Munich Economic Summit 2015

Competitiveness and Innovation

- May 2015 -

Restoring competitiveness: what has gone right, what has gone wrong?

Daniel Gros

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Issue:

Loss of competitiveness in euro area periphery during boom, then bust. What were the ultimate drivers during the boom, the bust and the recovery?

Focus of the Presentation:

1. Causes of loss of competitiveness: policy or capital inflows?
2. External adjustment and competitiveness
3. Putting the fiscal adjustment in perspective: the 07 – 13 cycle
4. The key role of exports: Portugal vs Greece, role of competitiveness
5. Concluding remarks

General remark:

Most comparisons are

'look how awful things are today compared to 2007/8'.

But these years were not sustainable. Decline in GDP, increase in unemployment unavoidable when capital inflows stop.

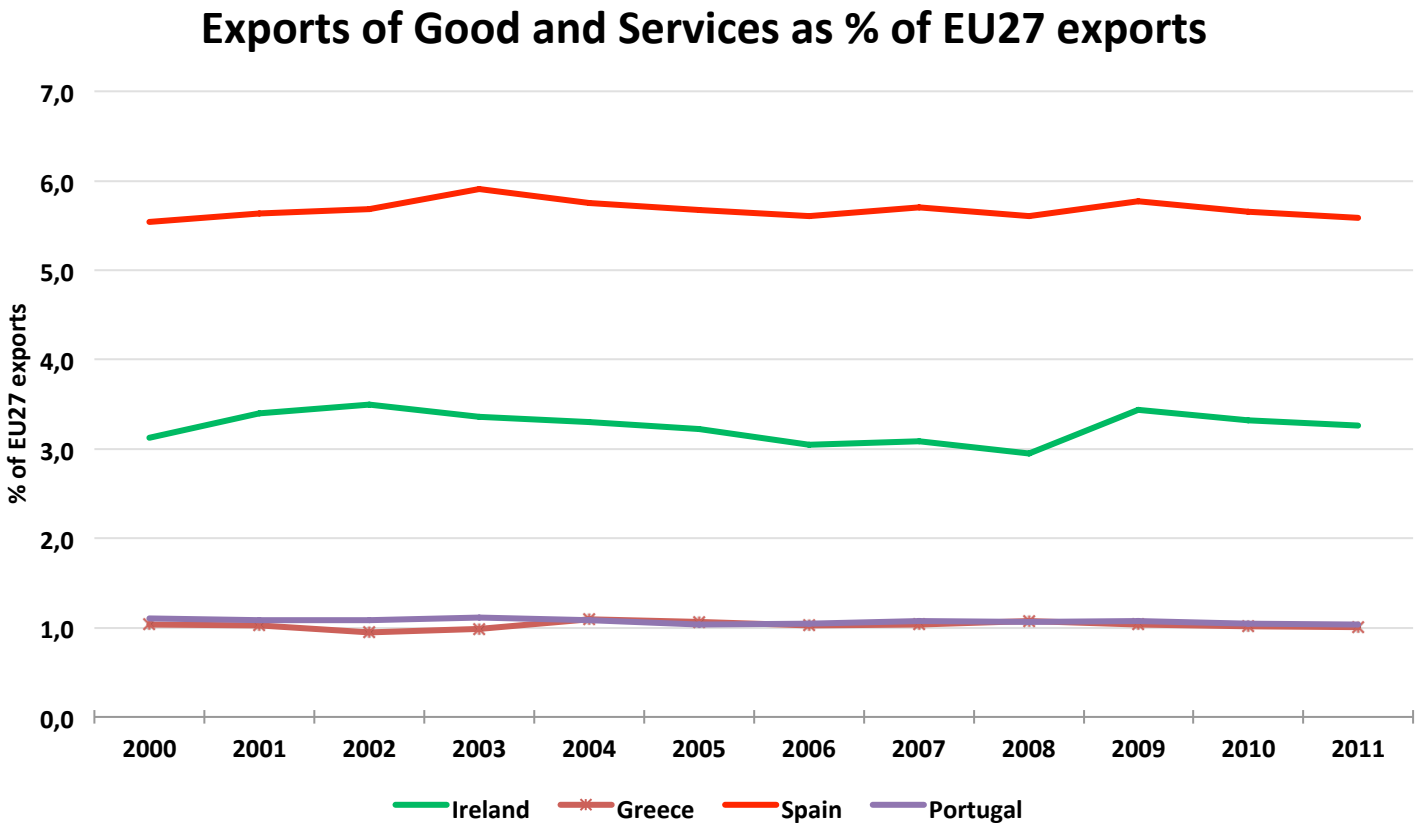
⇒ ***Need to look 'through' boom and bust!***

Second General Remark:
What caused the intra-EZ Competitiveness gap?

