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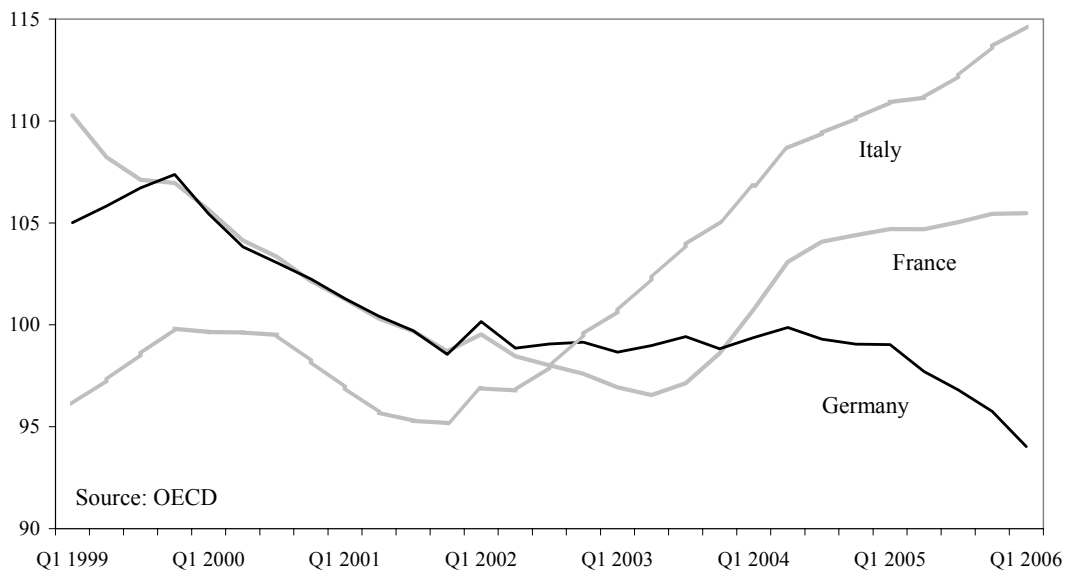
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Diverging Tendencies of Competitiveness

Jean-Paul Fitoussi

In 2003 Chancellor Schroeder launched an ambitious structural reform package (Agenda 2010), that simultaneously reformed the pension system and the labour market (following the proposition of the Hartz commission report, of August 2002). This program reinforced a trend already visible since the year 2000, aimed at increasing competitiveness of the German economy by reducing production costs. This effort was rather successful, as figure 1 shows.

Figure 1- Cost Competitiveness: Relative Labour Cost

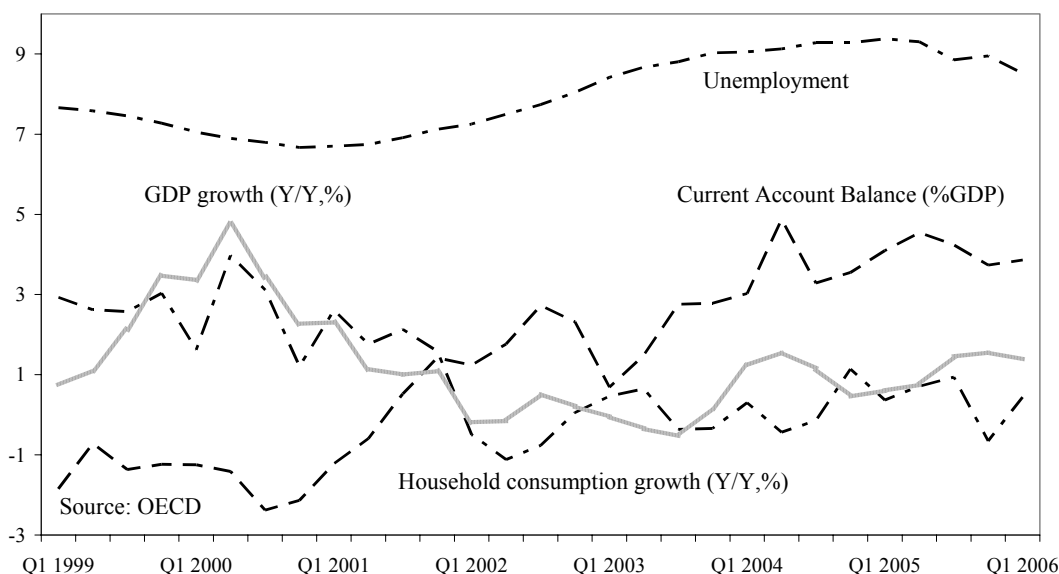


The competitive situation dramatically improved with respect to Italy, which was unsuccessful in controlling wage increases. But relative labour costs significantly dropped also with respect to France, which was in a similar situation at the end of the last decade. Germany became more competitive with respect to the UK and Spain as well.

