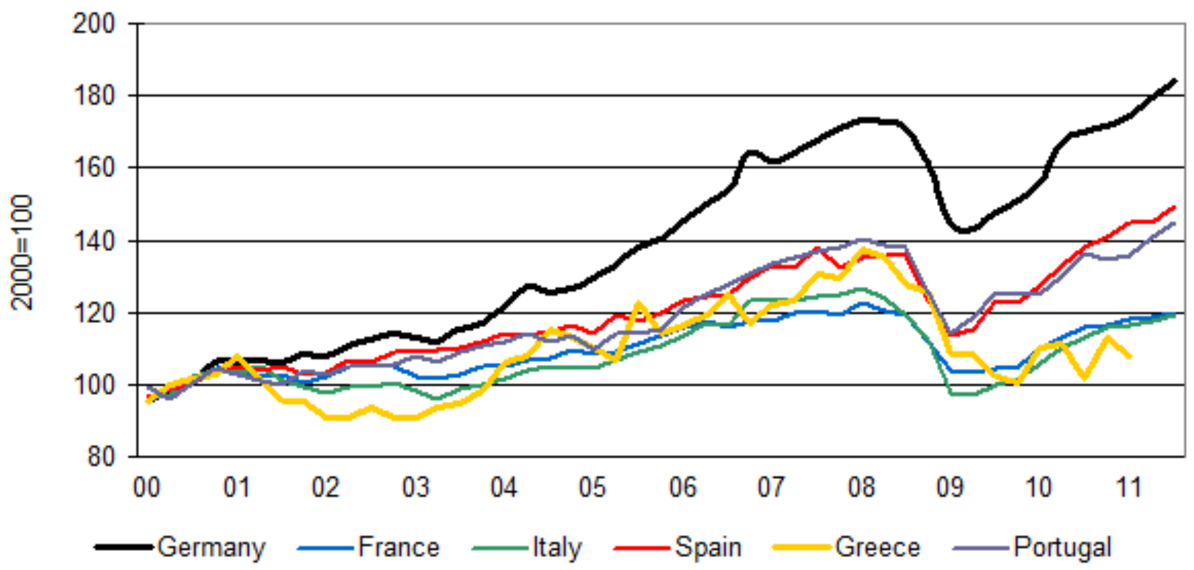
- German exports of total goods and services, including those to other European nations, rose more than 70% from 2000-2008. While they fell sharply with the global recession, they are now more than 80% above 2000 levels (see Figure 2).
- Over 60% of Germany's exports are to other European nations, denominated primarily in euros.

- Over the same period, its domestic demand was subdued, rising cumulatively 6.8%, 0.6% annualized.

Exports of other Eurozone nations have risen much more slowly, constrained by rising unit labour costs and the attendant deteriorating competitiveness.

- France and Italy's real exports of goods and services have risen 20% since 2000.
- Greece's real exports rose nearly 40% from 2000-2008, clearly benefiting from the new avenues of trade provided by the EU, but fell sharply during the global recession, and are now only about 10% higher than their 2000 level.
- Portugal's and Spain's real exports are up over 40%, despite unit labour costs that have risen significantly relative to those in Germany.

Figure 2. Real exports of selected EU nations



While each Eurozone nation's domestic demand has been slow to recover from recession, reflecting a loss in wealth, contraction of housing, and/or the effects of deleveraging, the weak export rebounds in Greece, Italy, Spain, and others have constrained their economic growth and job creation.

While these developments are not unusual, the euro means that the usual escape route is shut. With a single currency – and thus fixed exchange rates – these Eurozone nations no longer control their own monetary policies or have the option to depreciate their currencies as an adjustment valve to their differences in competitiveness.

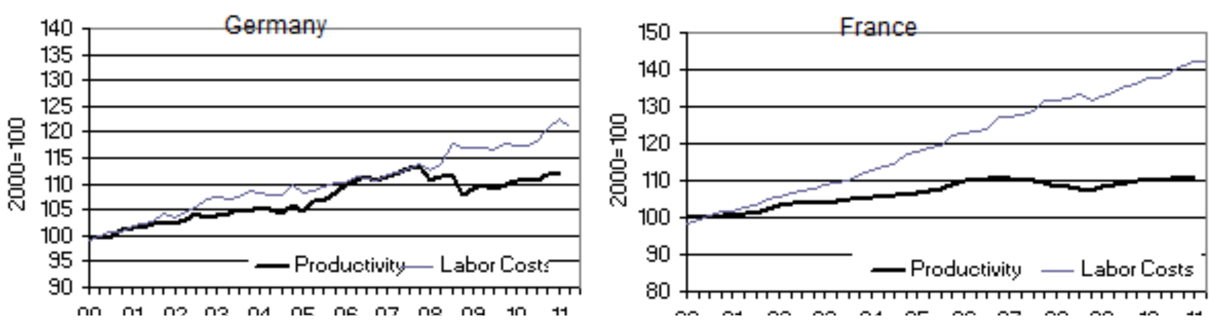
Looking behind the wage competitiveness changes

