Jean-Claude Trichet: The external and internal dimensions of Europe's competitiveness

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Institute of International and European Affairs, Dublin, 26 February 2009.

*   *   *

Ladies and gentlemen,

These are very challenging times – for Ireland, for Europe and for the global economy. I am very pleased to be here in Dublin today. When, last year, the Institute of International and European Affairs kindly invited me to give a lecture on Europe's competitiveness, I was delighted to accept the opportunity to look at Europe's economy from a broad perspective and to focus particularly on the growing challenge of globalisation. As the title for my address today I have chosen "The external and internal dimensions of Europe's competitiveness", because it is my deep conviction that these two dimensions are closely related. And they are also related to the current situation, as we shall see.

I will therefore also take the opportunity to talk about the economic crisis, its impact on Europe as a whole and on the Irish economy. Developments in the international economy were always likely to have a particular impact on this country, reflecting its very open nature and its strong dependence on international trade and financial flows. But it is important that we recognise the global nature of this crisis, in which public authorities everywhere are confronted by the adverse effects of the market turbulence on their own economies and financial systems. And it is important to recognise that despite these difficulties, we have not lost the things that have made our real economies so successful in recent years, notably our talented workforces, our dynamic businesses and our openness to trade.

Let me start by focusing on the topic suggested to me by the hosts of today's event. I would like to address some specific aspects of the external performance of the euro area and the euro area countries. And I would like to discuss how they relate to key internal dimensions including integration, flexibility and competition, drawing your attention to policy changes that are necessary to maintain and improve Europe's competitiveness. As I will argue, those reforms will not only help the European economy to succeed in an increasingly globalised world: they are also crucial for getting through the current situation.

1. Defining competitiveness

So what do we mean by "competitiveness"? For many people, competitiveness is a disconcerting word, suggestive of pressures to change and constant adjustments. And as we know, these pressures can have personal and social costs. But there are very large benefits – we need to stay competitive for the long-term welfare of the people of the euro area.

What does the word competitiveness mean to economists? In a narrow sense, it is often used to refer to international price competitiveness as measured by various indicators of effective exchange rates. At the European Central Bank we analyse developments according to a whole host of such indicators. This concept of competitiveness is linked to the "external performance" of a country, typically measured in terms of export growth, shares of export markets or current account balances. Developments in price competitiveness have always been important drivers of an economy's ability to compete in international markets. But in recent years, other factors have become increasingly important in the face of the structural changes engendered by globalisation. These relate to export specialisation, which includes the range and the quality of the products a country exports, and the particular markets it exports to. In this regard, it is important that our countries take advantage of their high technological advancement and well-educated labour forces, to produce higher quality and more sophisticated goods and to redirect their exports towards strongly growing markets.

Looking even more closely into the domestic structure of an economy we come to the notion of productivity. Productivity and competitiveness are two different concepts, but there are close links between them. "Competitiveness", when more broadly defined, includes a notion of relative productivity. Under this definition, the most competitive economy is the one with the best prospects for "generating" highly productive firms, contributing to longer-term economic growth and, ultimately, to the welfare of its citizens.

Recent advances in trade theory have stressed the connections between the external and internal dimensions of competitiveness, which have become increasingly relevant in a globalising economy. Some of the latest economic models of trade[1] see global competition as a selection mechanism, in which only the most productive firms do business outside their national borders.[2] Less productive firms, by contrast, which are unable to bear the transport and other costs related to foreign trade, are either forced out of business or remain confined to their domestic market. Countries in which highly productive firms can thrive are therefore also likely to do better in terms of their overall export performance, as this will allow more firms to compete successfully in international markets. In general, these are countries with more intense domestic market competition, better technology and greater openness to foreign competitors.[3]

These new models also stress the importance of countries' institutional framework which may make market access easier and push domestic firms to innovate. According to this body of economic knowledge, continuing efforts to promote stronger competition and further market integration within Europe appear to be important tools for supporting and enhancing the global competitiveness of European firms.

2. Globalisation and Europe's external competitiveness

Applying these concepts to Europe, how do we assess our external competitiveness; how are European firms performing in globalised markets?