Most common answers are:

1. Wage moderation in Germany
2. Divergences in productivity: this requires structural reforms e.g. competitiveness pact

Impact of loss of competitiveness on exports?



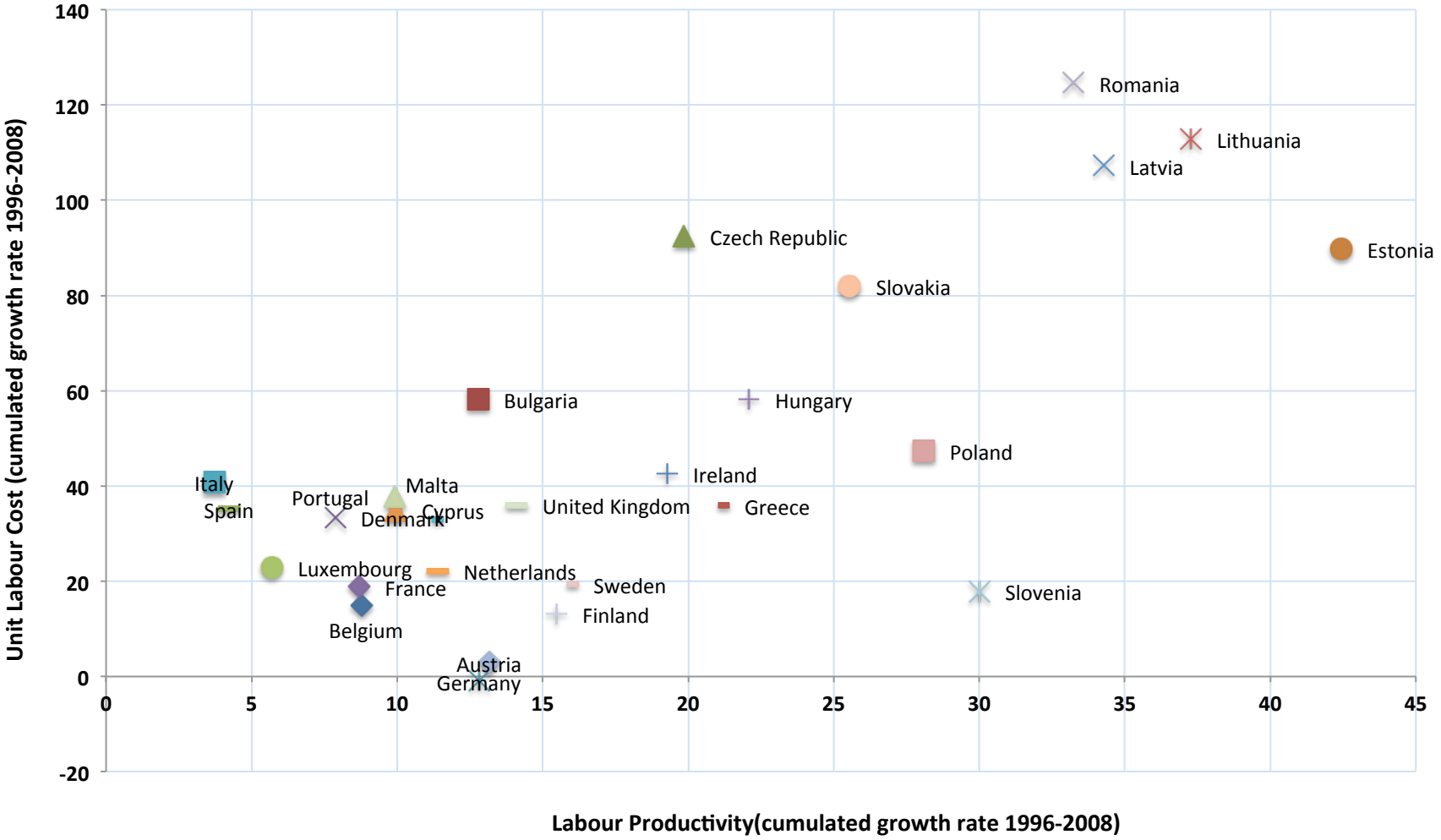
2. Divergences in productivity

- In principle, in a common currency area, higher growth of productivity = gain in competitiveness (at constant wages).

=> Higher productivity growth should mean lower relative unit labour costs.

- BUT Data show higher productivity associated with higher unit labour costs.

