Competitiveness and the European Financial Crisis

Erik Jones[*]

Johns Hopkins University SAIS

(erik.jones@Jhu.edu)

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There are three explanations circulating for why some countries were more affected than others during the European financial crisis – one that turns on levels of indebtedness, one focusing on 'competitiveness', and one centered on financial market dynamics. These explanations are not mutually exclusive. Countries can have bad debt problems, weak competitiveness, and face a sudden stop on their capital accounts at the same time.[1] By the same token, all three explanations point to real concerns that warrant attention. Countries would be better off if domestic actors borrowed responsibly, if they had competitive industries and flexible labor markets, and if they maintained the confidence of financial market participants. Given that politicians have only limited resources, however, what is the priority for action?

My argument in a series of related essays is that European politicians should focus on the financial dimension of the crisis before turning to other matters (e.g., Jones 2011, 2014). Private sector leverage and public sector indebtedness are critical problems, but they can be managed provided countries maintain the confidence of financial market participants. Japan and the Netherlands are both good illustrations of how to survive with over-sized debt problems; Belgium and Italy live a more precarious existence and yet still manage to muddle through so long as the markets are willing to support them.

Matters related to 'competitiveness' are also important, and yet should be at the bottom of the list of priorities. Of course it is true that countries cannot run large current account deficits if they do not have access to international finance. Herb Stein's Law says that such countries will have to bring their current accounts back into balance – because if something cannot go on forever, then it won't. The ability to reduce relative real unit labor costs or to rely on flexible labor markets could facilitate such adjustment. Under certain circumstances, a depreciation of the nominal exchange rate can help as well. The question is whether any of these measures offers more than a temporary palliative in a crisis where financial influences predominate.

The purpose of this chapter is to explain why restoring 'competitiveness' should not be a priority in the current crisis. European countries should have flexible labor markets, they should invest in human capital development, and they should refrain from unnecessary distributive conflict or excessive wage demands. This would be true whether or not there was a crisis – and, indeed, it was a priority long before the crisis unfolded. My goal here is not to refute those enduring requirements for recalibrating the European welfare state (Hemerijck 2012).

Rather my goal is to engage with those who contend that redressing competitiveness should be a priority in response to the crisis. The essence of their claim is that those countries most susceptible to the crisis were those that were least competitive either because they had excessive wage growth in the context of irrevocably fixed exchange rates or because they had rigid labor market institutions that translated even relatively moderate wage growth into excessive relative price differences. The corollary

is that those countries most affected by the crisis will only emerge once they have adjusted to restore their competitiveness.

Both the claim and the corollary are inaccurate. Countries did not get into crisis because they lost competitiveness. They may have lost competitiveness and fallen into crisis, but the two developments are not causally connected. Indeed, it is hard to show that the loss of competitiveness even heightened the susceptibility of governments to crisis dynamics. Any perceived negative correlation between competitiveness indicators and measures of vulnerability is likely to be spurious insofar as it derives from a prior causal mechanism. Worse, lowering relative real wages is not going to make matters better. At best real wage compression will crush down on import consumption enough to promote some kind of low-income equilibrium; at worst it will create suppress economic performance in a pro-cyclical manner.

The paper has four parts. The first outlines the case that the loss of competitiveness is at the root of the crisis. The second focuses on the Greek case. The third broadens the analysis to the rest of the euro area periphery. The fourth concludes by suggesting what this misdiagnosis of the financial crisis as a problem of competitiveness entails for the countries most affected and also what it reveals about our understanding of economic integration.

Exchange Rates, Competitiveness, and Current Account Imbalances

There are a number of commentators who point to competitiveness as the underlying cause of the euro crisis. More often than not, however, they do so without providing a clear exposition of the causal mechanism. Bob Hancké (2013) is an exception. In contrast to the usual short-hand treatment, Hancké maps the various steps in the argument that connects the creation of a monetary union to the onset of the European crisis through the impact of monetary integration on wage bargaining and relative cost structures. By doing so, Hancké resolves the seeming paradox that those countries with the most coordinated wage bargaining systems are also the ones most successful at sustaining a competitive advantage.

This section uses Hancké's argument to construct a framework for analyzing the causal mechanism. The argument starts during the run-up to monetary union at a time when national central bankers constrained national wage negotiators with the threat of punitive interest rate rises and national politicians shaped macroeconomic policy to achieve monetary integration through a process of convergence on German norms for inflation and government borrowing. The introduction of the single currency eliminated the role of national central banks and loosened the constraints on national politicians (who no longer faced the threat of exclusion from the single currency).

Wage negotiators faced new incentives and constraints under the common currency. More coordinated wage-bargaining systems made it easier for wage negotiators in the manufacturing sector to set norms for the economy as a whole. Meanwhile, tight macroeconomic policies in many of these countries – Germany in particular – placed downward pressure on wage bargains. Less coordinated systems responded differently. Manufacturing unions had less influence over wage negotiations in the public

sector and macroeconomic policy was more accommodating. While price inflation remained low in the more coordinated countries, inflationary pressures increased in those countries that lacked coordination and so lost wage discipline in the public sector (see also Johnston, Hancké, and Pant 2014).

The pressure of wage inflation was greatest in the non-traded sectors of the economy. Inevitably, however, it spread back into the internationally traded sectors. Over time, these inflation differentials created a divergence in relative export market performance and current account balances. Such divergence also implied systematic differences in relative levels of public and private sector indebtedness across countries with different wage bargaining regimes. The crisis in the Eurozone was a consequence.

This summary of Hancké's argument does not use quotations because it is a synthesis of a long exposition and my goal is only to give the structure in broad brush strokes. In testing the argument, however, it is important to be as true as possible to the original language of Hancké's exposition so that there is less danger of drawing out unfair or unnecessary logical entailments. The strength of Hancké's analysis is that he is so detailed and so transparent; hence there is no need to posit tests that he does not mention himself already.

Five elements are essential to the claim that Hancké makes. The first of these is the specification of competitiveness: 'Everything else equal, being able to control the growth of unit labor costs – the costs, expressed in wages, of producing a single good or service – faster than your trading partners in EMU implies an improvement an improvement in competitiveness' (Hancké 2013, 4). To be clear, 'faster' modifies 'control' and not 'growth' in this sentence. 'If the growth of ULC [unit labor costs] in country A is lower than in country B, A gains competitiveness vis-à-vis country B' (Hancké 2013, 100). This is a narrow definition of relative price competitiveness. Hancké (2013, 99) admits that 'many factors go into the determination of the real exchange rate'. Nevertheless, labor costs are a 'main determinant' and so Hancké gives them a central role in his analysis.[2]

A second element in Hancké's argument is the division between those sectors that are exposed to external price competition and those are not. The exposed sector includes manufacturing for export; the 'sheltered' sector includes non-traded services and, critically, public sector employment. This two-sector model is important in Hancké's argument because it explains how relative unit labor costs could diverge across countries in an integrated international economy where trading firms are price-takers and so face similar incentives and constraints.[3] According to Hancké (2013, 59-60), the creation of the single currency 'did not, in fact, open the possibility for across-the-board wage explosions, but only in the domestic (sheltered) sector. The exposed sector still faces a hard constraint in the shape of external competitiveness, and is therefore compelled to keep its wage growth under control.' It is only over time that wage increases in the sheltered sector feed back into wage bargains in the exposed sector 'as something like a reverse Balassa-Samuelson effect, in which relatively attractive wages and working conditions in the public sector force employers in the export sector to raise wages' (Hancké 2013, 63).