This impressive performance in increasing cost competitiveness has been greeted as the proof that the sick man of Europe was finally getting healthier, and ready to take its place as the locomotive for growth. The concern then shifted to those countries, like France and specially Italy, which did not engage in a process of structural reforms, thus putting at risk growth and stability for the EU as a whole. The comparative way of evaluating national economic policies may sometimes be misleading. A country may have good reasons to embark in a strategy of cost reduction which others have not. That is especially the case of Germany: as it is well documented, German unification led to a significant loss of competitiveness which should have led to a real depreciation of the mark in the second half of the 90s. In other words Germany joined the euro with an overvaluated currency. Should the other countries have embarked in the same strategy this would have nullified the German efforts without any significant benefit for the euro area. The search for competitiveness in a monetary union amounts to a non-cooperative game.

Because in fact, competitiveness is not an objective *per se*. Rather, it is instrumental to increase growth and welfare, the final objectives of policy action. By taking these variables as an indicator of performance, as seems more reasonable, we can remark that the German disease may not be over after all. Figure 2 shows some selected macroeconomic variables for Germany.

Figure 2 - Germany: Selected Macroeconomic Variables



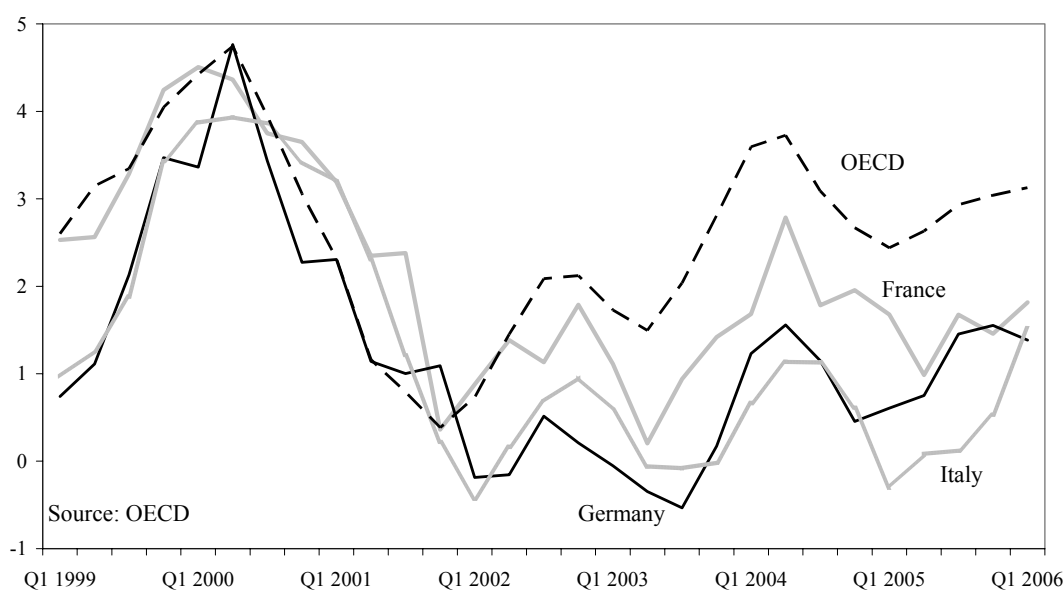
The growth performance since 2000 has been all but satisfying, and the modest recovery that we can observe since the beginning of 2005 is not expected to last well into 2007, when among other things the announced increase in VAT could depress internal demand. Furthermore, the already modest recovery is turning out to be a jobless growth, in spite of the increased flexibility of the labour market. Since 2000, unemployment has increased more than 2 percentage points. Finally, consumption on average has been increasing below the growth rate of the economy, and this is hardly surprising given the stagnation in real wages (real wages increased only by 2.8% in Germany since 2000) and the persisting unemployment.