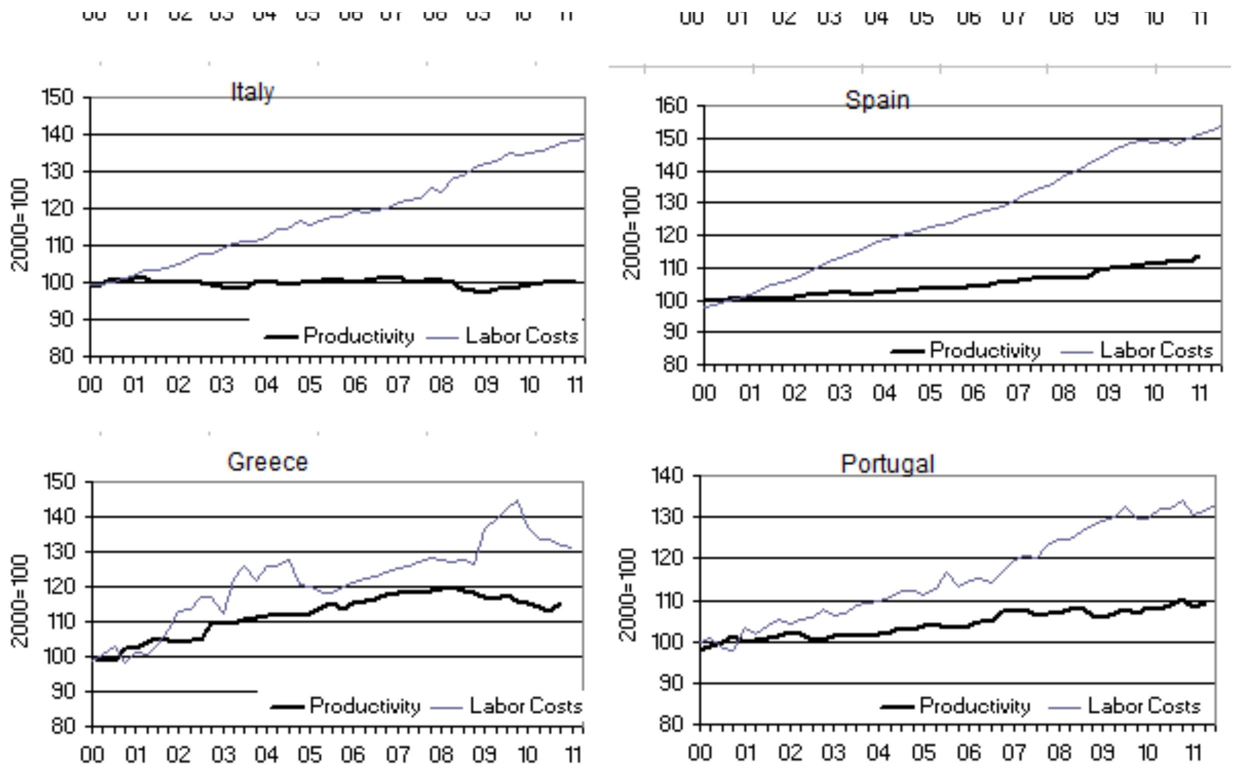
Disaggregating these competitiveness trends into wages and productivity shows that the bulk of the divergence stems from differing patterns of wage hikes. Certainly, from 2000-2008, Germany's productivity rose faster than most other Eurozone nations. But official data show that since 2000, including the recent period of deep recession and recovery, labour productivity gains in France, Spain, and even Portugal have kept pace with Germany. Italy has been the outlier, with no gains in productivity since 2000. It may seem odd that productivity gains in Greece have risen faster than in other EU nations, including Germany. Assuming the data are correct, this likely reflects Greece's low starting point when it entered the EU, and the benefits to trade provided by the union.

But the real story - contrary to the commonly held notion that German workers are more productive – is that the key was German wages restraint; its wages rose modestly, generally in line with labour productivity. In other Eurozone nations, wages have persistently risen faster than labour productivity.