A third element is the 'productivity whip' (Hancké 2013, 93). Those countries that have tighter control over wage bargaining tend to end up with tighter wage dispersion; this means that while real wage

growth is low, relative real wages are high. This creates an incentive for greater investment within competitive sectors because 'it imposes high productivity growth in the low-productivity companies and allows well-performing companies to invest more on the back of higher profits and thus raise their productivity. Average productivity thus permanently rises' (Hancké 2013, 93). In turn, this increased productivity reinforces competitiveness by lowering unit labor costs. Moreover, since competitiveness is implicitly a relative concept, what one country or group of countries gains in competitiveness, other countries necessarily lose (Hancké 2013, p. 102).

A fourth element concerns the impact of the loss of competitiveness of the export sector. In part, this impact can be anticipated in the vulnerability of the exposed sector as mentioned above. As Hancké (2013, 64) makes clear: 'If, adjusted for labour productivity, their wages rose faster than those in the export sectors of their main trading partners, the loss of competitiveness would rapidly lead to falling employment, lower wages, or both.' In part, it is also anticipated in the implications of differential productivity growth. In those countries that faced incentives to strengthen productivity due to wage coordination, 'average company strategies moved up market'; meanwhile, in those countries were the productivity whip did not operate, 'firms did not, on the whole, change their aggregate strategies or, if they did, moved down-market into more cost sensitive segments' (Hancké 2013, 94). The bottom line is that firms operating in countries that experienced a loss of competitiveness faced the prospect of 'the simple collapse of exports as a result of rising export prices'; 'aggregate inflation rises, the exposed sector is unable to compensate for a rising domestic price level, and export goods are priced out of the market' (Hancké 2013, p. 101).

The fifth element is the impact on current account balances and the accommodation of the current account by the capital account. The point to focus on is timing. Competitiveness problems reveal themselves over time in terms of contrasting current account positions between countries that have coordinated wage bargaining institutions and those that do not: 'The competiveness gains of the first, and the competitiveness problems of the second, which ultimately were reflected in massive trade and current account imbalances across EMU after 2009, and in accumulating public and private debt in the deficit countries, thus had their origins in the different evolution of wage-setting systems prior to the introduction of the euro in 1999' (Hancké 2013, 10 – but see also 57). The problems started almost immediately after the introduction of the single currency: 'What is immediately apparent is how the convergence [in current account performance] that governed most of the 1990s, was abruptly reversed in the years 2000-2001, with Germany's current account surplus rising fast and the others' deficit rising fast' (Hancké 2013, 103).

Within this dynamic, the current account predominates and the capital account accommodates. 'The profits made in the north thus found their way, via the banking system and the organized system of private and public debt, back to the south, where they were used to purchase more good exported by the north, which started the capital transfer cycle again' (Hancké 2013, 92). 'The upshot is that with the current account imbalances increasing between the northern European economies and the peripheral southern economies and Ireland, the divergence between private debt and public deficits in the two types of EMU member states increased in lockstep. . . . Put simply, no current account deficit, no fiscal crisis and/or no banking crisis, and vice versa' (Hancké 2013, 104).

These five elements make it easy to look for correspondence between the causal mechanism that Hancké uses in his argument and the macroeconomic data that is readily available. If we focus on those countries that have suffered most from the crisis, the factors to look for are:

- An acceleration in the relative growth of unit labor costs leading to a deterioration in the real exchange rate;
- An acceleration of domestic price inflation that cuts into export prices (and therefore performance) with a lag;
- A deceleration in productivity growth both relative to more successful countries and over time;
- A deterioration in export performance in terms of value composition, coupled with a decline in export manufacturing employment and export market share;
- A progressive deterioration in current account performance as the situation continues to worsen together with evidence of accommodation on the capital account.

The argument here is not that all of these elements must be present for Hancké's argument to succeed. Hancké is very careful in his analysis to note the many idiosyncrasies in national performance. Nevertheless there should be sufficient correspondence with the data to suggest that this mechanism operates both for individual countries and across the two groups – core and periphery or North and South.

Competitiveness in Greece

From this point onward, I will stop focusing on Hancké's work per se and will instead turn to the competitiveness argument in more general terms using the five-point framework I was able to extract from his argument. This framework would be representative of any claim that 'competitiveness' lay at the heart of the European crisis; one of Hancké's contributions to the literature is to make that structure explicit.

Unless otherwise indicated, the data I use is from the Annual Macroeconomic (AMECO) database of the European Commission. The codes for individual data lines are listed in parentheses next to the name of the indicator. The strategy I use for testing the competitiveness argument is to start with Greece and then broaden out to the wider group of adversely affected countries as a whole. Greece is not a country that Hancké would accept as representative. There are many reasons to agree that it is exceptional. Nevertheless, Greece is a useful starting point because it has the worst current account performance on the periphery of the euro area and because it has become a poster child for what has gone wrong within the single currency.

That said, the Greek case is not the only one tested. It is also not the pattern for other countries that were adversely affected by the crisis. Hence, the periodization I use in pulling together the economic data follows a more general chronology and not one dictated by events in Greece. Three periods warrant attention: 1991-1999, 1999-2007, and 2007-2013. This section touches only on the first two of

those periods – the run up to single currency and the experience of monetary union before the crisis. I deal with the crisis itself only later.

Going through the five parts of the framework in order, the first point to note is that the performance of relative unit labor costs does not conform to the competitiveness argument. Greek real unit labor costs (QLCDQ) increased by 4.5 percent relative to the EU 15 during the run up to the single currency and then declined by 1.7 percent after the euro started and before the crisis. This performance is not as impressive as Germany, where relative real unit labor costs increased by 3.2 percent prior to the euro and declined by 6.7 percent in the period to 2007. Nevertheless, it would be an error to compare these numbers directly because the situation in Germany is already calculated in the data for Greece (as a competitor country using double export weights) just as the situation for Greece is included in the data for Germany. Side-by-side presentation creates a complex form of double-counting; the point to note is simply that Greece did better after the euro started.

Of course there are more factors than just real unit labor costs that go into the calculation of real effective exchange rates (XUNRQ). Nominal effective exchange rates (XUNNQ) and relative movements in the price deflator for gross domestic product (PVGDQ) – a broad measure of price inflation – must also be taken into account. These two factors point in opposition directions for Greece, at least during the 1990s. The Greek nominal exchange rate tended to depreciate relative to Greece's main competitors and relative inflation rates tended to be higher. On balance, however, the impact of these two variables on Greek real effective exchange rates was much worse before the euro than after. The reason is simple: any depreciation of the currency tended to pass through quickly into domestic prices in an accelerating manner. Hence Greek real effective exchange rates appreciated relative to its main European competitors by 21.4 percent in the 1990s and only 4.5 percent in the 2000s.

Greece continued to lose competitiveness in the 2000s but at a much slower rate than beforehand. The reason is that the act of stabilizing the nominal exchange rate helped bring domestic price inflation under control. Where Greece's GDP price deflator increased more than 51 percent against it main competitors in the 1990s, it increased 'only' 9.9 percent in the 2000s. That deceleration in relative inflation rates more than offset the costs of surrendering the downward flexibility in the nominal effective exchange rate and yet still constitutes a problem. That is why Greece continued to lose competitiveness despite the relative compression of real unit labor costs. This would seem to vindicate the argument that export manufacturers experience the consequences of wage growth in the non-traded goods sector only with a lag. The length of the lag will be determined by the relative pace of productivity growth.

The productivity data offer another example of where the Greek case fails to conform to the competitiveness argument. Real GDP per worker (RVGDE) increased by only 8.3 percent in the 1990s but increased by 20.4 percent in the 2000s. The German data for the same periods shows and increase of 11.2 percent and 9.9 percent respectively. In other words, Greek productivity growth appears to have accelerated after the introduction of the euro rather than having decelerated; the German situation is the reverse. Before drawing too hasty a conclusion from this data, however, it is useful to look at relative employment growth – because these productivity numbers show output per worker and so

decline when the number of workers expands. Domestic employment (NETD) in Germany did not grow at all in the 1990s and increased by only 2.7 percent in the 2000s; Greek employment expanded by 7.4 percent in the first period and 12.7 percent in the second. In other words, Greek employers not only managed to accelerate productivity growth but also to accommodate a much larger increase in the workforce than in Germany.