Productivity and competiveness in EU



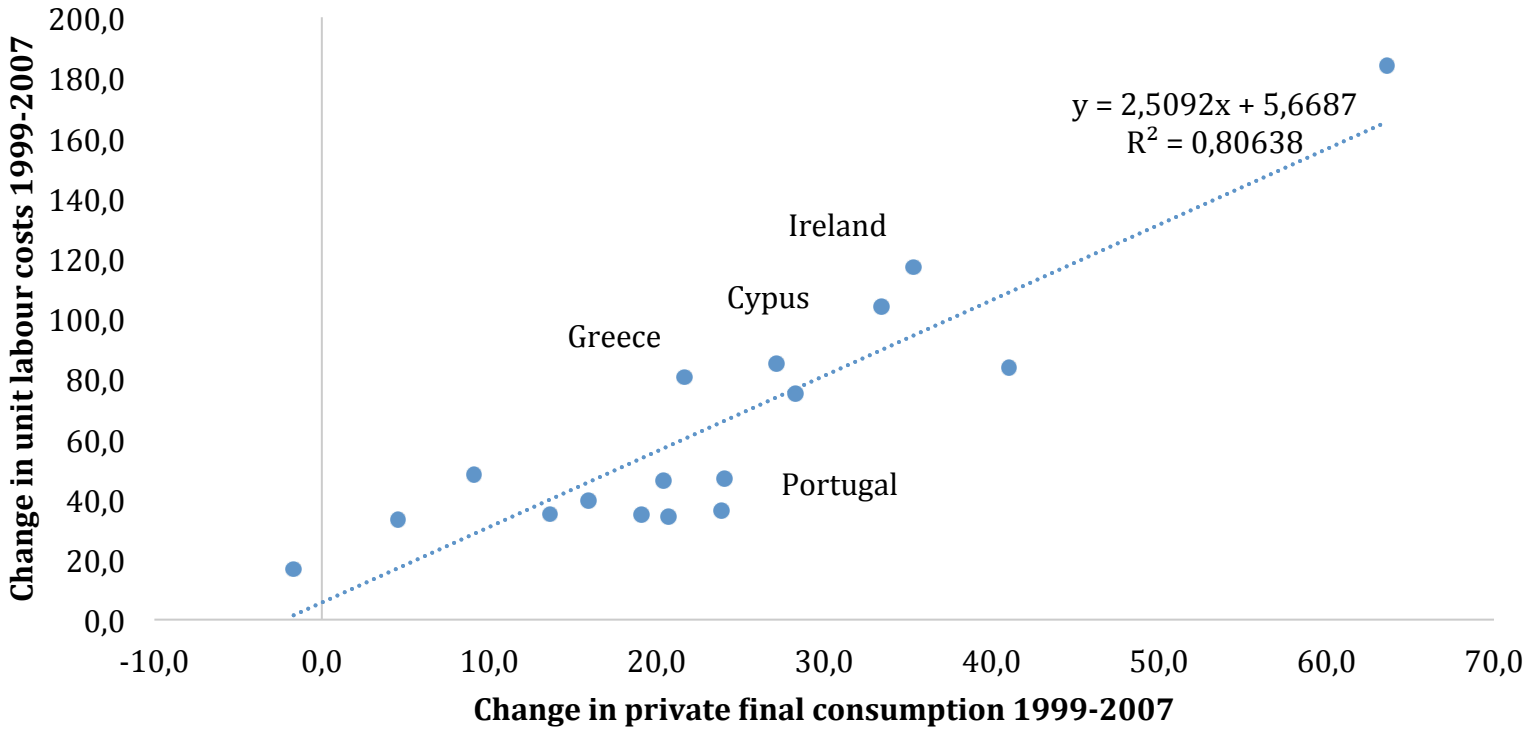
NOTE: Unit Labor Cost is an inverse measure of competitiveness

Causes of loss of competitiveness: The macro view

- Countries do not 'chose' to become uncompetitive.
- Wages/prices set in markets.
- Observed: strong demand growth + high wage/price increases + current account deficits.
- What was driving what?
- My presumption: demand growth drives wages and current account deficit at same time.
- Why demand up? IRL + SP construction boom (not policy), GR: fiscal policy (=policy choice), PT: in between.