The only visible effect of the increased cost competitiveness of the German economy is the strong improvement of the current account balance that over the period has yielded a surplus of 125 billions euros. We remark on the other hand that the Euro zone commercial balance increased of 30 billion euros over the same period, which means that the increased competitiveness of Germany has mainly caused a reallocation of market shares within the area. Germany's surplus is mainly absorbed by a corresponding deficit of its neighbours (France's position worsened of 46 billions, Spain's of 44, Italy's of 14). The improved situation of Germany was obtained at the expense of a deterioration of the position for other countries in the Euro zone.

Furthermore, like competitiveness, the ex-post national external balance in a monetary union is not per se an objective (as it could have been for the union as a whole), but an instrument, and as such it is not an indicator of good performance. It could even be said that the benefit of globalization being an optimal allocation of saving, it is not even an objective for a country characterized by its own currency. Otherwise, we should conclude paradoxically that the United States, which experienced important external deficits at least since the early 1980s, is the worst performer of OECD countries.

The growth performance is particularly disappointing if we compare it with the other countries, whose competitiveness position worsened with respect to Germany (figure 3).

Figure 3 - Real Growth Rates (Y/Y,%)



Without even mentioning the average OECD performance, that since 2002 was considerably better, we can observe that France on average grew faster than Germany, and that the situation of Italy is not dramatically worse.

In conclusion, at least so far the bold effort in cost competitiveness, that we can define as a non-cooperative “competitive disinflation”, did not bring the results its advocates hoped. The limited increase in growth can be attributed to the external balance, while internal demand and employment stagnated.

One could on the other hand argue that structural reforms, as all phenomena that involve deep modifications of the economy, can entail transitions in which the disruption hurt the economy before the benefits appear to compensate. Furthermore, the deeper is the transformation, the longer is the transition. According to this view, then, the best is yet to come, and we can expect the German economy to experience stronger growth as the system absorbs the structural changes.

In fact, simply by looking at standard economic analysis, it becomes hard to subscribe to this optimistic view. The natural consequence of a strong reduction in real wages (the main channel for boosting cost competitiveness) is a compression of domestic aggregate demand (consumption and investment). This has of course direct short term effects, in terms of sluggish growth. But, prolonged periods of slow growth also have long term effects that are often overlooked. If investment is consistently below normal, long term productive capacity, and hence the potential for future growth are also affected.

Thus, a competitive disinflation strategy to be successful needs an increase in external demand (by means of increased market shares) capable to match and more than compensate the decrease in domestic demand. Furthermore, this effect needs to appear in a sufficiently short time horizon, to avoid the long term adverse effects of low investment on potential growth.

But if the balance between external and internal demand components is the crucial factor determining the success of competitive disinflation, then country size becomes the main analytical element of the analysis. Smaller, more open economies face a very strong price elasticity of external demand. This means that everything else equal, a reduction in the price of their exports will increase the total demand for their goods of a larger amount. Thus, competitive disinflation may prove a winning strategy for a small country, especially when the exchange rate with its large neighbours is fixed (e.g. Ireland, or the Netherlands). A cost reduction will increase the exports of an amount that is significant for the country itself, more than compensating the decrease of domestic demand. The large trading partner, on the other hand will not necessarily feel the competitive pressure, and hence will not retaliate. Ireland is a good example of an export led growth, obtained through aggressive wage and price policies, which triggered a virtuous cumulative process feeding back through expectations and household wealth into domestic consumption and investment.

A large country on the other hand, has a larger share of domestic demand in GDP, and consequently a lower price elasticity of exports. Furthermore, its actions are more likely to affect its trading partners.

As we saw above, the important reduction in Germany's wages and labour costs has depressed internal demand, and the effect on exports has not been sufficient to compensate it. Furthermore, as its trading partners (France, Italy, and Spain) were negatively affected by the loss of market shares, their income could decrease, together with their demand for German goods. Last, but not least Germany's trading partners will most likely engage in the same strategies, reducing the competitive edge that Germany has temporarily obtained. The theory then predicts a race to the bottom, in which successive waves of reduction in costs will leave the competitive situations more or less unchanged, and further depress internal demand at each round. Such non-cooperative game will in the end leave every country worse off.

The constraints on macroeconomic policy set by the European institutions (the Stability and Growth Pact, and the statute of the European Central Bank) further complicate the picture, as the governments are prevented to sustain domestic demand by means of active policies.