Another way to discount the impact of a change in the labor force is to look at total factor productivity (ZVGDF). This measure of productivity is the residual once the impact of changes in the supply of capital and labor are taken into account. Economists use this as a means of capturing the rate of technological or qualitative improvement and central bankers like Peter Praet (2014) regard as the most reliable indicator of real economic convergence. Total factor productivity increases when the machines are better and the workers are smarter or more skilled. In Greece, total factor productivity increased by 5.3 percent in the 1990s and 15.5 percent in the 2000s. It outperformed Germany in both periods; in the second period, Greece only trailed Finland for total factor productivity growth in the euro area.

The question is whether the influence of any of this data can be seen in terms of export performance. Analysis of the composition of exports is challenging because of the level of detail involved in assessing whether Greek exporters are moving up or down the value chain. A quick survey of two-digit SITC codes published by Eurostat to assess the composition of the Greek export bundle suggests that there is some improvement in the period after the introduction of the euro. The code numbers are given in parentheses. Between 2001 and 2007, the value of fruits and vegetables (05), wool (26), vegetable fats (42), textiles (65), and clothing (84) all lost importance in the export bundle; pharmaceuticals (54), plastics (57), metal products (67, 68, 69), machinery (74, 77) and road vehicles (78) all increased. What that means in terms of firm strategy is hard to determine.

What is easier to note is that the rate of growth in real exports of manufactured goods (OXGN) increased from 26 percent in the 1990s to 33 percent in the 2000s. Meanwhile, Greece held onto its (admittedly very tiny 0.19 percent) global export market share (AXGT) and its roughly 500,000 manufacturing workers (NETM). If the impact of higher rates of domestic inflation hits only with a lag, then it had not manifest by the start of the crisis. On the contrary, Greek exports were in rude health.

The same is not true of Greek current account balances (UBCA). Here I have to change the periodization slightly to avoid double counting the end years. The cumulative Greek current account deficit for the years 1991 to 1998 was just 9.1 percent of GDP; for the years 1999 to 2007, it was just over 101 percent. That is more than a ten-fold increase from one period to the next. The current account deficit in 2007 alone was just under 18 percent of GDP – or twice the value for the pre-euro period. This dramatic increase requires explanation, particularly given the data for real effective exchange rates, productivity growth, and export performance. Even the most pessimistic interpretation of that data offers little to explain the worsening of Greece's current account position.

The most obvious step is to question whether the current account actually predominates in Greek balance of payments accounting – or whether what we observe as current account performance is actually determined elsewhere. Here it is useful to differentiate between the balance of payments as an

accounting identity and the transactions that take place on the different accounts. As an accounting identity, whatever happens on the current account must be reflected elsewhere as well. Two other main accounts complete the system. One is the account for capital transactions. The other is the account for official settlements, or transactions between central banks.

The argument so far is that the current account predominates and the capital account accommodates. That means that whenever the value of imports into a country exceeds the earnings that country's firms earn through their exports, the difference must be financed from abroad; an inflow of foreign capital offsets the gap between imports and exports or, speaking more broadly, the balance on current accounts. Two questions are relevant. The first is how importers lure foreign capital to pay for the products they purchase abroad; the second is what happens when that capital is not forthcoming. The answers to both questions make it possible to get a sense of whether the current account actually predominates in the balance of payments.

The answer to how domestic residents lure foreign capital is that they have to offer an attractive rate of interest. The more capital they require, the higher the interest rates they have to offer. Hence we should expect interest rates to rise as the current account deteriorates – but with a lag, because importers first have to run out of access to export earnings before they reach out for capital from abroad. Given this line of argument, the data for Greece show something unexpected. Long term nominal interest rates (ILN) decline prior to the emergence of significant current account deficits and remain low throughout the pre-crisis period. This can be seen in Figure 1.

Insert Figure 1 about here.

There are many reasons why long-term nominal interest rates would remain low in Greece. Some of these have to do with the peculiarities of sovereign debt markets. Therefore it is worth considering the possibility that the current account follows one logic and the capital account follows another. In that case, any shortfall on funding on the current account should show up in the transactions between central banks. Here we have a more limited data set that covers only Greece's experience in the euro and its attendant real-time gross payments system between central banks (Target2). Nevertheless, since that period is also a time of dramatic deterioration in current account performance, it is a reasonable place to look for any financial shortfalls. Like the balance on a credit card, the data reflect the Greek central bank's financial position with the rest of the euro area. A deficit indicates that the Greek central bank borrows money from the euro system as a whole. So long as that deficit is consistent from one month to the next, the central bank is not borrowing new money to meet its financing requirements – hence a constant position reflects a consistent, accumulated shortfall – or gap – in the balance of payments between the current account the capital account. Whenever the value for a country's position changes, that change reflects a sudden shift in the balance of payments either paying down or running up the balance with the rest of the euro system. If Greece were to have difficulty financing a sudden expansion of its current account deficit, we would expect the deficit on Greece's Target2 position to increase. What the data in Figure 2 show is that while there is some volatility on a month-to-month basis, the net debit position of the Greek central bank tended to diminish in the period before the crisis.

Figure 1: Greek Current Account Balances and Long-term Interest Rates
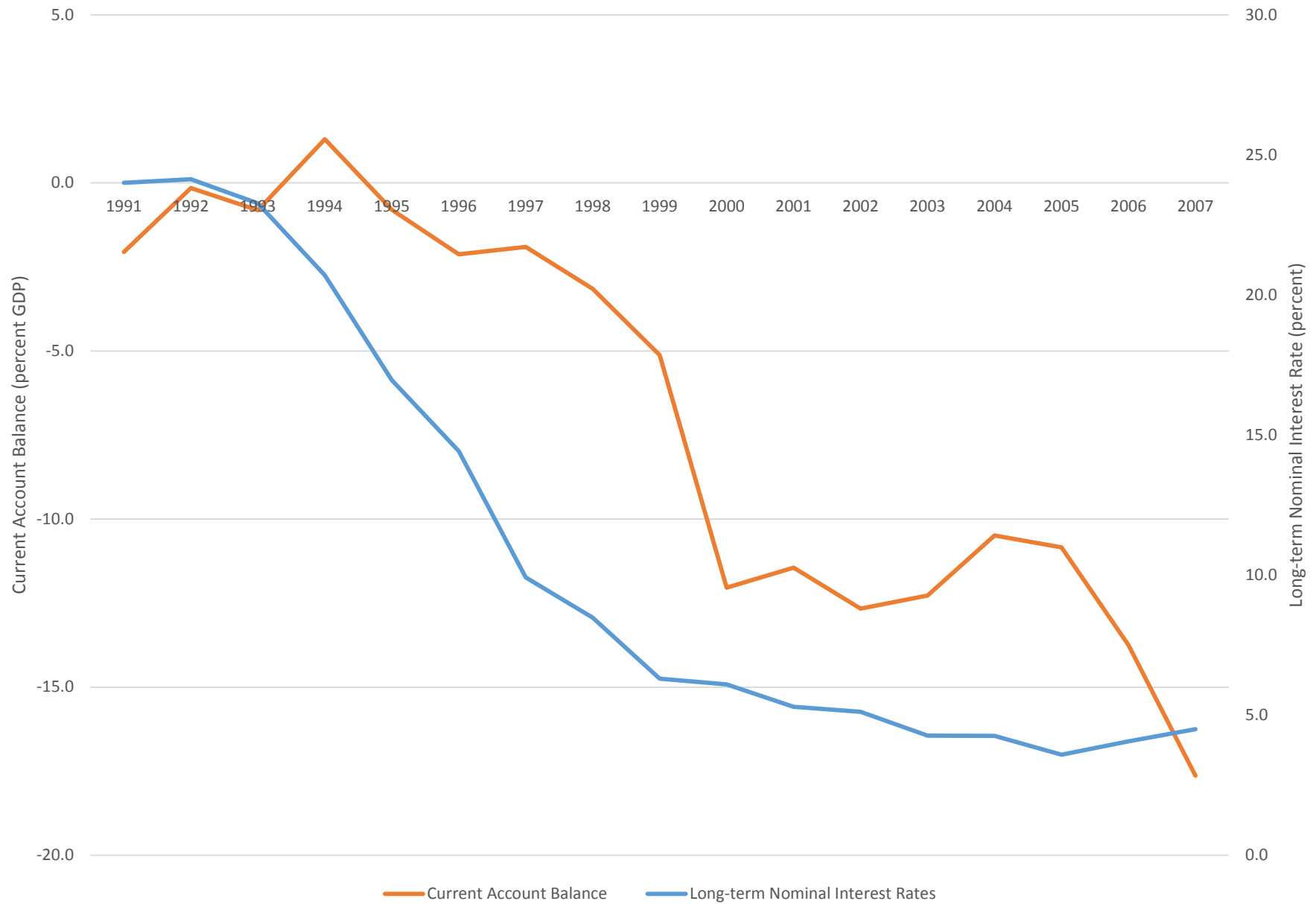
In other words, Greece was able to pay down its balance with the rest of the euro system even as its current account deficit increased.

