Issue 16 | November 2012

ISSN: 1831-4473

ECFIN Economic Brief

ECONOMIC ANALYSIS FROM EUROPEAN COMMISSION'S DIRECTORATE GENERAL FOR ECONOMIC AND FINANCIAL AFFAIRS

Slow but steady? Achievements and shortcomings of competitive disinflation within the euro area

By Marco Buti and Alessandro Turrini

Summary

There is a general perception in the policy debate that the euro-area imbalances are not adjusting: deficit countries are stuck in an unsustainable equilibrium and surplus countries' growth is mostly based on exports. The most pressing concern is that, for rebalancing to be complete and durable, a symmetric evolution of competitiveness between surplus and deficit countries is needed. This is something hard to achieve, notably because the competitive disinflation processes required in deficit countries are painful, while no strong incentives are always in place for surplus countries to reduce their excess savings (e.g., Krugman, 2011).

Downward wage rigidities linked to wage-setting frameworks and other labour market institutions are mentioned among the major impediments to competitive disinflation processes. It is not by chance that the relatively few successful cases of competitive disinflations were carried out in countries with decentralised wage setting institutions and flexible labour and product markets (e.g., Latvia). This also means that bold structural reforms to remove downward rigidities are a necessary prerequisite for successful competitive disinflation processes in countries with regulated labour markets. However, these are exactly the reforms that are most difficult to achieve, because they dent on the political capital of governments.

Recent evidence, however, provide some encouragement. Not only labour cost developments are increasingly supportive of more rebalancing down the road, but recent reforms in a number of euro-area countries appear to be bringing fruits. Further progress can also be expected looking forward, in light of the market reaction of wages to major unemployment divergences both in surplus and

Summary

There is a widespread perception that imbalances within the euro area are not adjusting, the major difficulty being that the competitive disinflation processes required in deficit countries are painful, while no strong incentives are always available in surplus countries to reduce their excess savings.

Recent evidence, however, provides some encouragement. Not only labour cost developments are increasingly supportive of more rebalancing down the road, but recent reforms in a number of euro-area countries appear to be bringing fruits in terms of reduced downward wage rigidities. Although the necessary adjustment for some deficit countries is still considerable, there could be light at the end of the tunnel provided that the process is supported by consistent wage developments in surplus countries and a recovery in productivity growth in take place in deficit countries. Improved potential growth in deficit countries is key to prevent the risk of foreign debt deflation and unstable Net International Investment Positions down the road. For this to happen, private capital will have to start flowing downhill again. To this purpose, a fast and effective adoption of a Single Supervisory Mechanism and moving eventually towards a banking union will be a key step.

ECFIN economic briefs are occasional working papers by the European Commission's Directorate-General for Economic and Financial Affairs which provide background to policy discussions. They can be downloaded from: ec.europa.eu/economy_finance/publications.

Comments by Anne Bucher, Ines Drumond, Joao Nogueira Martins are gratefully acknowledged, as well as analytical inputs by Matteo Duiella and Stefan Zeugner.

Economic and Financial Affairs

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deficit countries, and the full unfolding of the effects of past and forthcoming reforms. Although the necessary adjustment for some deficit countries is still considerable, there could be light at the end of the tunnel provided that the process is supported also by a recovery in productivity growth. However, for this to happen, capital will have to start flowing downhill again, overcoming the current fragmentation of financial markets across the euro area.

The present paper discusses recent progress in relative labour costs and competitive positions within the euro area and the conditions for this process to be effective in bringing back external positions on a sustainable path.