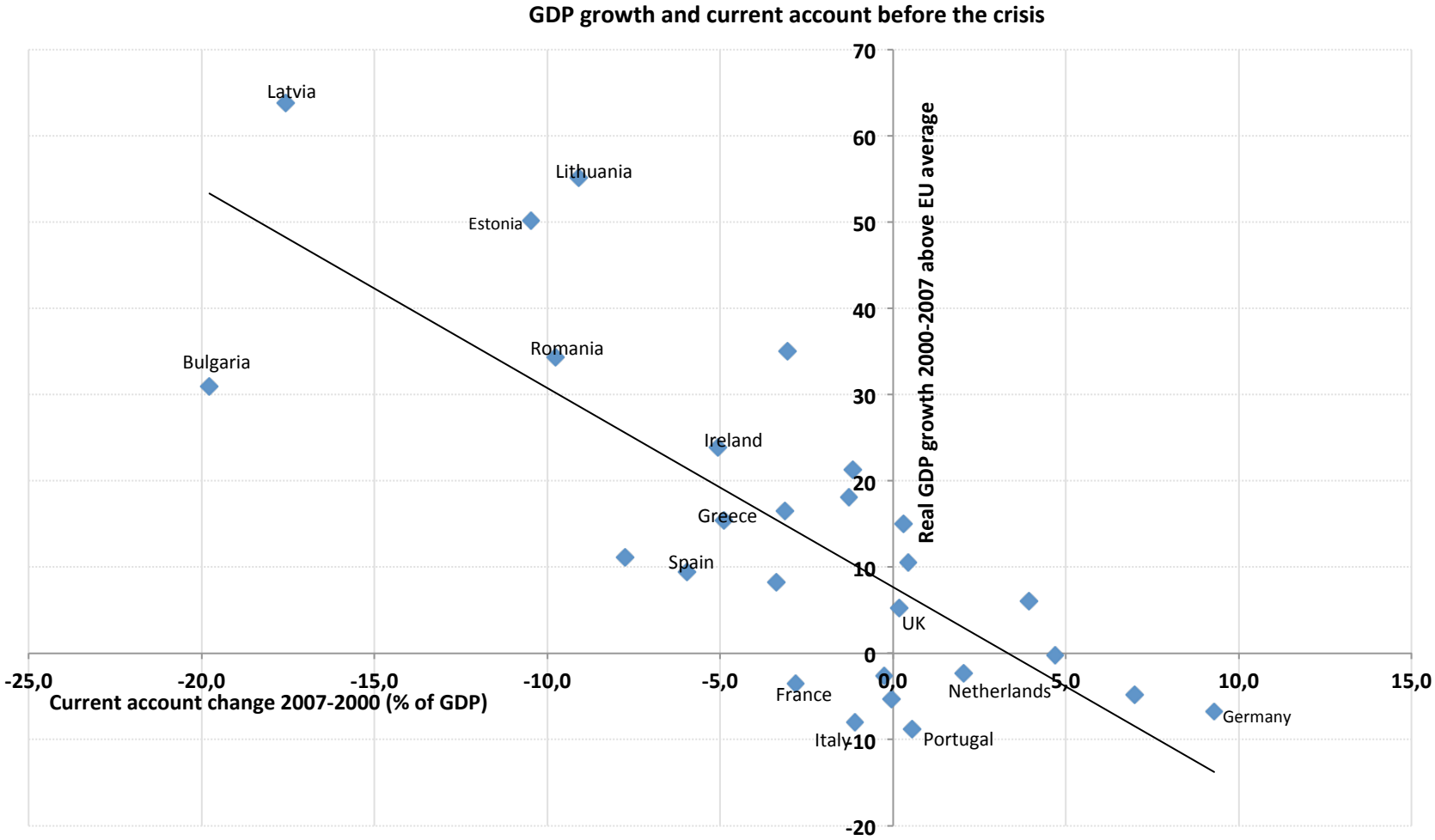
Demand and competitiveness

- Strong positive correlation between private consumption growth and loss in competitiveness (ULC).



Source: European Commission Services (AMECO), 2013.