Insert Figure 2 about here.

From this data, it is hard to see much evidence of current account dominance in the balance of payments. Greece experienced a huge increase in its current account deficit, but it did so against a backdrop of historically low interest rates and with little sign of difficulty in meeting its financing requirements. The crisis came to Greece; it did not arise from the loss of Greek competitiveness.

Competitiveness Elsewhere

The Greek case is counterintuitive. It is also idiosyncratic. The data for other countries do not look the same as they do for Greece. The question is whether that data conforms to the competitiveness argument any better than the Greek data does. The answer is mixed, if generally better than for the Greek case. Different countries conform to different parts of the argument; no country conforms to all of it, though some come close.

The country-by-country comparison is summarized in Table 1. The columns are the most affected countries in alphabetical order – Greece, Ireland, Italy, Portugal and Spain. The rows list different indicators corresponding to the five different parts of the framework. The individual boxes indicate whether the country's performance meets the expectations of the argument, yes or no.

Insert Table 1 about here

On the surface, the Irish case seems clear cut. Real effective exchange rates rise dramatically, fueled by increases in the relative growth of real unit labor costs and relative inflation rates. Meanwhile both labor productivity growth and total factor productivity growth slows down. The point to note, however, is that productivity growth in Ireland is much faster than it is in Germany by both measures. Moreover, Irish employment is increasing hugely both before and after the introduction of the euro. Real export growth slows down and manufacturing employment declines marginally. Meanwhile, the current account moves from surplus to deficit. There too, however, the amounts are unimpressive. The cumulative deficit on Irish current accounts over the period from 1999 to 2007 is just 12.9 percent of gross domestic product. As with Greece, Ireland's position in the Target2 system actually improved in 2007 when the current account moved most deeply into deficit.

The Italian case is somewhat similar to the Irish one insofar as Italy experiences a deterioration of performance in real unit labor costs and therefore also an increasing appreciation in the real effective exchange rate. Unlike, Ireland, however, Italy's performance in terms of relative GDP price inflation improves rather than worsening under the euro. [As an aside, most Italians will find that statistic hard to believe.] Productivity growth in Italy decelerates by both measures and is much worse than in Germany. Meanwhile, the growth in real exports of goods slows down. The point to note, however, is that Italy increases employment by 11 percent after the euro is introduced while at the same time holding onto

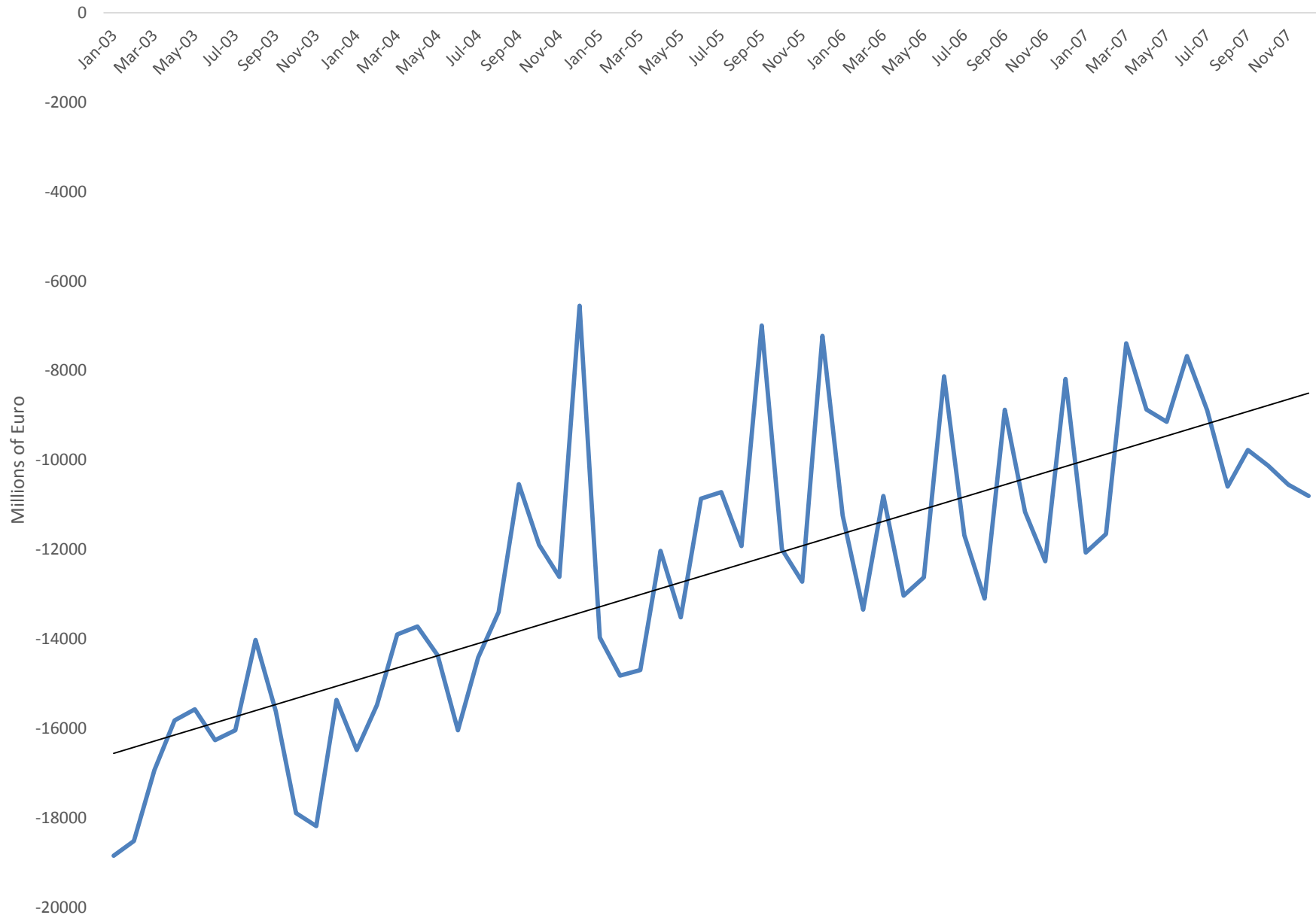Figure 2: Greek Target2 Position (and trend)

Table 1: Conformity of the Peripheral Countries to the Competitiveness Argument.

