Competitiveness. A prerequisite for wellbeing and convergence in Europe?

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1st TUREC, Vienna, 23.09.2016

1. Problems related to European authorities' interpretation and utilization of the concept of competitiveness, specifically in the "Five Presidents Report":

- ✓ Generally speaking, "competitiveness" is a positive term, and losses in competitiveness may have a negative impact on other macroeconomic outcomes. The problem arises when the improvement in competitiveness is placed at the very center of the economic policy strategy, with less emphasis on other more genuine objectives as full employment or a more egalitarian society. Although it is argued that competitiveness will lead to the attainment of these goals, the specific measures actually displayed (labour market reforms, wage restraint, cutbacks in the welfare state) are detrimental to them.
- ✓ This excessive emphasis on competitiveness is related to the promotion of an export-led growth strategy -for each Member State and, consequently, for the entire Eurozone-. Nevertheless: a) domestic demand is –and it should be- the main source of aggregate demand for European countries, b) the Eurozone suffers a chronic demand shortfall; and c) policies aimed to increase external competitiveness aggravate it, especially when they are applied simultaneously.
- ✓ Even if some Eurozone countries avoid unemployment through international trade, in a context of inadequate aggregate demand, this policy would simply shift the problem of lack of demand to other countries.
- ✓ Net exports and current account imbalances are seen almost exclusively as the result of nominal ULC and price-competitiveness divergences, while structural competitiveness and demand factors are probably more relevant.
- ✓ The Competitiveness Authorities proposed in the Five Presidents Report will provoke a downward bias in wage growth, because the reference for national wage policies is implicitly set in terms of the country where ULC growth is lower.
- ✓ Instead of promoting institutions devoted to assure a European convergence to high standards of living and high levels of decent employment, most proposals supposedly designed to improve competitiveness deteriorate these social standards.

2. Wage restraint policies and the wage-led character of the European economies.

- ✓ From a macroeconomic perspective, this fixation on competitiveness seems to consider wages as a production cost exclusively, forgetting their crucial role as a source of domestic demand. However, the theoretical framework proposed by A. Bhaduri and S. Marglin has clearly shown the importance of differentiating between wage-led economies (where a decrease in the wage share provokes a fall in aggregate demand) and profit-led economies (where the improvement in investment and/or external demand is able to offset the decrease in consumption derived from a lower wage share).
- ✓ Empirical evidence recently collected clearly shows that most Eurozone economies are wage-led, with the probable exception of some smaller and very open economies.

- ✓ Moreover, this wage-led character of the European economies is even reinforced when a wage restraint strategy is simultaneously pursued to increase competitiveness and promote export-led growth. Even those economies that, considered in isolation, were profit-led, become wage-led.
- ✓ Consequently, an opposite strategy oriented to a coordinate recovery of wages could have positive effects on aggregate demand, both for each country and for the whole Eurozone.

3. Recessive effects of internal devaluation and austerity policies: the case of Spain.

- ✓ The case of Spain is used as an example of this kind of policies.
- ✓ Recent economic growth in Spain is sometimes presented as an evidence of a successful economic policy strategy precisely aimed at the improvement in competitiveness by the means of an "internal devaluation". The other elements of this strategy are fiscal sustainability and structural reforms to increase potential output.
- ✓ Specifically, "internal devaluation" policies have been justified with two main arguments:
    - o Firstly, internal devaluation is prescribed to correct external imbalances, which are seen almost exclusively as a problem of "bad behaviour" and lack of competitiveness in the deficit countries. As nominal devaluation of the exchange rate is no longer possible, internal devaluation is presented as the only way to rebalance price competitiveness among monetary union members.
    - o But, secondly, the European and national authorities also argue that internal devaluation helps to restore economic growth, in a context characterized by domestic demand shortfall and fiscal austerity measures. The impulse to external demand due to a higher competitiveness should offset the decline in domestic demand, which the internal devaluation policy itself –however- exacerbates. Then, if internal devaluation actually works, it should trigger an export-led growth recovery.

- ✓ Current account imbalances have been reversed in Spain during the last years, going from a net borrowing of over 10% in 2008 to a net lending of 2% in 2015. Simultaneously, net exports have gone from making a strong negative contribution to growth before the crisis (an annual average of -1% between 2001 and 2007), to a positive contribution from 2010 to 2013 (+1.5%). Apparently, these two facts can be interpreted as a confirmation that the strategy of internal devaluation is finally achieving the desired results and that it should be valued positively.
- ✓ However, a more in depth analysis shows that they can hardly be attributed to a "successful" internal devaluation:
    - o The change in the foreign sector is better explained by demand factors than by changes in relative prices. Relative export prices have changed to a much less extent than relative unit costs, and the empirical literature confirms that the coefficient that links REER to trade balance or is not significant, or it is clearly lower than those on domestic and foreign incomes.
    - o The collapse of imports has contributed in a fundamental way to the improvement of external balance and to the positive contribution of external demand to growth. Although the average annual growth rate of exports has actually improved in Spain, there has been a much more remarkable change in

