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Europe's Competitiveness Obsession

Daniel Gros

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The President of the European Central Bank is said to show at each meeting of the European Council a graph depicting the evolution of relative wage costs across the eurozone's 16 member countries. This chart shows increasing divergences over the last ten years, with the countries now facing difficulties (Greece, Portugal, and Spain) having lost competitiveness by around 20% relative to Germany. In other words, since 1999, wage costs have increased by about 20% less in Germany than in southern Europe.

The conclusion seems straightforward. The eurozone's southern European members must reduce their wage costs to claw back the competitiveness that they have lost since adopting the common currency.

Concern about such divergences has also reached the task force headed by European Union President Herman Van Rompuy, which is supposed to devise fundamental reforms to the rules for economic policy coordination within the EU. A key proposal from the task force's first meeting was to develop competitiveness indicators, and then force member countries to take "remedial action" should the EU find large divergences.

But this approach risks leading in the wrong direction. Competitiveness, which is usually measured in terms of unit labor costs, is a relative concept. One country's gain is another's loss. Restoring competitiveness in some member countries (Spain, Greece) would require others (Germany in the first instance) to accept deterioration in theirs.

The adjustment might come about through wage increases in countries with lower labor costs, rather than cuts in countries where costs are too high. The official response to this is that no country should be forced to increase wages, and that everybody gains if structural reforms increase productivity.

The latter is certainly true, but it does not solve the fundamental problem – that a country's relative unit labor costs can decline only if another country's rise.

Even assuming that agreement can be found within the eurozone on how to allocate the desired gains and losses in competitiveness across countries, member countries are not centrally planned economies. There is little that government can do in a market economy to force down wages in the private sector.

Daniel Gros is Director of the Centre for European Policy Studies (CEPS), Brussels. An earlier version of this Commentary was published by Project Syndicate, 3 June 2010.

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Governments can, of course, enforce public-sector wage cuts. This is being done on a large scale in Greece and Spain, for example. But there is little empirical evidence that public-sector wages have a significant impact on private-sector wage growth.

So is higher productivity the way out? Even assuming that governments could identify and implement structural reforms that yielded quick productivity gains, it is not clear that higher productivity leads to increased competitiveness.

In fact, across the EU, the opposite often is true. Some of the countries that achieved the highest growth in labor productivity also lost the most competitiveness (e.g. Ireland).

How is this possible? After all, higher productivity should bring lower unit labor costs. But improvements in productivity are easily overwhelmed by changes in wages. While productivity growth usually is measured in fractions of a percentage point, wage increases have been much larger.

So the real question is, What drives wages? Country-level data suggest that the largest wage increases over the last decade are generally associated with the strongest growth in domestic demand (e.g. Spain, Greece).

Are wages driving demand, or vice versa? Most of the loss of competitiveness in southern Europe occurred once unemployment there had fallen significantly. The measured loss of competitiveness in southern Europe thus should not be ascribed to a lack of structural reforms or unreasonable trade unions, but rather booms in domestic demand, fueled mainly by the easy availability of cheap credit for consumption (Greece) and construction (Spain, Ireland). This excessive consumption and construction demand led to excess demand for labor, especially in protected sectors like services, thus driving up wage costs.

If excessive domestic demand was the problem, the solution should now be on its way. International capital markets already have curtailed credit to these countries. The sharp fiscal retrenchment that has now started throughout southern Europe should contribute further to a sharp deceleration, if not outright fall, in domestic demand there. If labor markets are flexible, this should result in lower wages. Indeed, that is the key condition: labor-market flexibility on the way down as much as on the way up.

Adjustment would be much easier, of course, if wages did not fall in Germany as well. But, given that unemployment is actually declining in Germany, which in the past has tended to increase wages (moderately), this is unlikely.

The proposition that governments “must do something about competitiveness” risks leading to an excessively activist approach to economic policy coordination, with governments and EU institutions constantly trying to influence wage-setting in the private sector. This might work – at least partly – in the current crisis, but it will not be able to prevent future divergences in competitiveness if domestic demand diverges again.

Structural reforms are always useful, but increasing productivity takes a long time and does not always translate into higher competitiveness. What is needed in southern Europe is acceptance that domestic demand must fall to a level that allows countries to live without further capital inflows. After that, it should be sufficient to allow labor markets to work until the system finds its new equilibrium.