

Has the Competitiveness Obsession Killed Europe?

ECOLINKS

The policies implemented in response to Europe’s sovereign debt crisis and serious economic imbalances evoke the concept of “competitiveness.” Yet this concept and the measures it implies are ill-suited to Europe’s situation and may worsen its predicament.

Over a year ago, on the eve of France’s presidential elections, Ecolinks wrote that “the obsession with competitiveness will kill Europe.”¹ This text offered a critical analysis of the anti-crisis policies that had been proposed by European institutions (the European Commission and the European Central Bank, or ECB) with the support of the International Monetary Fund (IMF). These policies were based on a debatable diagnosis of current account imbalances resulting from an upward spiral of labor costs on the euro zone’s periphery. Yet in economics as in medicine, an inappropriate treatment is at best useless and, at worse, can seriously threaten a patient’s health. In April 2012, we expressed our doubts regarding this diagnosis²: we feared that the toolkit used by the troika (the International Monetary Fund, the European Commission, and the European Central Bank) might result in even graver imbalances—imbalances of a political nature—which could endanger more than half a century of European construction. In this article, Ecolinks revisits this diagnosis and considers the patient’s health over a year after the treatment began. Now more than ever, a new treatment is necessary.

Imbalances in the Euro Zone: An Upward Drift of Salaries?

In the years preceding the crisis, a number of economies in the euro zone’s “periphery” (Cyprus, Greece, Portugal, Spain, Italy, and Ireland) accumulated significant current account deficits, while other economies in the zone (Germany, Austria, the Netherlands, etc.) acquired surpluses. Though it did not make it into the exclusive club of “poor students,” France was, at the crisis’ outset, included in the category of countries deemed “non-competitive,”³ due to the rising trade deficits it experienced in the 2000s, following years of surpluses.

¹ Ecolinks is an association of economists. Ecolinks’s blog is available at www.ecolinks.fr.

² See "[L’obsession de la compétitivité va tuer l’Europe](#)" on the Ecolinks blog.

³ There are many definitions of competitiveness. In this article, we will refer to the concept of “external” competitiveness, that is, an economy’s capacity to export, which is typically used in reports published by the European Commission and the International Monetary Fund. “External” competitiveness is the focus of this “obsession” we have identified, both in reports by international institutions and in numerous articles and commentaries appearing in the news media. By themselves, however, export performances are not indicators of an economy’s good health. In what follows, we offer an example—that of Germany—which proves that strong imports do not necessarily imply sustained economic growth. A broader definition of competitiveness makes it possible to

The troika's diagnosis cannot be disputed: over the course of the 2000s, a discrepancy in labor costs did indeed emerge in European economies, which could be correlated to current account trends.⁴ Believing that this correlation was a *cause*, the troika claimed that current account imbalances in the euro zone were the consequence of an upward spiral in labor costs that was undermining competitiveness in Spain, Italy, and Greece. The remedies proposed followed from this diagnosis. Under pressure from Europe's institutions, the deficit countries not only imposed drastic budget austerity on their economies, but also a strict regime of wage moderation intended to restore price competitiveness.

Note that according to Brussels, the country that must bear the burden of the adjustment is always the deficit country, and never its partners in the zone that have surpluses. Yet at least as far as trade within the euro zone is concerned, one country's deficit is always another's surplus, and has as its counterpart capital movements flowing in the opposite direction. German as well as French banks contributed significantly to imbalances in the euro zone by helping to finance Greek, Portuguese, and Spanish imports through very generous loans.⁵ The burden of adjustment, it must be observed, has fallen harder on peripheral economies that imported (and borrowed) too much than on their euro zone partners who lent them too much.

Correlation Is Not Causation

The causal relationship that attributes current account imbalances to a deterioration of labor costs in Spain or Greece, which has been widely cited by the troika and numerous political officials, is highly debatable.⁶ Yet it is precisely on this basis that anti-crisis policies have been crafted. It neglects the major role played by flows of intra-European capital in the years leading up to the crisis.

Paradoxically, this is the result of the euro's enormous success when it was launched in 1999. The euro allowed European capital to circulate without currency exchange risks in a region characterized by a very high level of economic integration and shared institutions. After the fact, however, the current crisis demonstrates the inability of European institutions to monitor and issue warnings relating to the risks associated with such investment flows, which can be enormous when they are used to finance speculative projects. Far from financing investment that increases the productivity and standard of living of European economies, these investment flows created real estate bubbles, weakened banks, and forced states to intervene to ensure the financial system's stability, resulting in a colossal rise in public debt.