The two faces of euro-area adjustment

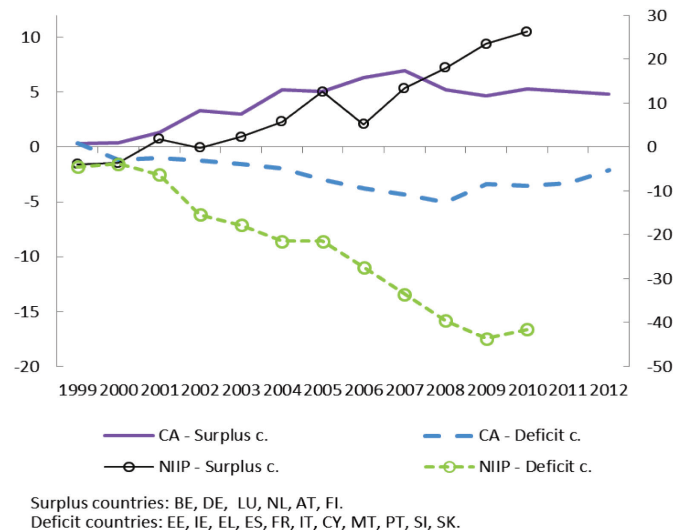
Within the euro area, two distinct adjustment processes are essential for its good functioning.

First, an adjustment process is needed to *absorb asymmetric shocks*. This is needed to ensure that cyclical divergences are absorbed in the absence of independent monetary policy and nominal exchange rate adjustment. Automatic, market-driven fluctuations in cost and price competitiveness, i.e., the real effective exchange rate (REER), contribute to this adjustment, with competitiveness losses taking place mostly in overheating economies. This adjustment channel worked efficiently since start of EMU until the crisis. Moreover, as financial integration deepened, income stabilisation was provided by financial markets, which acted as a relevant shock absorber (European Commission 2009).

A second adjustment process is needed *to correct external imbalances*. In the first decade of EMU, growing current account imbalances were the counterpart of increased financial integration and capital flowing downhill (European Commission, 2006, 2009). Protracted current account deficits also led to the accumulation of large stocks of net foreign liabilities in a number of euro-area countries (Graph 1)[1].

During this process, competitiveness developments helped narrowing output divergences linked to reduced risk premia, but made current account imbalances entrenched, by tilting expenditure towards imports and non-tradables.

Graph 1: CA balance (lhs) and NIIP (rhs) as % of GDP



Source: DG ECFIN AMECO database, Autumn 2012 European Commission Forecast update.

Nonetheless, the accumulation of external imbalances was not considered an issue in the first years of EMU, and was rather seen as the necessary counterpart of increased financial integration and capital flowing downhill, with potential benefits for resource allocation and growth potential (e.g., Blanchard and Giavazzi, 2002). With hindsight, the re-appreciation of risk following the debt crisis and the ensuing sudden stop in capital flows to deficit countries revealed the relevant risks linked to large current account imbalances in a monetary union with incomplete financial supervision arrangements and lacking tools to deal with bank-sovereign feedback loops (Merler and Pisani-Ferry, 2012).

All in all, since EMU inception until the debt crisis the adjustment to asymmetric shocks worked, but had growing external imbalances as a counterpart. Conversely, following the debt crisis, the sudden stop in capital flows and the progressive process of financial disintegration led to a prompt reduction in current account imbalances, but this re-direction of financial flows was a major driver of the recessions in the euro-area

[1] The classification between deficit and surplus countries used in the paper is such that, all surplus countries recorded a surplus over the 1999-2012 period (the only exceptions being DE and AT before 2002 and FI after 2010), while deficit countries recorded a deficit on average starting from 2000.

periphery: capital flows stopped being a shock absorber and contributed instead to the widening of output divergences[2].

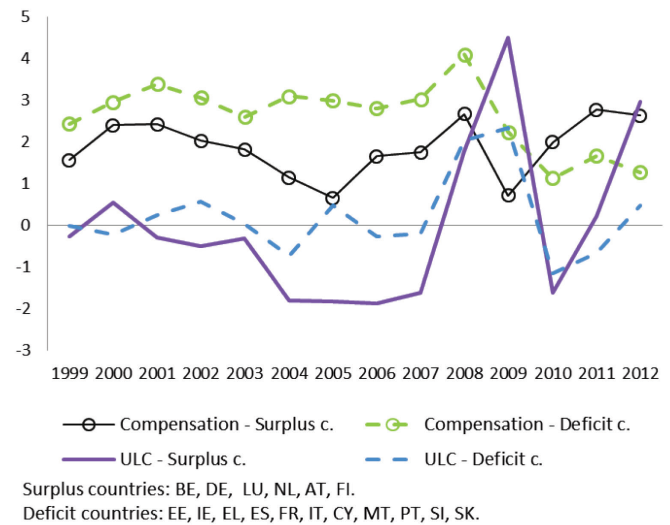
Looking forward, competitiveness will play a key role in redressing external imbalances on a sustainable basis. For the rebalancing process to be durable, it cannot be linked to expenditure reduction only, but also to a switch of expenditure away from imports and towards domestic production. The output structure needs also to shift, away from non-tradable and to tradable activities. For the both the above processes, the role of relative wages and prices is key.