Question (indicator)	Greece	Ireland	Italy	Portugal	Spain
Does the growth in relative real unit labor costs increase after the introduction of the euro?	**NO**	*YES*	*YES*	**NO**	**NO**
Does the appreciation of the relative real effective exchange rate increase after the introduction of the euro?	**NO**	*YES*	*YES*	**NO**	*YES*
Does the growth in the relative GDP price deflator increase after the introduction of the euro?	**NO**	*YES*	**NO**	**NO**	*YES*
Does labor productivity growth decline after the introduction of the euro?	**NO**	*YES*	*YES*	*YES*	*YES*
Does total factor productivity growth decline after the introduction of the euro?	**NO**	*YES*	*YES*	*YES*	*YES*
Does the growth in real exports of manufactured goods decrease after the introduction of the euro?	**NO**	*YES*	*YES*	*YES*	*YES*
Does employment in manufacturing decrease after the introduction of the euro?	**NO**	*YES*	**NO**	*YES*	*YES*
Does the current account move (deeper) into deficit after the introduction of the euro?	YES	*YES*	*YES*	*YES*	*YES*
Does the central bank's borrowing from the euro system through Target2 increase with sudden changes in the current account position?	**NO**	**NO**	**NO**	**NO**	*YES*

its roughly 4.9 million manufacturing jobs. And while the current account moves from surplus into deficit, the cumulative total over the period from 1999 to 2007 is even smaller than in Ireland at just 5 percent of GDP. Italy has no difficulty financing this deficit. On the contrary, its position in the Target2 system is positive and increasing. In other words, the Bank of Italy is a net creditor for the euro system as a whole and Italy has little trouble meeting its balance of payments financing requirement.

Portugal experiences a slowdown in the growth of relative real unit labor costs after the introduction of the euro and a slowdown in the appreciation of the real effective exchange rate as well. That said, both indicators of relative cost competitiveness continue to worsen, even if at a slower pace. So does relative performance of the deflator for gross domestic product. Meanwhile labor productivity growth slows down and total factor productivity growth grinds to a halt. This story does not conform exactly to the competitiveness argument but it comes close enough. The effects show up in the data for export performance and manufacturing employment. The growth in real exports slows after the introduction of the euro and Portugal sheds roughly 150,000 manufacturing jobs (or about 15 percent of the initial total) along the way. The current account deficit widens to more than 10 percent of GDP and while Portugal's Target2 balance improves in 2007, it will struggle when the crisis hits in 2008.

Spain is a lot like Portugal. The big difference is that relative performance in real unit labor costs improves after the introduction of the euro rather than deteriorating. This is more than offset by the worsening of relative performance in GDP price inflation and so Spain experiences a relative appreciation of its real effective exchange rate. Meanwhile, labor productivity growth slows and total factor productivity actually shrinks (which is a sign of labor hoarding). This is unsurprising given the rapid expansion of Spanish employment – which rises by more than 28 percent after the introduction of the euro. It is nevertheless worrying from a competitiveness standpoint. Spain also loses about 100,000 manufacturing workers, albeit from a much larger population of manufacturing employment, and real export growth slow from 83 percent in the 1990s to 41 percent after the euro. Again, like Portugal, Spain's current account peaks in 2007 at roughly 10 percent of GDP. Meanwhile Spain's balance in the Target2 system moves from surplus to deficit between June and December 2007. This is very close to what we would expect from the competitiveness argument.

Ireland and Italy seem less likely candidates for a crisis of competitiveness; Portugal and Spain seem more likely. Hence the question is whether the competitiveness story makes sense on balance as a diagnosis for the peripheral region of the euro area as a whole. Recent analysis by Jose Luis Diaz Sanchez and Aristomene Varoudakis (2013) suggests it does not. They use a panel data vector-autoregressive (VAR) model to capture the relative influence of standard indicators for competitiveness on current account balances. What they discover is that changes in relative unit labor costs or real effective exchange rates account for only about 3 percent of the variation in current account performance. The rest is accounted for by factors that do not fit within the competitiveness argument. That finding is not unique. Charles Wyplosz (2013) comes to a similar conclusion using a different set of analytic techniques. The argument in both cases is that any adverse movement in competitiveness indicators and current account balances is the result of prior causal factors.

Such findings seem counterintuitive because the logic of the competitiveness argument is so strong. Nevertheless, they resolve certain anomalies in the aggregate performance of the five peripheral countries of the euro area (Greece, Ireland, Italy, Portugal and Spain – PC5) in comparison with other parts of Europe like Germany or the collection of wealthy countries – the United Kingdom, Sweden, Norway, Denmark, and Switzerland (USDNS in the figures) outside the euro area. Two indicators are worth highlighting: world export market shares (AXTN) and manufacturing employment (NETM).

Figure 3 shows the evolution of world export market shares from 1991 to 2007. During that period, all three areas lose ground, which is only natural given the concurrent rise of China. Germany loses most in the 1990s, falling from 11.5 percent of world export markets to 9.6 percent at the start of the euro in 1999. Meanwhile, those wealthy countries that did not adopt the euro saw their market share fall from 10.6 percent to 9.4 percent and the peripheral countries remained roughly constant at 8 percent. Once the euro started, German performance fluctuated around 9.4 percent of total world markets and the market share of the five euro area peripheral countries declined from 8 percent to 7 percent. Meanwhile the wealthy non-euro countries lost twice as much ground to fall from 9.4 percent to 7.4 percent. The five peripheral countries of the euro area may have lost competitiveness after the introduction of the euro, but the non-euro countries lost more.

Insert Figure 3 about here.

The data for manufacturing employment are even more striking. These are collected in Figure 4. Germany lost 2.3 million manufacturing workers during the post-unification period and the run-up to the euro; after the euro was introduced and before the crisis, German manufacturers shed 400,000 more jobs. By contrast, the wealthy countries that did not adopt the euro showed the reverse. They lost 500,000 manufacturing jobs in the 1990s and another 1.3 million in the early 2000s. The performance of the five peripheral countries of the euro area was much stronger. They lost only 400,000 manufacturing jobs during the 1990s and another 300,000 after the introduction of the euro. That represents an attrition of less than 8 percent of the starting pool of manufacturing workers over a 17 year period. Roughly 40 percent of the population will have retired during the same time frame; those workers must have been replaced.

Insert Figure 4 about here.

These aggregate data make it hard to support the conclusion that the five peripheral countries of the euro area got into trouble because of a dramatic loss of competitiveness. They may have lost competitiveness, but the resulting change in export market share and manufacturing employment was not dramatic in comparison with performance elsewhere. What was dramatic was the increase in cross-country variation of performance on the current account. This can be seen in Figure 5 as the standard deviation across national current account balances as a percentage of GDP. Some countries – mostly in northern Europe – moved significantly into surplus while others – including the five peripheral countries of the euro area – moved into deficit. This variation peaked shortly before the crisis and then started to diminish rapidly.

Insert Figure 5 about here.