Globalisation has given a boost to world trade. Over the past two decades world trade has grown one and a half times faster than world output, and the difference has even considerably higher in recent years as world trade growth accelerated very strongly. Transport costs have dropped dramatically, as have tariffs, and the surge in information and communication technology has facilitated a global exchange of goods and services as well as globalised supply chains. More and more goods and services have become tradable, and domestic companies have increasingly engaged in international trade. The euro area has actively contributed to the rise in international trade. Our continent has a long history in trading, but the openness of the euro area has increased that business markedly. In the mid-1990s, exports of goods and services from the euro area were equivalent to around 30%[4] of GDP; now they are equivalent to around 44% of GDP. Earlier observers who said that

---

1 For an overview, see, for instance, Bernard et al (2007).

2 More particularly, once countries become more exposed to trade, higher foreign competition will have two impacts: On the one hand, this will lead to shrinking operating profits of domestic firms in domestic markets, which will force the least productive firms to exit the market. On the other hand, for those firms that are productive enough to cope with the additional costs of foreign activity (i.e. transport costs or costs related to administrative duties or institutional and cultural barriers), the opening of distant markets also provides additional opportunities to enlarge their market shares and to get additional profits from foreign venues.

3 See, for example, Melitz and Ottaviano (2008) and Ottaviano, Taglioni and di Mauro (2009).

4 Source: ECB calculations based on IMF World Economic Outlook.

European integration could lead to a closing vis-à-vis the outside world have proved to be utterly wrong: quite the opposite has happened.

Of course, Europe's trade has grown not only because of Asia's, and particularly China's emergence as a fully-fledged trading partner, but also by the growing role of the central and eastern European countries. But even though we are roughly comparable in size to the United States, the euro area is about ten percentage points more open, and we are much more open than Japan, despite our larger size. This is an indication of why Europe has a key stake in global economic developments.

Europe's openness is also remarkable in international finance: over the past decade, the stock of outward and inward foreign direct investment has virtually doubled as a percentage of GDP. And even more strikingly, the euro area is more open financially than other advanced countries, like the United States and Japan. In 2007, international financial assets and liabilities of the euro area, as a percentage of GDP, reached almost 160%, compared with about 135% for the United States and 90% for Japan. And this explains why Europe is largely exposed to the current global financial crisis and it underscores to which extent Europe has an important stake in global financial stability.

Greater openness in trade and finance has of course created new challenges, which have rarely been as visible as today. And just as with the global financial crisis, global trade integration calls for constant adjustment. As low-cost competitors have emerged, the euro area – just like other advanced economies – has recorded some losses in world export market shares. These losses partly reflect the mechanical effect of the increasing shares of the new entrants, but the challenge for advanced economies remains: to adjust their export portfolios according to their technological comparative advantages, towards higher quality products, and towards products that are more skill-intensive and capital-intensive.

So what is the comparative advantage of the euro area in the global economy? Recent ECB analysis[5] has looked at so-called Balassa indices of revealed comparative advantage. According to these indices, a country specialises in a specific product or sector, if the share of that product or sector in the country's exports is higher than the share of that product or sector in world exports. This analysis suggests, somewhat surprisingly, and in contrast to other advanced economies, that the euro area specialisation overall has not changed much over last one and a half decades. There has been neither a decline in the specialisation in labour-intensive products, nor the expected shift towards more research-intensive production. This might reflect structural rigidities that constrain the ability of euro area firms to adjust rapidly, but it could also mean that euro area firms have so far not been under significant pressure to make substantial changes in their specialisation – particularly in medium-high-tech exports.

But this general picture for the euro area does however not necessarily hold for all euro area countries. Overall, there have been substantial differences in the export performance across individual countries. And euro area countries have witnessed significant differences in cost competitiveness since the launch of the euro. This explains why the ECB has always said that an appropriate peer surveillance of the evolution of competitiveness indicators, including cost competitiveness and unit labour costs was of the essence.[6]

5 For more details, see di Mauro and Forster (2008), providing an update of the earlier analysis by Baumann and di Mauro (2007).

6 See also ECB (2008), *Monitoring labour cost developments across euro area countries*, Monthly Bulletin, November 2008, pages 69-85.

3. The internal dimension of European competitiveness

This brings me naturally to the second part of my talk, the internal dimension of European competitiveness. Understanding the causes of growing labour cost differentials or the cumulative increases in labour costs across euro area countries is very important for improving the adjustment process of countries within Economic and Monetary Union.

From an economist's perspective, increases in unit labour costs stem from higher compensation per employee or lower productivity, or a combination of the two. In the case of the euro area, the main source of difference in recent years has been differences in the growth rates of compensation per employee, rather than differences in productivity growth. Let's look at the reasons behind these differences and the options that countries have to improve their situation. Such analysis is particular important at this time. Some countries may not only be affected by the global downturn and the financial crisis; they may also need to adjust in order to undo domestic imbalances.