- From 2000-2007, Germany's wages rose modestly in line with inflation and closely tracked labour productivity gains, as shown in Figures 3 and 4.
- Since that sustained period of flat unit labour costs, a pickup in wages has lifted unit labour costs by about 5%.
- France's and Italy's wages and unit costs have increased 40% above their 2000 levels (Italy's real GDP has expanded a strikingly anaemic 5.5% cumulatively, a 0.5% average annualized growth pace). Trends are similar in Spain and Portugal.
- Greece's wage pattern is striking - compensation rose a whopping 15% in 2002, and spiked again in 2003, seemingly as a bonus for Greece's admission into the Eurozone. And much of this was in government employees' wages.

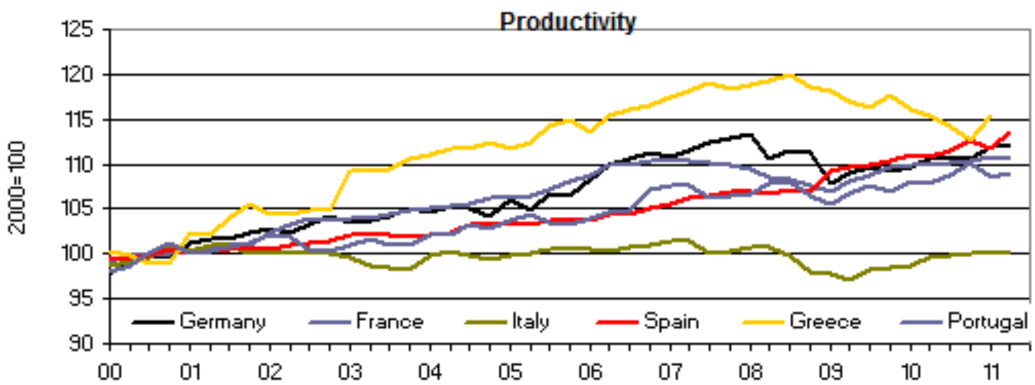
Figure 3. Productivity and total labour costs in selected EU nations

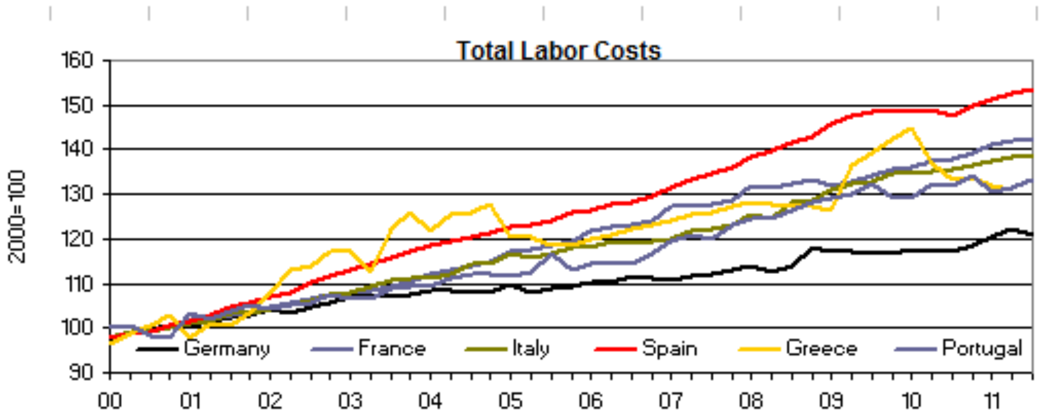




Source: Eurostat

Figure 4. Productivity and total labour costs in selected EU nations





How did the Germans do it?

A combination of factors led German labour unions to accept modest wage increases during 2000-2008. Very soft economic growth and rising unemployment during 2000-2005 raised fears of job layoffs. Prime Minister Schroeder's "Agenda 2010" reforms reduced safety nets for the unemployed, encouraging people to accept lower-paying jobs. German businesses increased reliance on part-time workers and outsourced more production to Eastern Europe. Inflation was low, averaging about 1.5% during 2000-2008 (persistently below the Eurozone average of about 2.25%) and largely maintaining real purchasing power.

Under these circumstances, the German labour unions worked closely with government and business leaders and accepted modest wage increases in exchange for job security. These factors improved Germany's international competitiveness and built the foundations for its economic outperformance. Export-driven growth has supported a rising number of jobs that are now fuelling healthier growth in domestic demand and real wages.

The way forward

At present, the loss of competitiveness in many Eurozone nations, on top of the need for fiscal austerity, adds a complicated and difficult obstacle to healthy economic performance. Fiscal austerity is necessary, but not a substitute for restoring some degree of competitiveness. Financial support from the ECB and other governmental institutions are temporary bridge loans that do not address the problems.