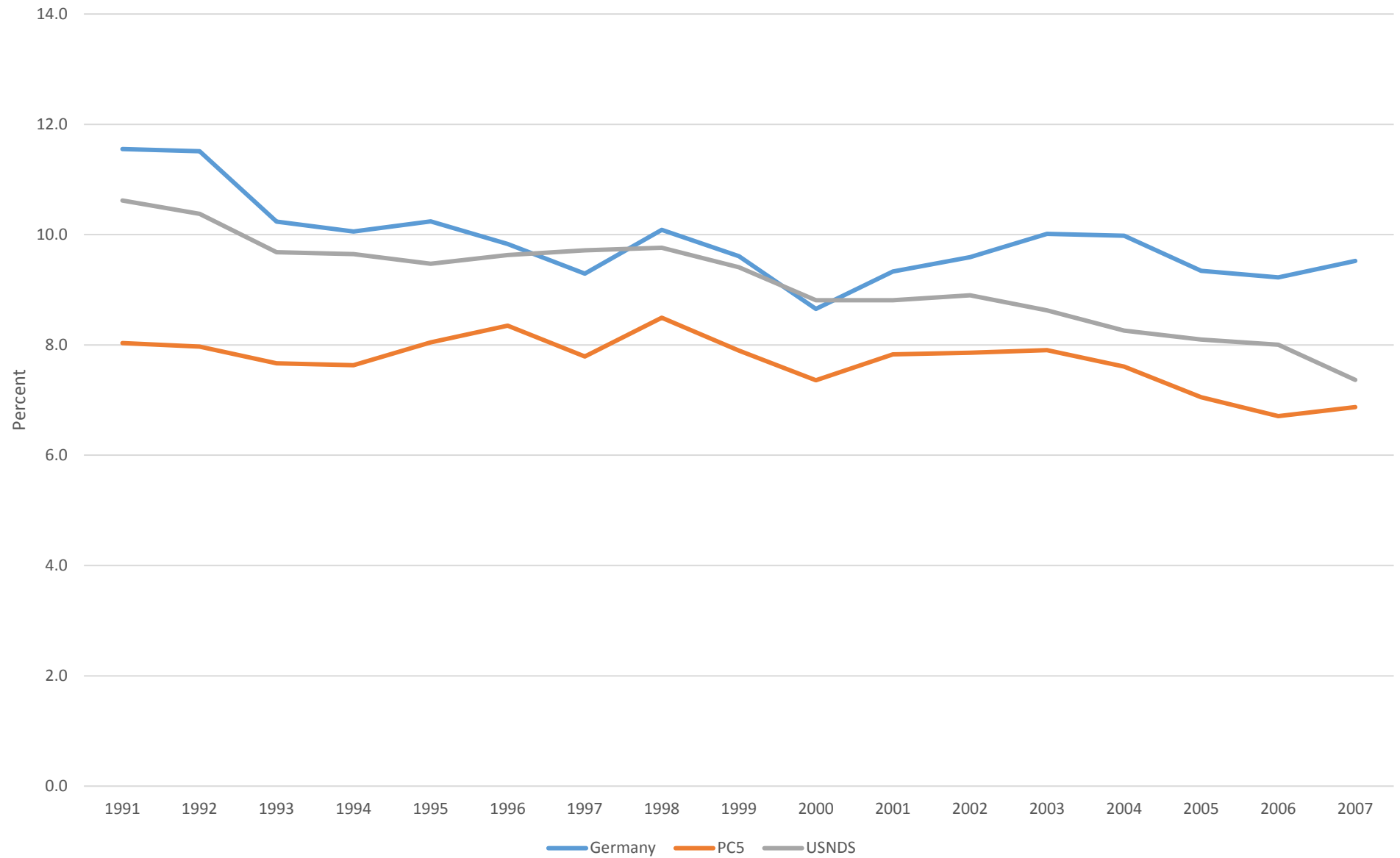Figure 3: World Export Market Shares (AXGT)
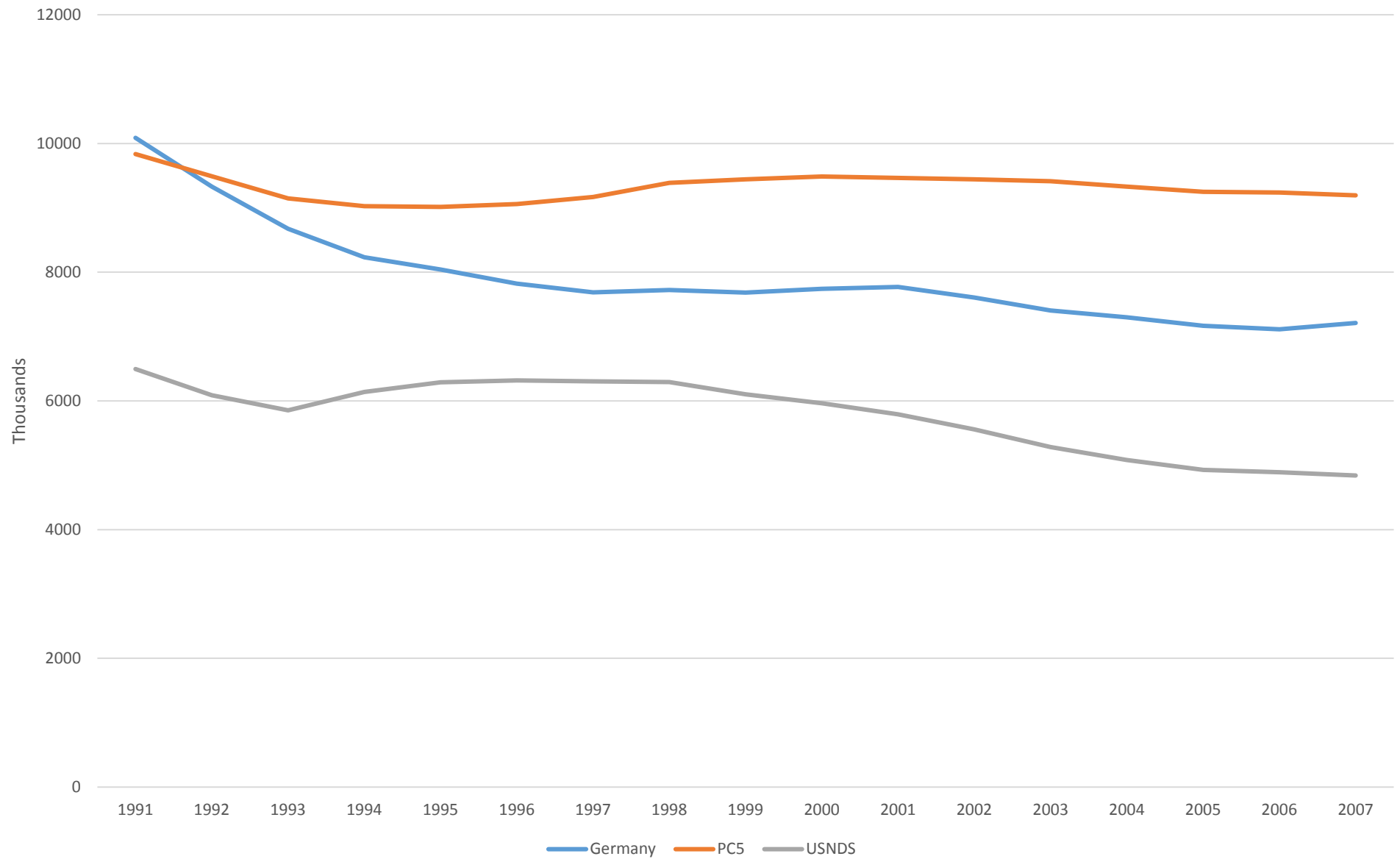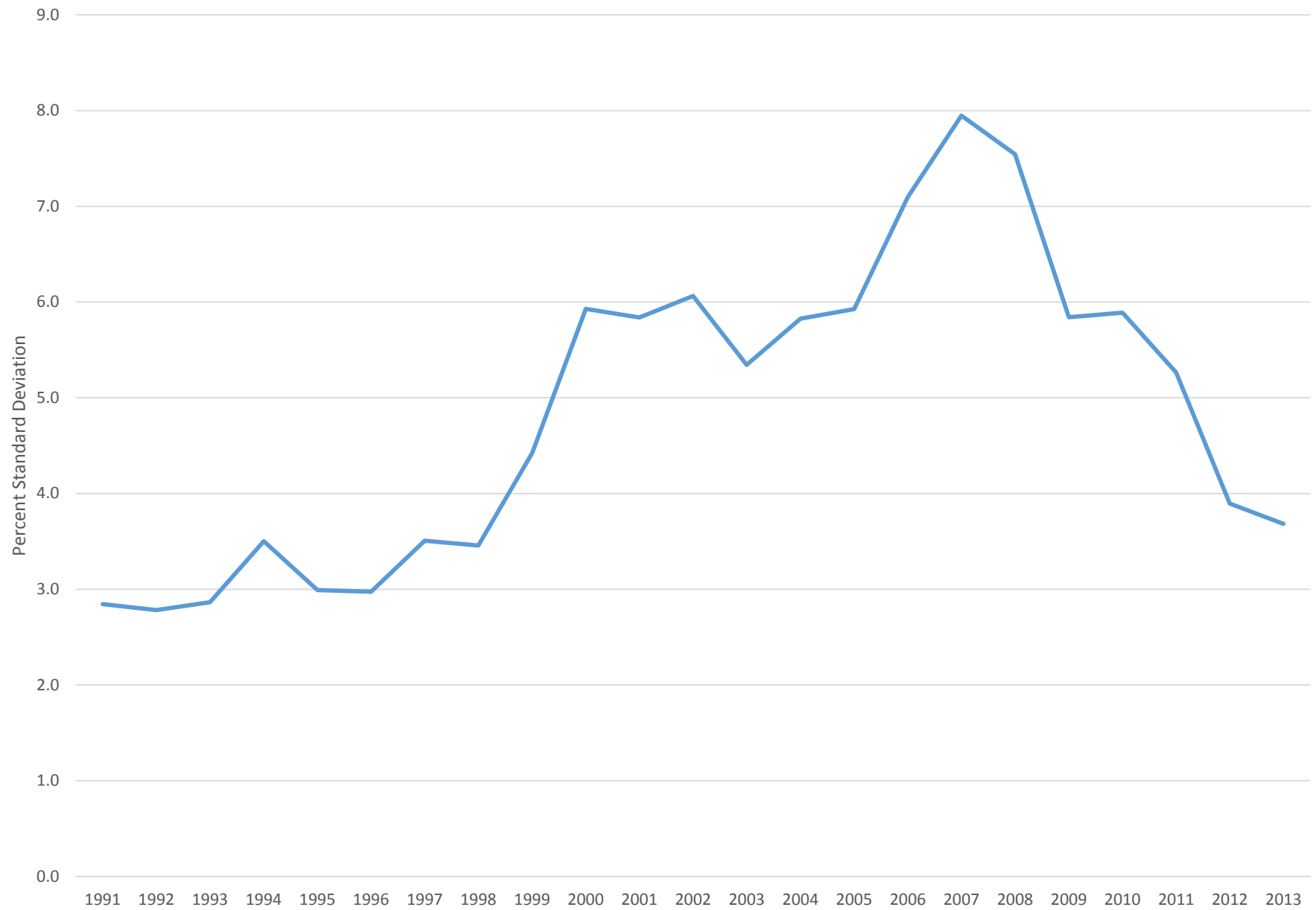
Figure 4: Employment in Manufacturing (NETM)