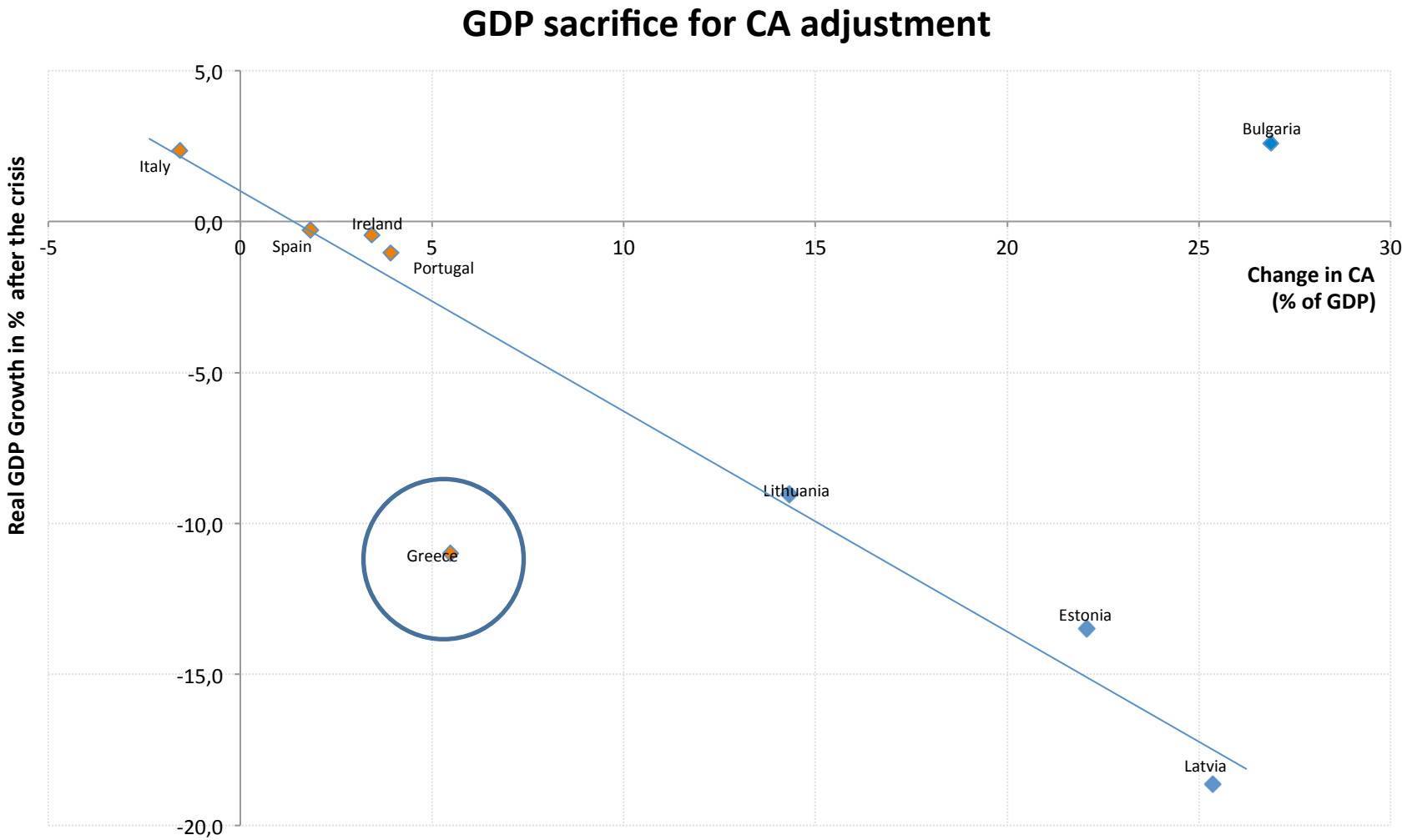
Growth and current account before the crisis



Bust

- Current account deficits = capital inflows.
- => Capital inflows stop: current account has to adjust (slow inside euro area, quick