The conclusions that we can draw from this analysis are not encouraging. The modest effect of the German competitive disinflation is likely to be structural, i.e. linked to its size with respect to the trading partners. Thus it does not seem plausible to expect substantial benefits from this strategy once the transition is over. Furthermore, if Germany's trading partners retaliate adopting the same strategy, Europe as a whole could be facing hard times. The generalization of non-cooperative behaviour may well lead to a *malaise* in the European Union. The Euro zone will then be threatened if France and Italy follow Germany, not if they don't.

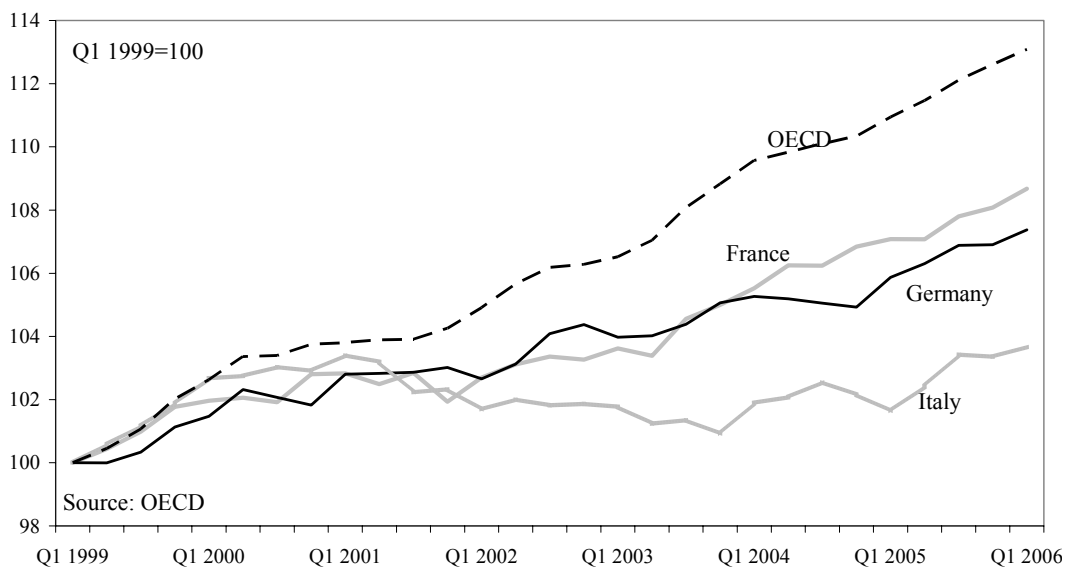
Finally, even if we were to assume that cost competition may work with respect to the European and North American trading partners, it is hard to believe that it would be the appropriate response to the challenge coming from emerging economies. How much will we have to lower wages before we can compete with China's labour costs? How much of our welfare state will we have to give up, to give firms the necessary flexibility? What will be left of the European social model, if we engage in price competition with East Asian countries?

If cost competition does not seem a viable path to walk, another strategy must be put in place to face the increasing pressure that comes from emerging countries

and to counter the tendency to non cooperative behaviour that threatens the European project.

In fact, an increase in a country's competitiveness may come from a reduction of labour costs, with all the problems detailed above, or from an increase in productivity. Better quality goods can compete even with the low cost production coming from emerging markets. Figure 4 shows the evolution of a rough measure of productivity, real GDP over employment. Figure 4 shows the evolution of a rough measure of productivity, real GDP over employment.

Figure 4 - Productivity (Real GDP / Employment)



It is immediately apparent that these figures are more coherent than labour costs with the growth figures reported above (figure 3): the OECD average is well above the three largest eurozone countries, and within this group France fares better than Germany and Italy.

The key to increasing productivity is strong private investment, so that policies aimed at increasing competitiveness need to create a business-friendly environment. Measures to cut costs must be complemented and preceded by development of financial markets, implementation of industrial policies, funding of basic research, and academic excellence. Furthermore active policies, by smoothing the cycle, may act as an insurance and lower uncertainty. This sustains investment, and hence both the quantity and the quality of productive capacity.

Research and Development, industrial policy, and even demand management (because of the demand linkages between European economies), are all characterized by increasing returns. This naturally calls for cooperation among European governments that allows exploiting economies of scale. Instead of fighting with each other with the illusion of gaining cost competitiveness, European governments should cooperate to build a business friendly environment, to develop private investment and competitiveness.