Figure 5: Current Account Variation in the Euro Area

The wide dispersion in current account performance proved to be unsustainable. One-by-one, the five peripheral countries of the euro area experienced sudden difficulties in meeting their balance of payments obligations. The evidence for this can be seen in their Target2 positions. A sudden collapse in the net position relative to the rest of the euro system is what a balance of payments crisis looks like within Europe's monetary union. What is important to note is that a balance of payments crisis can unfold when a country is experiencing a current account surplus. The rapid deterioration of Ireland's Target2 position in 2010 is a good illustration because the country's current account balance recorded a surplus worth 1.1 percent of GDP that year. All that matters is that the money flowing out of the country exceeds the money flowing into it. The Target 2 data is collected in Figures 6 and 7. Figure 6 shows the separate data lines for Portugal, Ireland and Greece (PC3); Figure 7 shows how the crisis spread from these three countries to Italy and Spain.

Insert Figures 6 and 7 about here.

The order that the countries got into trouble bears little relationship to how well they fit the competitiveness argument. Otherwise Spain and Portugal would have gone before Italy, Ireland, or Greece. Where it matters is how they are expected to get out. Whether or not the competitiveness argument explains what caused the crisis, it offers a clear set of recommendations for adjustment. Governments in affected countries should liberalize their labor markets and hammer down on their relative unit labor costs and real effective exchange rates. This way they can improve the relationship between imports and exports and so strengthen their current account balance. The result will not eliminate the crisis altogether, as the Irish case in 2010 suggests. Nevertheless, so the argument runs, it should make these economies more sustainable. The only question is at what cost.

Competitive Adjustment

The five peripheral countries of the euro area have seen a larger drop in their manufacturing employment in the last three years than at any point in the last two decades. They have experienced a slowdown or reversal in real export growth and a loss of world export market shares as well. This worsening of export performance is not dissimilar to what is happening in Germany or in those northern European countries that did not adopt the euro. The impact of the crisis has damaged export performance almost everywhere in Europe and the fact that all parts of Europe are suffering a worsening of export performance makes it hard to hold out much hope for a sustained return to export-led growth. Meanwhile, labor productivity (and total factor productivity) has contracted in those countries like Italy where employers had incentives to hoard labor and unemployment has skyrocketed in countries like Spain where employers could release workers back into the market. Greece experienced both sides of this dynamic, facing both collapsing productivity measures and rising unemployment at the same time. The resulting destruction of human and physical capital will have a lasting impact on economic performance.

The problem is that policymakers are focusing too much attention on the wrong side of the balance of payments. Instead of looking at competitiveness indicators and current transactions, they should be