outside) => demand has to adjust (exports cannot jump).
- Depth of recession related to size of boom (= current account correction needed).

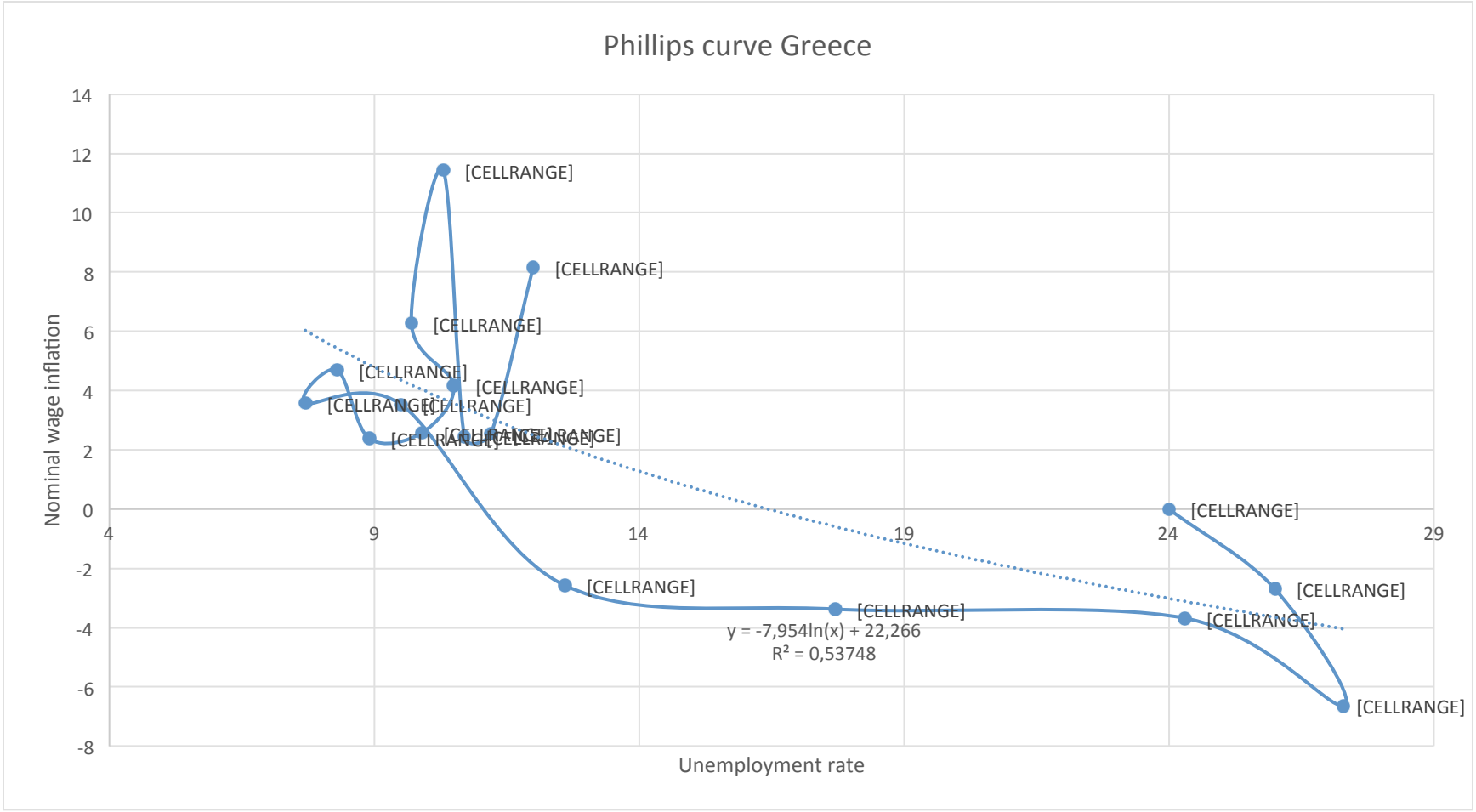
The sacrifice ratio (GIPSY vs. BELL)