Against this background, a number of questions stand out: Will deficit countries be able to engineer the competitive disinflations required to make the adjustment in current accounts durable and reduce unemployment? Will these disinflation processes be sufficient to ensure sustainable stocks of net foreign liabilities? Are surplus countries also adjusting?

Wage and competitiveness adjustment: where do we stand?

Unit labour costs (ULCs), after having increased in all EU countries after the great recession, due to productivity losses linked to labour hoarding, have fallen substantially in 2010. Since 2011 a decoupling is observed: the growth is stronger in surplus than in deficit countries (Graph 2). This is in clear contrast to the pre-crisis situation.

Graph 2: ULC and Nominal compensation per employee, % change



Surplus countries: BE, DE, LU, NL, AT, FI.
Deficit countries: EE, IE, EL, ES, FR, IT, CY, MT, PT, SI, SK.

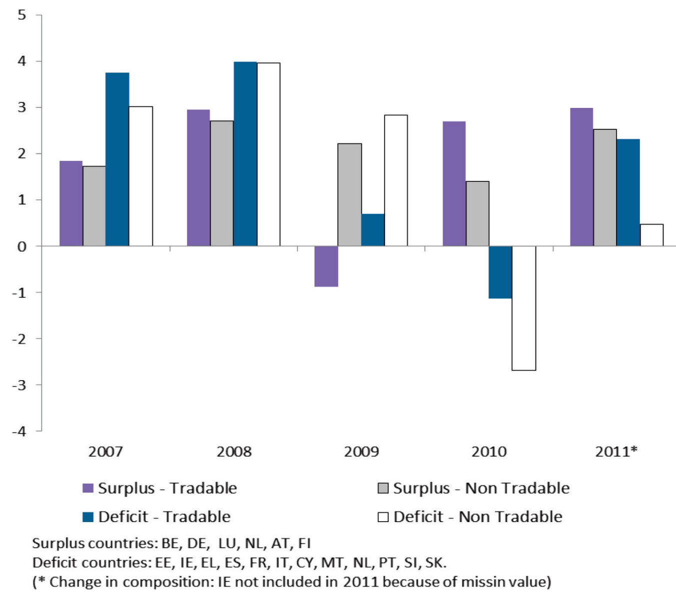
Source: DG ECFIN AMECO database, Autumn 2012 European Commission Forecast update.

The recent relatively subdued growth rate of unit labour costs in deficit countries was not entirely linked to productivity gains linked to job shedding, as the most recent dynamics regarding nominal compensation per employees are also reassuring. Wage growth has fallen considerably across the whole euro area since the start of the crisis in 2008. However, when a pick-up in nominal compensation took place with the recovery in 2010, this was limited to euro-area countries characterised by current account surpluses. For deficit countries, the growth rate of nominal compensations kept falling instead. Since 2010, wage growth started being faster in surplus countries (by about 1 percentage point).

The gap in nominal wage growth between surplus and deficit countries also appears to be concentrated in sectors producing tradable goods (Graph 3). Since 2010, wage moderation in deficit countries took place especially in the non-tradable sector, which is supportive of the necessary shift of employment from the non-tradable to the tradable sector during the rebalancing process.

[2] Current account deficits are forecast to be below 3% of GDP in all euro-area countries in 2012, with the exceptions of Greece, Cyprus, Portugal (European Commission, 2012a).