the behaviour of imports. Clearly, this is mainly explained by the negative evolution of domestic demand.
    - Internal devaluation and fiscal austerity reinforce each one and have a joint strong negative impact on domestic demand. Between 2011 and 2013, external demand contribution to growth was not sufficient to offset the contraction of domestic demand and initiate a process of sustainable economic recovery.
    - The return to positive growth rates that has occurred in Spain since 2014 is not due to an export-led expansion, but has more to do with the recovery of domestic demand. This, in turn, is the consequence of some external factors and the (provisional?) abandonment of fiscal austerity. External demand is making again a negative contribution to growth.
    - Internal devaluation has not corrected the structural problems of the Spanish external sector and it remains as a possible restriction to the required growth to eliminate the high unemployment created during the crisis.

4. Does all this mean that external imbalances are not relevant? Balance-of-Payment-Constrained Growth Rate and current account imbalances within the Eurozone.

- ✓ Rejecting the one-sided emphasis on competitiveness and the use of wage restraint as a "mercantilist" strategy to promote export-led growth is not equivalent to deny that external imbalances might potentially suppose a constraint to economic growth and full employment. This also arises some concerns on the possible limits of "one country Keynesianism", whose potential relevance is highlighted by the current account imbalances registered within the Eurozone between 2000 and 2007. Those (unsustainable) imbalances were mostly related to persistent differences in the growth rates of its members, and they can be considered as one of the main causes of the current crisis and its severity. Nevertheless, the economic policy implications of both perspectives are completely different.
- ✓ The application of the concept of "Balance-of-Payments-Constrained Growth Rate" (BPCGR) to the case of a monetary union is the appropriate theoretical framework to address this topic. The BPCGR of a country depends on the growth rate of the rest of the Eurozone; the difference between domestic and average inflation; and price and income elasticities of exports and imports.
    - If actual growth is higher (lower) than the BPCGR, current account balance decreases (rises).
    - With given foreign growth and inflation, the BPCGR of a single economy can be increased by a lower domestic inflation, a higher income elasticity of exports, or a lower income elasticity of imports. In turn, the change in these elasticities can be derived from non-price competitiveness gains or from some structural changes, as a lower energy dependency.
    - On the other hand, interdependence between economic policy decisions in different countries is evident. Restrictive policies that reduce domestic demand in one country provoke lower BPCGR in other countries as well.
- ✓ As a proper functioning of a monetary union is incompatible with persisting unsustainable current account imbalances, economic policies should be aimed not only to generate high demand growth, but also to assure the minimum possible distance between actual growth rates of each country and its respective BPCGR.

- ✓ Nevertheless, the existence of growth differentials might be inevitable, due to: a) countries with higher unemployment rate (such as Spain) need to grow more to reduce unemployment at a social acceptable rate; and b) convergence of lower income countries. These growth differentials would probably imply differences between actual growth and BPCRG as well, and some current account imbalances might appear[1]. Regarding this:
  - Due to the high growth rates that characterizes deficit countries, the stabilisation of the net foreign debt-GDP ratio can be compatible with a trade deficit, if it does not exceeds some threshold.
  - Two different situations should be distinguished when "a country grows too fast" relative to its BPCRG and current account deficits appear: a "bad case", which is characterized by a bubble or by a credit expansion that fuels debt financed consumption, and that should be avoided (this was the case of Spain between 2000-2007); and a "good case", associated to convergence processes and massive productive investments, which should be welcomed.
  - Alternatively, we could adopt a different approach and conclude that "the BPCGR is too low" and not that actual growth is too fast. This would mean that some measures should be applied to increase it. Specifically, improving non-price competitiveness, which would imply a higher income elasticity of exports, or a lower income elasticity of imports. On the contrary, redistributive policies at the expense of the labour income to gain price-competitiveness should be avoided, because their deflationary and demand depressing effects.
- ✓ Returning to the Spanish example, internal devaluation has not solved the structural external dependence of Spanish economy, which constitutes one of its major weaknesses. It has a historically high dependency of imports and the income elasticity of imports is clearly above the Eurozone average. Consequently, new measures for securing external sustainability in a context of high growth should be taken:
  - Transforming the productive structure is necessary to lift up the BPCGR and to avoid this "balance of payments constraint". This means, for example, bending the productive structure towards high value added sectors, increasing exports and thus reducing this imports dependency.
  - In spite of the strong decrease in oil prices, the trade deficit registered by the Spanish economy during 2015 (-2.3% of GDP) is completely explained by the energy deficit. Between 2010 and 2015, the average trade balance is positive (0.5%) if we exclude energy, while the average deficit in this sub-balance is equal to -3.6% of GDP. From an economic policy point of view, then, measures oriented to reduce this dependence of the Spanish economy on energy imports are very relevant, although their effects take place mainly in a medium-term. This measures should foster a new energy model, focused on renewable energies and improving energy efficiency in buildings and constructions.

[1] Catching-up countries will have a tendency to grow above their BPCGRs, whereas the mature countries will tend to grow below their respective BPCGRs.