Several comments on the thrust of fiscal austerity are appropriate.

- First, levels of spending and taxes in EU nations are already very high, harming potential growth.

In France and Italy, general government expenditure exceeds 50% of GDP; it's similarly high in Greece and Portugal. Raising taxes would further damage economic performance, risk capital outflow and widen rather than narrow budget imbalances. Fiscal austerity must come from spending cuts. Research suggests that spending cuts would not be as damaging to economic performance as tax increases.

- Second, the vast majority of government spending is for retirement pensions and benefits, income support, etc., while very little is allocated to investment-oriented activities.

This generates high unemployment and low investment spending that constrains productive capacity. While it is well known that fiscal austerity requires making retirement and pensions less generous, reallocating more national resources toward activities that would raise productive capacity is necessary to improve economic performance, job creation, and real wages over time.

Nations whose competitiveness has eroded must either raise productivity or reduce real wages relative to international standards. Necessary adjustments will be tough to achieve. Many EU nations have entered recession. Implementing necessary fiscal austerity, along with the constraining impacts of deleveraging and tighter availability of credit, will constrain domestic demand and uncompetitive nations will have difficulty generating higher exports. Some (like Greece) suffer from very low foreign direct investment. Increasing labour productivity that boosts labour competitiveness will be difficult to achieve in this environment of weak product demand.

The implications of this reasoning are clear. For Eurozone nations unable to devalue their currencies, and limited upside potential to increase productivity, there is only one way to restore competitiveness - deflationary reductions in real wages.

- For some nations, like Greece and Portugal, the gaps are sufficiently large to question whether they can or will be closed without more radical actions such as default or worse.
- In others, like Italy, there will be significant obstacles to accepting wage reductions.

Powerful labour unions, both public and private, will strongly oppose wage cuts. Adjustment delays will harm economic performance and government finances, negating the intentions of fiscal austerity measures. Eventually, workers in Italy and elsewhere must realise that past high returns to labour are unsustainable and must decline.

Conclusions

Failure to implement such necessary adjustments will prolong economic underperformance and harm finances. During this transition period when nations incur the unpleasant medicine of austerity after years of living beyond their means, temporary financial support will be necessary. The ECB will continue to lower rates, purchase sovereign bonds of troubled Eurozone nations, and provide liquidity to financial institutions to facilitate their deleveraging and recapitalisation. It may engage in a quantitative easing programme as a quid pro quo for meaningful economic reform. Better-off Eurozone nations led by Germany will subsidise the weaker nations and, ultimately, the Eurozone must move materially towards a fiscal union that provides an alternative adjustment mechanism, with more regulatory coordination.

There are, however, limits to the resources the well-off nations will be willing to transfer to the troubled nations, particularly without assurances of necessary economic reforms. Ultimately, achieving reform is in the hands of the individual nations. My hunch is most European nations will eventually make significant strides that will move them toward sustainable paths, but it will be a bumpy road.

References

Wyplosz, Charles (2011), “Getting there, slowly though”, VoxEU.org, 9 December

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Topics: Europe's nations and regions, International trade, Labour markets, Productivity and Innovation
Tags:

Comments

Nominal Labor Unit Cost vs Real Labor Unit Cost

On January 19th, 2012 pgonzalez.731 says:

If we use Real Unit labour Cost (RULC) in our musings instead of the Nominal Unit Labor Cost the story plots totally differently.
In Spain and in Germany RULC fell from 2000 to 2011 and it fell more in Spain than in Germany.

I do not think that Nominal Unit Labor Cost is a better proxy for Competitiviness than Real Unit Labor Cost.
I think that you and many other "reseachers" use Nominal Unit labor Cost because it supports the story of competitiviness as told by the the Comminssion. Germany's "competitivieness" has more to do with the composition of their exports than with price. With their companies more than with the prices.
Nominal Unit Labor Cost reflects inflation more than anything else and it is a bad measure of competitiviness.
A solution for convergence would be to force German companies to do direct investments in a sustancial proportion in the perifery Euro countries, that way the CA inbalances would be compensated via direct investments instead of via purchases of debt of perifery countries.

nominal or real wages

On January 27th, 2012 albertobi says:

Dear Gonzales, sorry disagree. If you take locals inflation rates to get real wages, you are hiding the higher inflation in the Euro periphery. Just the reason for the weakness of their competiveness, under the same currency.

Alberto Melis Bianconi