I see four main developments which have arisen in the Monetary Union and which help to explain the observed differences in increases in labour costs in a number of euro area countries.

- First, some countries might have entered the euro area at a moment where this overall cost competitiveness was clearly hampered for a number of reasons. Germany offers a clear example of such an economy due to the strong increases of unit labour costs associated with the reunification. A lower level of increases in unit labour cost than the average of the euro area was advisable for such economies.
- Second, the opposite case has also been observed. Some countries have entered the euro area in a position of relative "over-competitiveness". The Netherlands for instance had in 1999 a very strong competitive position due to the success of their longstanding previous strategy of competitive disinflation. A higher level of increases of unit labour cost during several years is explainable in such a situation.
- Third, some countries might be or might have been catching up in terms of growth. Then they may have experienced relatively strong trend increases in per capita GDP. To the extent that these income per capita developments are sustainable, relatively strong wage increases are justifiable by reference to the fundamentals of the economy.

These three first developments are economically justified and need not be a concern to policy makers.

- However, there is a fourth type of developments which poses problems for the economies concerned. Some euro area countries have witnessed a long period of strong growth in domestic demand. These demand pressures were related to expectations of consumers or firms about future income and profit prospects, which, it is now clear, were overly optimistic.[7] This situation was often accompanied or intensified by an insufficiently tight fiscal stance, even if headline fiscal numbers (such as the deficit and the debt ratio) still suggested a healthy fiscal situation.

Technically speaking, governments and the public have mistakenly taken a cyclical or temporary expansion to be an upward shift in potential output and long-term income growth. They thus took insufficient account of the impact of a possible downturn in activity on the public finances and private income. In simpler terms, this means nothing less than extrapolating the good times almost for ever and accordingly increasing spending and indebtedness.

[7] See Campa and Gavilán (2006) and Blanchard (2007).

In our economic models, we often speak about “forward-looking agents”, portraying households, firms and governments as making rational economic calculations with a watchful eye on the future. But in reality, we have to be aware of too many “forward-spending” agents, private and public alike. Such a situation can stoke inflation and bring cumulated losses in competitiveness, lower export performance and a high current account deficit. Moreover, it has often resulted not only in pressures on the prices of goods and services, but also in asset price inflation, notably in the housing market.

In addition, in some cases sizeable wage increases in the public sector during normal or good times may have provided the wrong signals for wage bargaining in other sectors.

The accumulation of relative losses in competitiveness and the build-up of domestic imbalances need, at some point, to be corrected. The correction within a monetary union can and must be achieved through lower unit labour costs increases relative to the average of the Union. In an environment of flexible wages and prices, this adjustment could proceed smoothly without significant losses in output and employment. However if the economy concerned suffers from structural rigidities in product and labour markets, a more protracted and more painful adjustment in output and employment will then finally take place.[8]

As enhancing flexibility has been a message that the ECB has championed for a long time, let me focus on such rigidities, which unfortunately appear to affect most countries. I believe there should be more public awareness that insufficient attention of wage setting to current and expected productivity developments makes any correction to previous losses of competitiveness more painful in terms of output and employment losses.

4. Competitiveness, the crisis and the challenges for policy

Let me now turn to the current difficulties in the international economy, which are having such a strongly negative impact on the Irish economy. For many years, Ireland has been a great success story: openness to trade and a high degree of flexibility have allowed the country to benefit substantially from globalisation during the last decades. It now has a very high income per capita, and it is characterised by a skilled workforce, a flexible labour market, moderate taxation and a business-friendly regulatory environment.

None of these advantages have been lost as a result of the global financial crisis. But crucially for Ireland, this unprecedented international shock has come at the same time as the economy has been undergoing a necessary rebalancing in the composition of its growth, intensifying the challenges it faces. In particular the construction and the banking sectors need to adjust.

The Irish government is acting resolutely to address the situation. With the public finances, important action is being taken to make immediate savings, and plans are being drawn up for a return to compliance with the Stability and Growth Pact. A fiscal policy that convincingly reduces future public deficits is indeed absolutely essential. In addition, measures have been taken or are under way to recover lost competitiveness and to exploit the country’s comparative advantages in its high-tech, high-skills industries.