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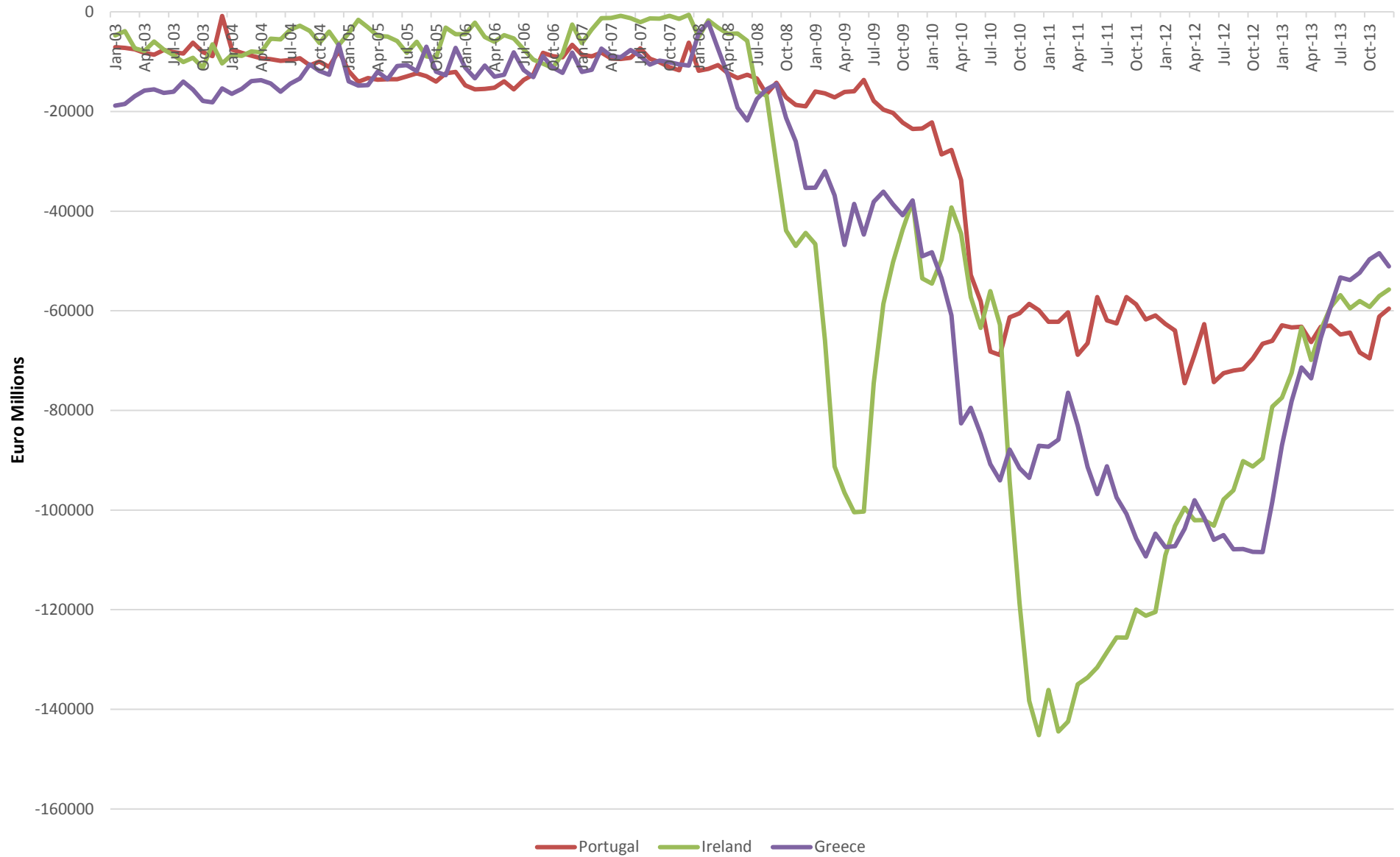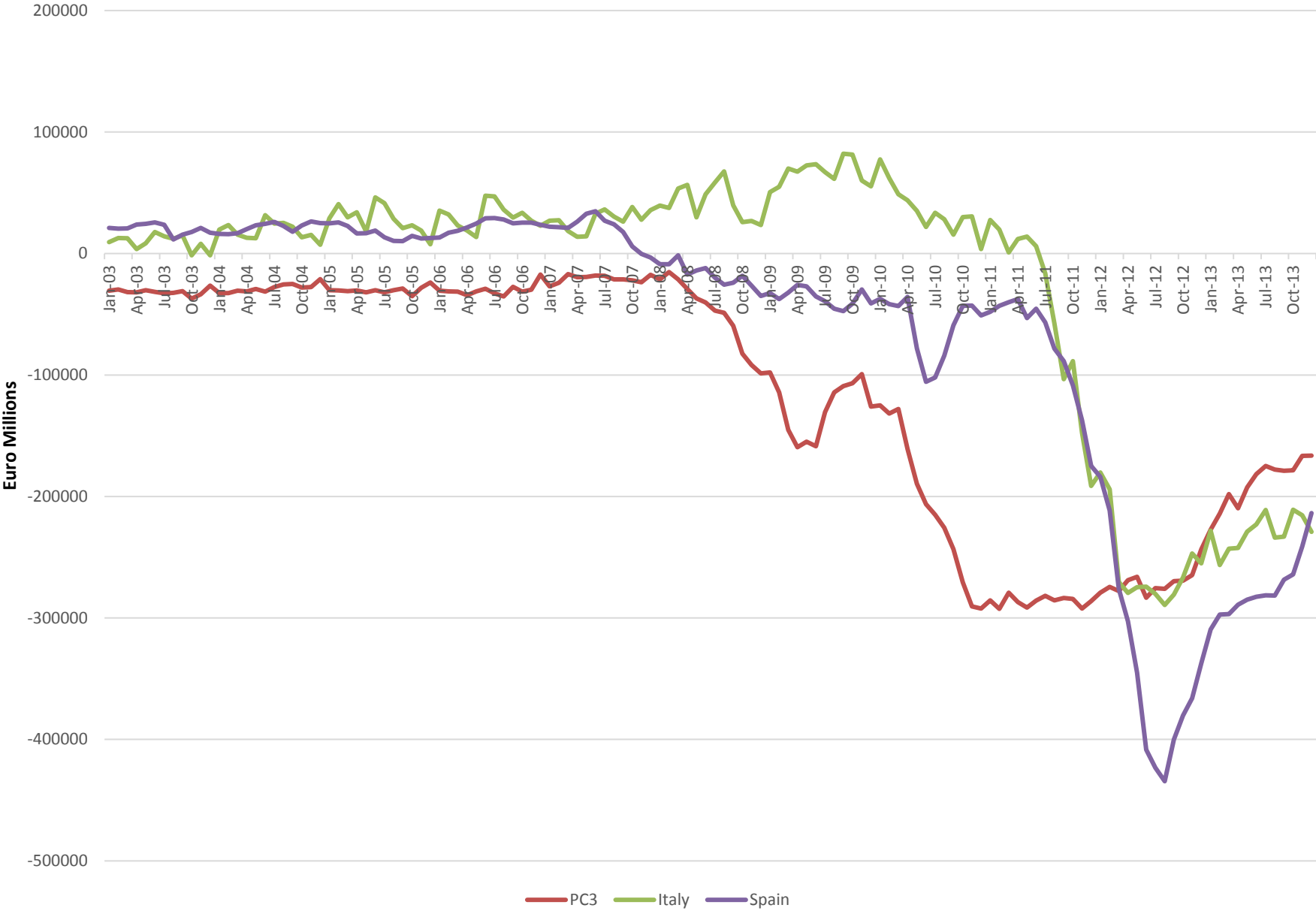Figure 6: Target2 Balances for Greece, Ireland, and Portgual (PC3)

Figure 7: Target2 Positions for PC3, Italy and Spain

focusing more clearly on the capital account. The competitiveness argument is attractive because it derives from a well-established literature on monetary integration and because it ties into a trade-based interpretation of the European single market. The competitiveness argument also draws attention to the complex interaction between national institutions and European integration. If we accept European institutions as given, the only way to improve the fit for individual countries is to engage in a concerted effort at market-structural – and perhaps also political and social – reform.

This call for reform is hardly new. Indeed, it long predates the recent crisis. The call for reform is not without merit either. Europe's policymakers need to recalibrate their welfare states if they are going to preserve them for future generations. The question is whether this enduring and necessary call for reform is relevant as a response to the crisis that hit Europe – and hence whether what Europe really needs at the moment is to restore its national economies to 'competitiveness'.

No matter how much merit there is in the aspiration to improve European competitiveness, the reality is that national differences are epiphenomena in the underlying causal mechanism. National institutions can explain how the tensions expressed themselves in a given context and they can influence who are the winners and losers at different points in time, but different national institutions cannot insulate countries from feeling the effects of the crisis eventually and neither can they prevent it from recurring. In other words, there is a wider structural problem at work beyond the problem of national competitiveness – one that operates at a higher level of aggregation than the nation-state and that can explain the variation in national performance better than the relative movement of unit labor costs. The only way to identify and address that problem is to look to the other main explanations for the crisis – those grounded in European financial markets.

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[1] Sebastian Royo (2013, chapter 6) calls it the 'triple crisis'.

[2] Johnston, Hancké, and Pant (2014, 5) make a similar claim when they say 'Divergences in current accounts in the Euro-area between the North and South, which grew persistently since EMU's introduction in 1999 . . . can be explained by divergent trade balances and national competitiveness. Because monetary union removes nominal exchange rates between Euro-zone member-states, RER competitiveness is solely determined by relative inflation: Countries with lower inflation hold more advantageous RERs, and hence greater propensities for trade surpluses, than those with higher inflation.'

[3] This model is similar to the Salter-Swan model popularized by Max Corden (1986).