Thus the so-called "drift" in per unit labor costs in Greece and Spain can be explained by two factors. First, the real estate bubble, spurred by capital from the rest of Europe, resulted in higher inflation than in other parts of the euro zone. The sharp rise in demand for new housing construction was particularly favorable to rapid salary increases, which were passed on to the

identify an economy's capacity to improve, over the long term, its inhabitants' standard of living, and, more generally, their wellbeing.

⁴ This correlation is negative: in the 2000s, before the crisis, there was greater deterioration of current account balances (i.e., deficits were rising) in countries that experienced faster increases in per-unit labor costs.

⁵ Paul Krugman, 2012, "Revenge of the Optimum Currency Area," *New York Times*, June 24.

⁶ See Gabrisch (H.) and Staehr (K.) (2012) "The Euro Plus Pact: Competitiveness and External Capital Flows in the EU Countries," Bank of Estonia Working Papers, 2012-5.

rest of the economy. Second, productivity did not increase, as investment was directed at sectors that were the least exposed to international competition and comprising the least productive companies.⁷

Thus the main cause of Europe's current account imbalances was not the deterioration of labor costs in the euro zone's periphery. Rather, these imbalances are the result of intra-European capital flows, which financed massive investments in sheltered economic sectors, while contributing simultaneously to a deterioration of current account balances due to rising imports. In other words, prior to the crisis, the German savings surplus met the financial needs of Greece, Portugal, and Spain.⁸ The swift elimination of current accounts deficits post-2009 confirms the important role played by capital flows, which can create sudden imbalances and quickly reabsorb them when capital flows dry up.

The troika's diagnosis, which holds the "drift" in per-unit labor costs responsible for the current account imbalances on the euro zone's periphery, is mistaken. And a bad diagnosis often results in ill-suited policies.

The German Model's Misleading "Good" Solution

Germany's role is central to this analysis, given its export performance and its significant current account surpluses. Its strong export performance has turned Germany into a European "model," which has inspired many European leaders, including French politicians on both the left and the right. They are held up as proof of the German economy's health, which, it is believed, can be traced back to the labor market reforms implemented in the early 2000s.

Yet prior to the crisis, Germany did not distinguish itself by higher growth (measured in Gross Domestic Product) than the rest of the euro zone. Moreover, wage restraint policies are likely to prolong the recession in the periphery's weakest economies.

The so-called "Hartz" reforms, which were part of Chancellor Schroeder's "2010 Agenda," introduced flexibility into the German labor market. They decentralized collective bargaining in industry, and newly signed company-level agreements limited wage increases while also, in some instances, increasing work time without corresponding pay raises. Other labor market reforms (very short-term contracts, mini-jobs, and reductions of eligibility periods for unemployment insurance) also resulted in declining service sector wages.

The first victim of these measures was household purchasing power. Consequently, German growth in the 2000s was primarily driven by exports, in a context of rapidly rising demand in the remainder of the euro zone, while weak domestic demand slowed down imports. Without the particularly vibrant external demand that was to be found in the rest of Europe, the Hartz reforms

⁷ On this topic, see the text published in [Books and Ideas](#).

⁸ In macroeconomics, a strict equality exists, at the global level, between one agent's ability to provide finance and another's need for finance. In principle, current account imbalances improve capital allocation. The European example demonstrates that capital flows can also feed real estate bubbles and lead to sudden reversals of these flows in times of crisis.

would probably not have been adopted, given their negative impact on growth. Furthermore, German employees would simply never accepted lower salaries without better employment opportunities in return.

Did the drop in per-unit labor costs help promote exports? The answer is very unclear. Strong wage stability, in addition to significant productivity gains, greatly reduced labor's per-unit cost in relation to other euro zone countries. This drop in costs was, however, imperfectly passed onto to export prices, since German companies decided to significantly increase their margins (and hence their profits) rather than cutting prices. However, greater corporate profitability most likely influenced their decision to keep some of their industrial production in Germany.

Yet the fact remains that it is difficult to reach an unambiguous conclusion on the role of cost factors in explaining differences in export performance prior to the crisis. The situation in Spain is, in this regard, paradoxical, as its pre-crisis performance was comparable to Germany's, despite a significant rise in per-unit labor costs. Other factors must be considered to complete this diagnosis. For example, Germany's central geographic position in Europe at a time of intense fragmentation in production processes could explain Germany's export performance.

Beyond the impact of Agenda 2010 on German exports, it is crucial to emphasize the fact, which we noted above, that Germany's growth rates in the 2000s were not significantly higher than the rest of the euro zone's. Its superior export performance occurred at the expense of domestic demand and purchasing power and resulted in increased inequalities. Did they knock off the patient?