Graph 3: Nominal compensations per employee, % change y-o-y, by country groups within the euro area (GDP-weighted averages)

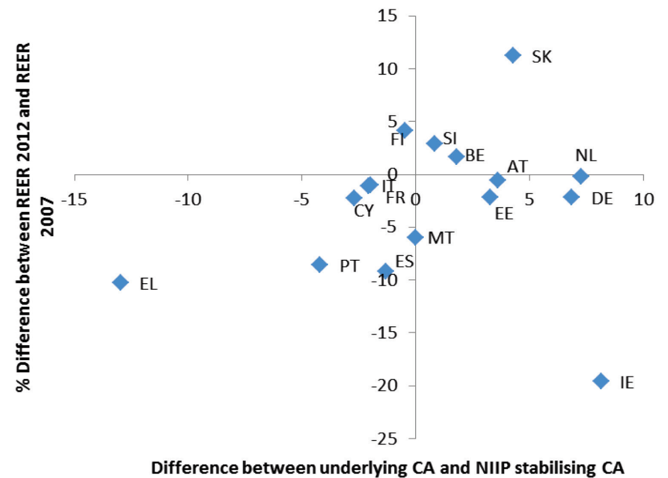


Source: DG ECFIN AMECO database, Autumn 2012 European Commission Forecast update.

It needs to be added that the overall extent of wage moderation is probably underestimated using aggregate statistics. Since the start of the crisis job shedding was more intense among unskilled workers, so that there was an increase in the skill intensity of employment on aggregate. Once composition effects are netted out, wage growth turn out being considerably lower (ECB, 2012). The implication of skill composition for unit labour costs is probably of second order, since productivity developments are symmetrically amplified. However, taking into account the growing skill intensity since the crisis permits to have a better gauge of the extent of downward nominal rigidity.

When assessed across countries, the downward adjustment in unit labour cost compared with competitors (the ULC-based REER) since the start of the crisis seems proportionate to the external adjustment channel: more pronounced reductions in the REER were recorded in countries characterised by a wider gap between the underlying current account and that consistent with a sustainable position in the Net International Investment Position (Graph 4). The graph also suggests that for some countries, notably Greece and Portugal, the magnitude of the adjustment challenge is such that further competitiveness improvements will be needed. Symmetrically, despite some sizable positive current account gaps in countries like Germany or the Netherlands, competitiveness in these countries did not change substantially since start of the crisis, and competitiveness gains were the rule rather than the exception.

Graph 4: Competitiveness gains and current account gaps



Source: European Commission, DG ECFIN, Autumn 2012 European Commission Forecast update.. The underlying current account takes into account both cyclical effects and lags in the impact of REER changes (Salto and Turrini, 2010). The NIIP-stabilising current account is defined as the current account that stabilises the NIIP at the 2011 value on the basis of medium-term projections for potential growth.

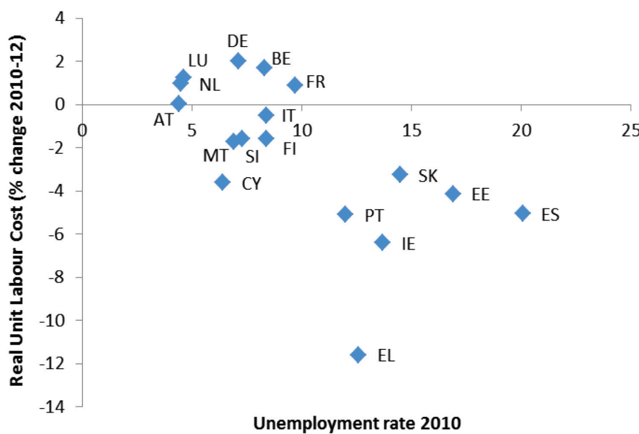
Peeking behind the corner: market-based adjustment, reforms, and wage developments

Overall, it appears that wage adjustment has recently contributed to the rebalancing, although there is still a quite long way to go in a number of deficit countries and limited symmetric adjustment in surplus countries. What next? The answer depends most notably on two factors: the working of the market-based response of wages to the labour market slack and the impact of current and forthcoming labour market reforms.

