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CEPS Commentary

Thinking ahead for Europe

Competitiveness

Treat the illness, not the symptoms

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In standard textbooks on macroeconomics, the competitiveness of a country is measured by its relative prices or relative production costs with respect to those in another country, adjusted by the nominal exchange rate. Within a monetary union, the competitiveness measurement takes a simplified form. Since all the member countries share the same currency, the nominal exchange rate equals one. Moreover, given that financial markets are highly integrated, the cost of capital should be the same for everyone, hence the only factor of production that matters is labour. For these reasons, the most common competitiveness indicator is simply the labour cost of a country vis-à-vis the rest of union.

Since the start of EMU, this indicator has diverged continuously in the eurozone, with Germany having lower unit labour cost increases than most other members and the Southern European economies losing competitiveness.

The sovereign debt crisis of 2010 has now hit the countries with the largest problems in terms of with falling competitiveness and growing current account deficits. The solution seems clear: the usual suspects need to improve their competitiveness! The official line is that the lesson has been learnt and the Union will force them to adopt structural reforms to improve their competitiveness and sanction them if they fail to comply. Yet the fundamental problem is that, like fever, a decline in competitiveness is just a symptom and not a cause of the true illness (which could be different from country to country).

It is quite surprising that the official diagnosis has been accepted so uncritically because ~~in~~ fact, it implicitly maintains two unrealistic hypotheses: 1) that ever since the start of EMU, innovation had stopped in the European periphery and 2) in those same countries, trade unions had succeeded better than anywhere else at achieving unjustified wage increases. It is a priori unlikely that this disease of low productivity and distorted labour markets should have hit only one part of the euro area.

Our own research suggests a simpler explanation. In several countries on Europe's periphery, domestic demand increased dramatically following the creation of the monetary union, fuelled by the availability of easy credit. This resulted in lower employment and thus in higher wages. By contrast, other countries like Germany, where demand had been low over the previous decade, experienced falling wages.

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On the one hand, if excess credit and demand were at the root of the problem, then the cure requires tight credit conditions and falling demand. While this treatment will be painful, it is already well on its way, given that domestic demand is now falling rapidly throughout Europe's South. Structural reforms will of course be useful, but experience suggests that the main way in which the countries in trouble regain competitiveness is by keeping their labour markets weak, which will make wage hikes impossible.

On the other hand, now that Germany is making a strong recovery from the crisis, it is also experiencing a strong increase in domestic demand, which could lead to substantial wage increases as the country is nearing full employment.

To conclude, if, as argued above, the illness comes from the combination of falling demand in some countries and excess demand in others, the ongoing adjustments induced by the crisis may lead naturally, though painfully in some cases, to greater and faster convergence than will structural reforms.