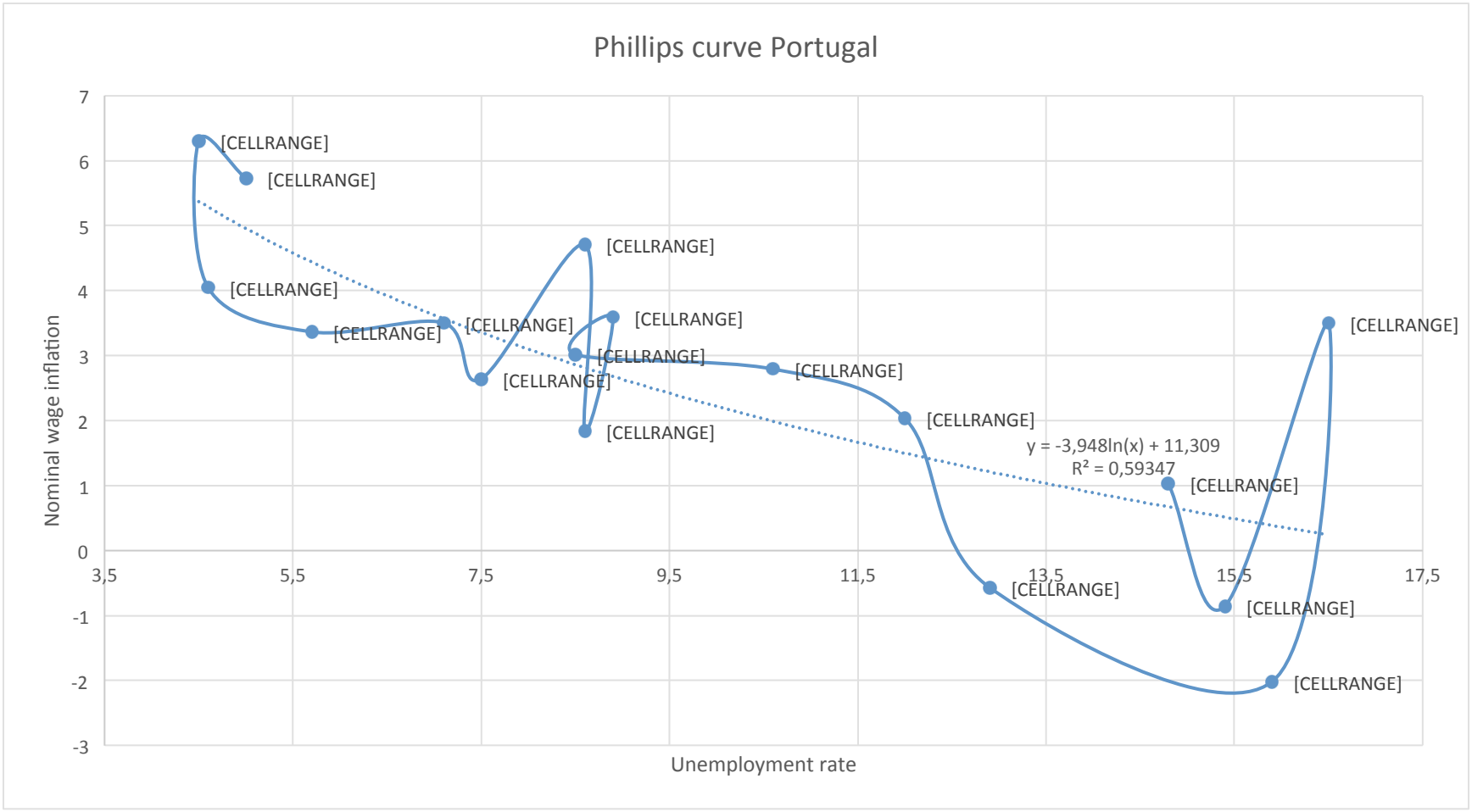
Mitigating the bust

- Bust = Boom in reverse?
- Demand down, prices down, current account improves (exports up)?
- Depends on slope of Philips curve, export supply.

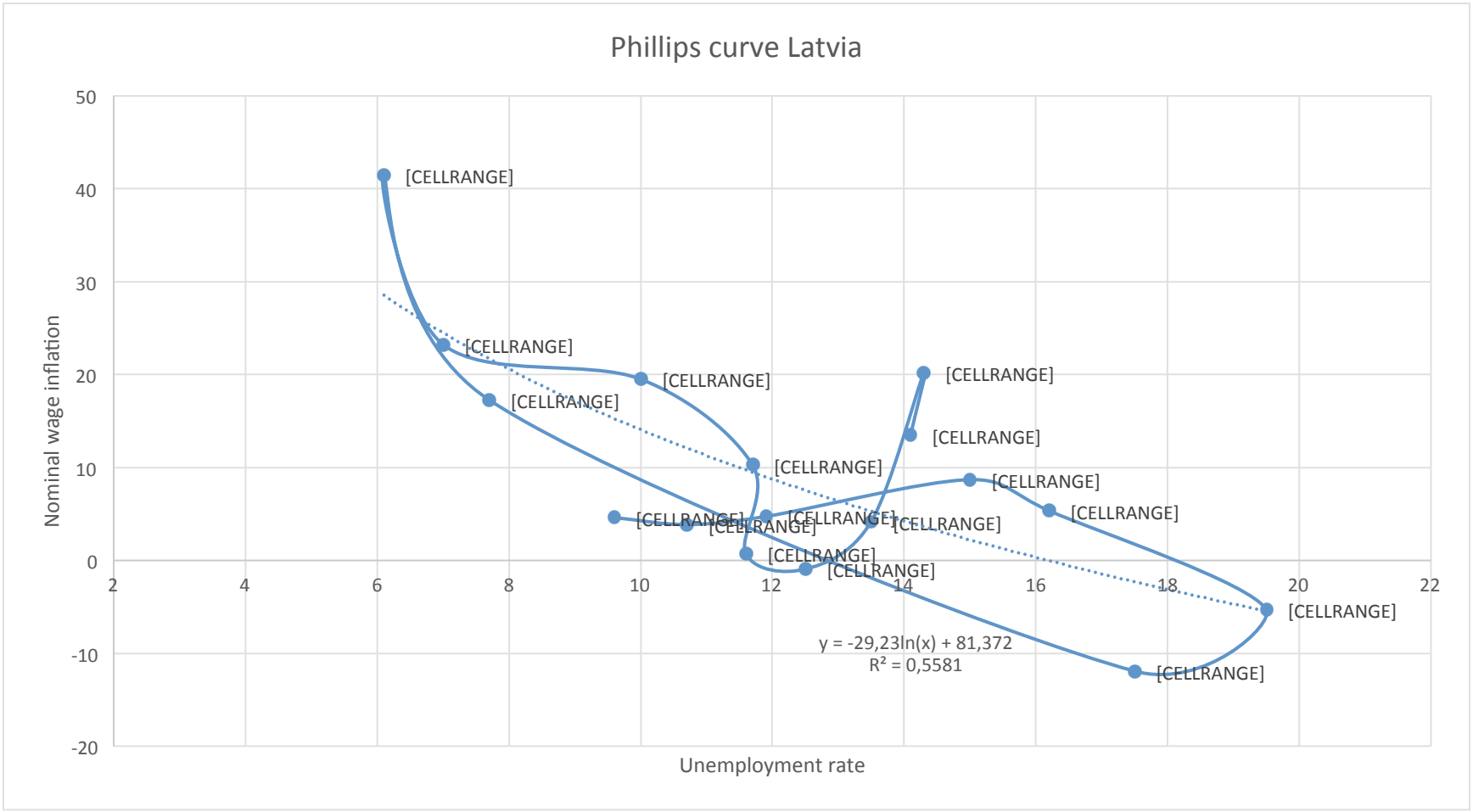
Philips curves differ: Greece as usual a special case



Portugal: a standard case?