The market-based adjustment of wages appears to be currently working in a fashion which is supportive of external adjustment. While in low-unemployment countries real wages are growing above productivity, the opposite occurs in countries characterised by high unemployment (Graph 5).

This pattern of adjustment is consistent with the expected market reaction of wages to the labour market slack and contributes to a correction adjustment of output and unemployment divergences within the euro area. Since the countries with the lowest (resp., highest) unemployment rates also correspond to those with largest current account surpluses (resp., deficits), the process is expected to continue contributing to rebalancing until the large unemployment divergences are fully offset.

Graph 5: Real unit labour costs (% change 2010-2012) and unemployment rates, 2010

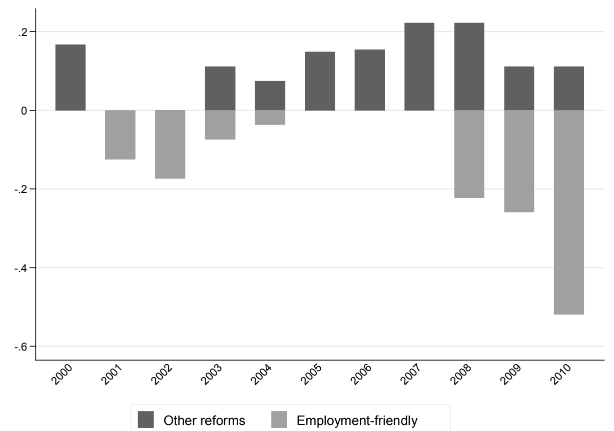


Source: DG ECFIN AMECO database, Autumn 2012 European Commission Forecast update.

For low-unemployment countries, there is no strong reason to expect that wages cannot adjust upward, in absence of countervailing policies. For instance, the most recent evidence on collective contract negotiations in Germany suggest rather brisk wage dynamics looking forward. IG Metall, the German trade union for the mechanical and engineering sector that traditionally plays a leading role in wage negotiations, in May 2012 negotiated the highest pay increase in 20 years, with the renewed collective contract stipulating a 4.3% wage increases above over 13 months (Sackmann, 2012). Conversely, for high-unemployment countries, downward rigidities linked, for instance, to binding minimum wages, wage indexation clauses, or inertia in the renegotiation of wage floors set in collective agreements, could kick in and hamper downward wage adjustment. This is where labour market reforms matter.

Also in this respect, prospects do not look too gloomy. EU countries, notably those more severely hit by the debt crisis and major fiscal consolidations, engaged in recent years in a number of courageous labour market reforms, whose effects are not yet fully reflected in employment and wage developments (Buti and Padoan, 2012; European Commission, 2012b). In particular, as compared with years before the crisis, pro-competitive reforms aimed at revisiting the wage setting system became much more frequent (Graph 6, Table 1).

Graph 6: Government intervention in wage setting (average yearly frequency per country across the EU)



Source: DG ECFIN LABREF database. Employment friendly reforms are those with ex-ante expected positive impact on labour demand or labour supply. In the above graph, these reforms are counted as negative numbers.

Wide-ranging and deep reforms were carried out in countries concerned by EC/IMF structural adjustment programmes, notably Greece and Portugal, but also Italy and Spain took relevant steps towards reforming employment protection, the unemployment benefit system, and the framework for wage bargaining.

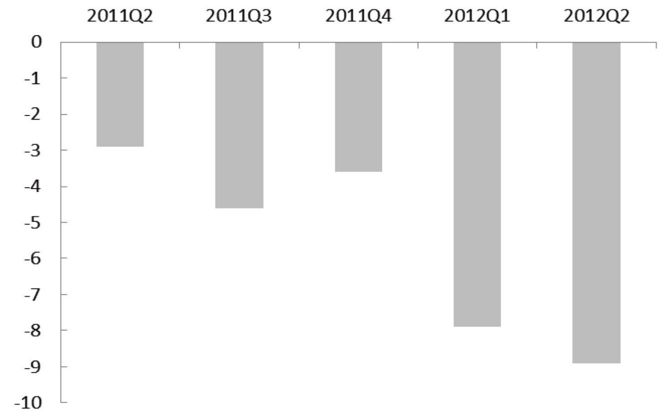
Table 1: Selected measures affecting the wage setting system carried in euro-area countries since 2010