Under the troika's influence, European governments have sought, since the beginning of the crisis, to launch structural reforms inspired by Germany's example. In this regard, the pressure from European institutions (both the European Commission and the European Central Bank has been great. On June 26, 2013, Mario Draghi, the governor of the European Central Bank, declared before the French National Assembly:

[F]or all euro area countries, a new approach is needed. An approach that can deliver growth and jobs, and sustain social models, without creating an unsustainable debt burden for future generations.... The *first response* is to ensure that fiscal consolidation, which is necessary to contain debt levels, is made as growth-friendly as possible.... The *second response* is to raise competitiveness and increase the underlying productive capacity of our economies.

Some progress has already been made in rebalancing the euro zone. Per-unit labor costs have dropped in countries where they had risen too much, current account deficits have been cut in economies that experienced significant imbalances, and exports are generally increasing in problem-plagued countries.

However, in many euro zone countries, the gap between wages and productivity remains incompatible with competitiveness.

The troika has thus very clearly promoted supply-oriented policies as a way to pull Europe out of the crisis. In keeping with the economic policies that have been adopted, governments sought to reform (in other words, to make more flexible) their labor markets to achieve two goals: to promote the reallocation of work towards export-oriented sectors and to reduce cost competitiveness by increasing productivity while cutting wages.

There is no doubt that such policies, launched at the beginning of the crisis undeniably, cut current account deficits in the euro zone's periphery (Spain's current accounts are now balanced!). Yet this rebalancing proved painful. It is best explained by a decline in internal demand (and thus of imports), which is tied to lower salaries and increased unemployment, rather than significantly higher competitiveness, which would contribute to more exports, growth, and employment in countries with deficits. Without a noticeable rise in demand in the euro zone (in other words, in Germany but also France), structural reforms in the periphery's labor markets will only increase the unemployment rate, as Spanish, Greek, or Italian exporters will not be in a position to hire and will opt to increase productivity.

In other words, the structural reforms that have been implemented since the crisis began have promoted an economic slump rather than growth. The effect of these policies is to impoverish the working classes, young people, and older workers, who are in the most precarious position on the labor market. These policies have also led to great political instability in Europe, resulting in major resentment towards right as well as left-wing governments. They have favored the rise of populist movements, like the Five Star Movement in Italy, and strengthened extreme right, sovereignist, anti-European, and even neo-Nazi movements, like Golden Dawn in Greece. Beyond their economic consequences, European economic policies risk calling into question more than fifty years of European construction. While these policies have not yet killed Europe's patient, they have certainly postponed its healing. The time for change has come.

Stimulating Demand and Investment

The collapse of demand in the euro zone's periphery—and the effects in the core—are one of the main risks to which European governments are now exposed (without getting into the political consequences of these trends). Emerging from the slump requires new policies and a coordination of efforts at the European level. Until now, most adjustment has occurred in peripheral countries. Yet it should be shared by central countries (Germany, Austria, the Netherlands, Finland, etc.), the countries that have been the least affected by the crisis, which must now play a role in stimulating Europe's economy. Without a significant rise in demand in the center countries, current accounts can be rebalanced only through a prolonged decline in demand in the periphery and a drop in per capita wealth.

Consequently, other policies coordinated at the European level are required to guide national efforts, with the goal of promoting a rapid return to growth:

- ▶ Greater wage increases in Germany compared to Europe's deficit-plagued countries, combined with *temporarily* higher inflation in the entire euro zone, would help to rebalance current accounts without requiring deflationary policies in the periphery. In short, salaries should not decline in France, any more than in Spain or Greece. Inflation for the entire euro zone, which

currently is far below that 2% target, should temporarily be set at 3% or 4%, thus allowing salaries to rise more rapidly in Germany in particular.

- ▶ A looser budgetary policy, which would primarily involve postponing budgetary adjustments, would make it possible to support demand in the center as well as the periphery. A clear commitment on the part of governments would allow budgetary measures to be made based on the economic cycle. Temporarily higher inflation would, once again, lessen the debt burden.
- ▶ Clear directions relating to public investment aimed at promoting long-term growth should be debated by European governments in collaboration with the European Commission and the European Parliament, in order to support future projects, particularly in European economies that have been hurt the most by the crisis.

While the competitiveness obsession has not yet killed Europe, it is urgent to recognize the failure of the deflationary policies that have until now been implemented by European governments. A new policy direction is needed, one that should support demand and investment in euro zone's center as well as its periphery.

Published on Books&Ideas.net, 13 November 2014. Translated by Michael C. Behrent with the support of the Institut français

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First published on lavedesidees.fr, 28 January 2014.