What is crucial at this moment for all economic policy actors, is to take measures that are both supportive in the current environment and in the longer-term interests of the economy. Many euro area countries, despite some progress, still exhibit structural impediments triggered by a rigid legal and regulatory environment. Unemployment is a clear concern right now in many parts of the euro area, and we surely do not want to lose human capital or scar a large proportion of the people of working age. As I mentioned before wage restraint would help a lot in this respect. More generally, in order to minimise job and output losses related to

[8] See European Commission (2006).

the current downturn, it is vital that euro area governments and social partners pursue four objectives:

- First, wage setting needs to take account of the competitiveness and labour market conditions in a responsible and timely manner.[9]
- Second, national authorities should pursue courageous policies of spending restraint especially in the case of public wages. A prudent fiscal stance should be always in place.
- Third, the completion of the Single Market, particularly in services and network industries, should be achieved. A deeper integration of markets is crucial to foster competition and open product and labour markets. Measures that hinder free competition and cross-border trade must be avoided. In this context, it is of the utmost importance to resist protectionist measures.
- Fourth, in the context of the Lisbon agenda, the necessary reforms that enhance competition and improve long-term growth prospects in the euro area must be implemented.

Especially in these difficult times such reforms are very important in all euro area countries to counteract the economic downturn and limit its negative impact on employment. The price of delaying reforms is particularly high at the current stage. For many years, we have been saying that we need structural reforms – more openness, more competition. The crisis offers us the opportunity and the obligation to seize the moment and implement the right reforms. These would help the economy overcome the crisis and be stronger afterwards.

I also want to call on European policy makers as a whole. As a lesson from the current crisis, we should consider ways how to strengthen our surveillance of competitiveness within the European Union, and in particular the euro area. This should help countries to build stronger buffers in good times. And it should also help to avoid excessive increases in unit labour costs. In other words, this would prevent us from again extending public and private spending beyond sustainable levels and experiencing difficulties similar to the current ones.

5. Conclusion

Let me draw to a close. As you know, the great Irish playwright George Bernard Shaw was not at all impressed by the economics profession. His was the famous disparaging remark that “if all economists were laid end to end, they would not reach a conclusion”. Certainly in these very challenging times, it is not easy for all economic policy-makers to reach agreement on the way forward. But let me offer some conclusions on which I hope we can all agree.

The euro area is resolutely addressing the challenges of the global financial turbulence, the global imbalances and the resulting global slowdown. Looking forward, we need to continue with our efforts to make the euro area stronger, more flexible, more resilient and more prosperous. The ECB’s Governing Council, of which Governor Hurley has been a member for many years, is tirelessly working to make the euro area better off.

I am also optimistic about the prospects for this country. The Irish economy clearly faces severe challenges over the next few years – and hard decisions will have to be taken. But in many ways, the Irish economy is an excellent example of some of the characteristics that foster global competitiveness – in its openness, its flexibility and its high levels of education. And this has paid off in significant increases in income per capita.

---

[9] For a review of wage arrangements across euro area countries, see DuCaju et al. (2008).

Some things will of course have to change. But none of the positive characteristics are lost nor should they be lost in the crisis. In my view, the open nature of this economy with its associated flexibility and adaptability means that Ireland will be well placed to benefit greatly from the eventual recovery and to compete effectively in the global economy in the future.

References

Baumann, U. and F. di Mauro (2007), “Globalisation and euro area trade – interactions and challenges”, ECB Occasional Paper No. 55, March.

Bernard, A.B., Jensen, J.B., Redding, S.J. and P.K. Schott (2007), „Firms in international trade“, Journal of Economic Perspectives, 21, 3, pp. 106-130.

Blanchard O. (2007), “Current account deficits in rich countries”, NBER working paper no. 12925.

Campa J.M. and A. Gavilán (2006), “Current account in the euro area: an intertemporal approach”, Documento de trabajo del Banco de Espana, no. 0638.

di Mauro, F. and K. Forster (2008), “Globalisation and the competitiveness of the euro area”, ECB Occasional Paper No. 97, September.

DuCaju P., Gautier, E., Momferatou, D. and M. Ward-Warmendiger (2008), “Institutional features of wage bargaining in 22 EU countries, the US and Japan”, ECB Working Paper no. 974, December.

ECB (2008), “Monitoring Labour cost developments across euro area countries”, Monthly Bulletin, November, pp. 69-85.

European Commission (2006), “The EU economy: 2006 review. Adjustment dynamics in the euro area – Experiences and Challenges”, European Economy n.6.

Melitz, M. and G. Ottaviano (2008), “Market size, trade and productivity”, Review of Economic Studies, 75, pp. 295-316.

Ottaviano, G., D. Taglioni and F. di Mauro (2009), “The euro and the competitiveness of European firms”, Economic Policy, pp. 5-53, January.