	Measure	Surveillance framework
Greece	▪ Suspension of favourability clause for firm-level collective contracts and increased room for work councils to conclude firm-level collective contracts ▪ Suspension of extension mechanism for sectoral collective contracts ▪ Increased flexibility of working time management ▪ Minimum wage reduction ▪ Measures favouring the re-negotiation of collective contracts ▪ Reduced non-wage labour costs ▪ Reform of minimum wage system (ongoing)	Adjustment programme
Portugal	▪ Enhanced possibility for work councils to conclude firm-level contracts ▪ Reduced cost of overtime and increased flexibility of working time management ▪ Reform of extension mechanism	Adjustment programme
Spain	▪ Increased room for firm-level bargaining to derogate from sectoral contracts ▪ Reduced room for survival of expired collective contracts	EU Semester
Ireland	▪ Revised system for sectoral and professional minimum wages and registered collective agreements	Adjustment programme
Italy	▪ Agreement among social partners on criteria for of representativeness in firm-level bargaining ▪ Enhanced possibility for firm-level collective agreements to derogate from sectoral agreements and labour law in pre-defined matters ▪ Enhanced fiscal incentives to wage elements linked to productivity at firm level (ongoing)	EU Semester

Greece is the country where wage setting reforms were implemented first and where they went deeper. The decentralisation of wage bargaining was pursued via the possibility granted to firm-level bargaining to derogate from sectoral agreements and via the suspension of the faculty of extending collective contracts to non-signatory parties.

The minimum wage negotiated at national level was cut, and measures were taken to reduce the inertia in the re-negotiation of collective contracts.

Graph 7: Labour cost index growth (% change compared with same quarter of previous year – working day adjusted)



Source: Eurostat.

The most recent evidence from quarterly labour cost data suggests that these reforms are producing effects, as the speed of wage reduction was accelerating over the past year, reaching levels above 10 per cent on annual basis (Graph 7). Downward wage reductions were until few months ago mostly linked to new or re-negotiated firm-level collective contracts. Currently, nominal wage reductions are established also in a few newly negotiated sectoral contracts.

Wage setting reforms in other euro-area countries have not yet produced comparable effects to those carried out in Greece. More may come, however. Relevant reforms in the wage bargaining framework are currently being finalised in Portugal within the framework of the EC/IMF adjustment programme. The increased room for decentralising the wage setting system via firm-level collective bargaining in Spain and Italy may also gradually contribute to reduce downward rigidity and improve the responsiveness of wages to labour market conditions. Forthcoming action on indexation system is expected in Cyprus and Malta, as a response to Country Specific Recommendations issued within the EU Semester framework for structural surveillance.

Making competitive disinflation work: what is missing?

Despite these encouraging developments, the road to rebalancing is still long and dotted with uncertainties. Substantial competitiveness improvements are still needed in countries like Greece and Portugal to bring their net foreign asset position on a prudent path; real unit labour costs still have to adjust to bring down the high unemployment rates in countries like Spain, Greece, Portugal. Will the on-going trends and reform measures be sufficient for ensuring a complete and sustainable rebalancing? The answer crucially depends on whether some key conditions will materialise in the near future.

First, the improvements in cost competitiveness need to have an impact on current account balances. So far, a great deal of the correction of the imbalanced external positions took place via a re-direction of capital flows, leading to a sudden compression of domestic demand. A durable adjustment requires effective expenditure switching and output re-composition. For this to happen, the reduction in relative unit labour costs in deficit countries needs to be matched by *a reduction in relative prices as well*. Higher profit margins in the tradable sector undoubtedly contribute to rebalancing by supporting the necessary inter-sectoral transfer of resources. However, expenditure switching becomes fully effective only when underpinned also by consistent movements in the relative price between tradables and non-tradables (the "internal real exchange rate") and between domestic and foreign tradables (the terms of trade). Unfortunately, the evidence indicates that the recent improvements in labour cost competitiveness in deficit countries was not matched by proportionate gains in relative price competitiveness (see, e.g., European Commission, 2012b).

Second, to be sustainable, competitiveness gains cannot be based uniquely on wage and price restraints: *productivity and non-price export competitiveness need to grow again*. This is the key condition to stabilise the high share of net foreign liabilities on GDP weighing on the economies of a number of euro-area countries. In some countries net liabilities need not only to be stabilised as a share of GDP, but need to be reduced to prudent levels, which would however be above than under a pre-EMU situation of fragmented markets. During the process of rebalancing, growth is inevitably subdued for some time, as domestic demand needs to be moderate to favour the expenditure shift away from imports and non tradables. However, if recessions are protracted for too long, the sustainability of external positions could be compromised and risks that competitive disinflations turn into a negative spiral of external debt deflation could emerge.

Third, as discussed above, competitive disinflations in deficit countries may need to be sustained over a relatively long period of time, which raises a general issue of their *sustainability from a social and political perspective*.

Fourth, the adjustment needs to be symmetric, underpinned by *consistent developments in surplus countries*. In most surplus countries, only very recently wage growth has accelerated despite persistently high current account surpluses and largely positive and still growing net international investment positions. Looking forward, it is important that the rebalancing implications of the ongoing market driven response of wages to the tightening labour markets operates fully, without being hampered by offsetting measures. Reforms raising productivity in the non-tradable sector would help further help rebalancing in surplus countries, as well as a fiscal stance which is not unduly restrictive.

A more *supportive role of financial markets* appears to the single most important requisite for the fulfilment of the above conditions for rebalancing, and to ensure that the two faces of euro-area adjustment start working again in a complementary fashion. The re-direction of cross-border private capital flows away from deficit countries and towards surplus countries that followed the financial and debt crises contributed to narrowing current account deficits, a process that was only partially compensated by official capital flows. However, this withdrawal of financial resources also implied reduced investment rates and reduced room for TFP improvements. Moreover, it also increased non-labour costs, which may explain, in addition to lagging and insufficient product market reforms, the incomplete pass through of labour cost competitiveness gains into price competitiveness gains. Fragmented financial markets also imply delayed and reduced benefits from structural reforms in vulnerable countries, because part of the future gains from reforms can accrue much sooner provided efficient and developed financial markets help bringing these gains forward in terms of higher asset values (Buti et al., 2009). Going forward, orderly investment conditions will be needed to compensate the loss of capital and have TFP growing

again, which is at the same time a key requisite for a complete of durable adjustment of unit labour costs and for the social and political sustainability of courageous reforms and protracted wage moderation.

Completing the monetary union with a Single Supervisor Mechanism for the banking sector and eventually a banking union will help redressing the sovereign-bank link which segments financial markets and permit capital flowing downhill again. An effective framework for macro-prudential policy as well as structural reforms in recipient countries will be needed to ensure that, unlike the pre-crisis period, capital is channeled towards productive uses.

Conclusions

Successful rebalancing via competitive disinflations has always been considered a key test for the euro area. Despite widespread scepticism, labour cost developments since 2010 appear overall supportive to the correction of external imbalances. Moderate wage growth in deficit countries is needed for the absorption of record-high unemployment rates, while the acceleration of wage growth in surplus countries contributes to an evolution of cost competitiveness that helps the rebalancing process. Most importantly, recent and on-going reforms of the wage setting bode well for overcoming downward rigidities in wage adjustment looking forward. This reform process needs to be sustained and supported by effective implementation of the measures taken.

Despite these encouraging signs, the way forward for a complete and durable rebalancing is still long and bumpy. While some deficit countries have made substantial progress towards restoring competitiveness, in other countries much more substantial competitiveness gains are needed. In addition to wage moderation, productivity gains will need to underpin unit labour cost developments in deficit countries, while upward wage dynamics in response to labour market tightening in surplus countries should operate freely.

A more supportive role of financial markets will be a key condition to overcome the risks linked to the social and political feasibility of a challenging process and to ensure that restored potential growth underpin the sustainability of high stocks of net foreign liabilities. Completing successfully the monetary union will be a key step.

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