Latvia: flexibility or just wild swings?



Flexible labour markets are an advantage

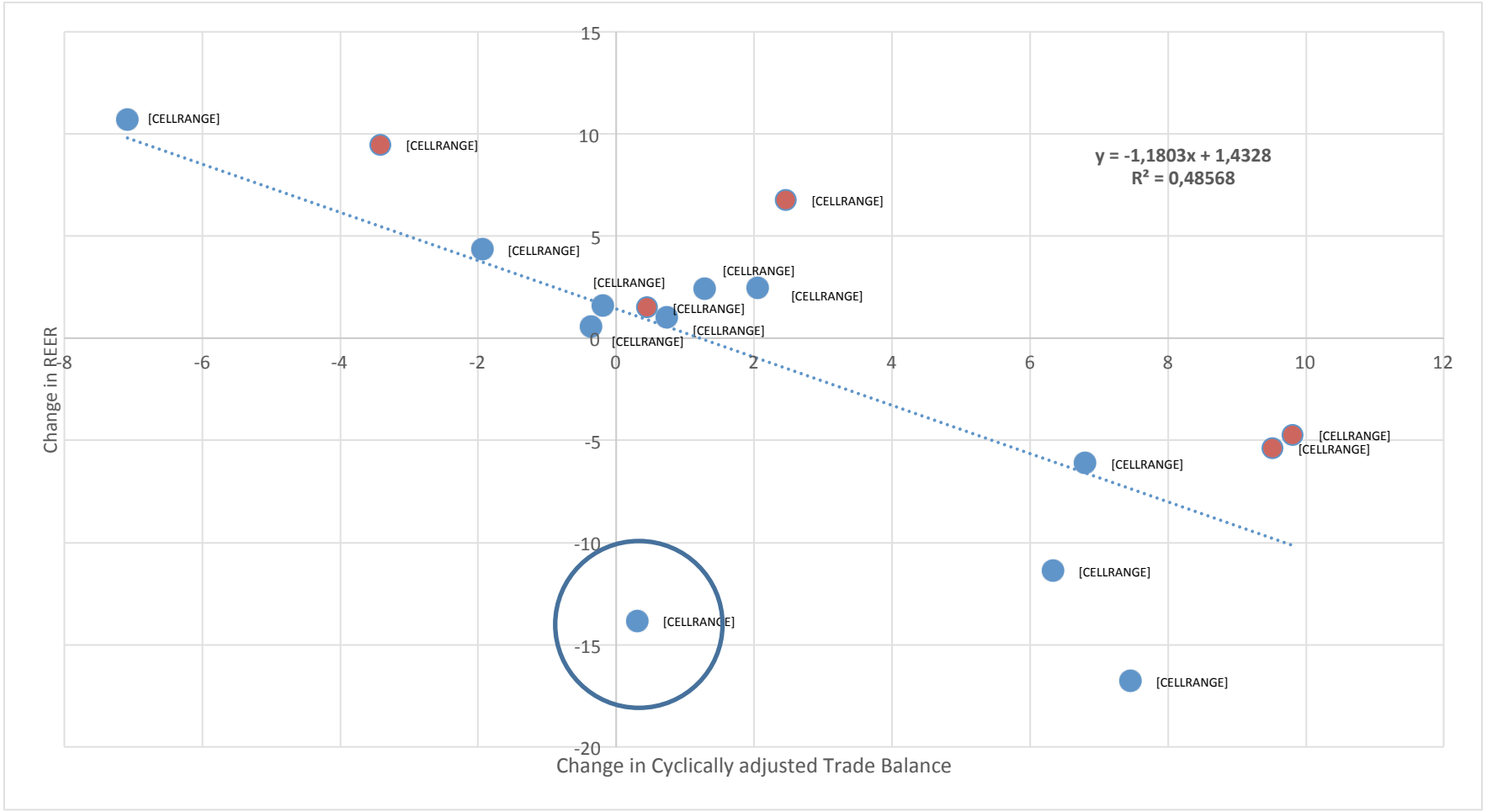
Slope of Philips curve in Latvia = 5 times Portugal or Greece (or Germany).

$\Rightarrow$Fall (or duration) in unemployment 5 times lower to achieve same gain in competitiveness.

How important was gain in competitiveness?

Openness and nature of export base.

Competitiveness important, but not only factor in external adjustment



The fiscal adjustment: theory and practice (I)

- 'Pure' Keynesian predicted that Greece would go into depression (large multiplier and large deficit: 2.5 * 10).
- Was not taken into account, hence programme off track
- This also implied unrealistic projections for tax revenues.

Country	Keynesian multiplier: 1/(1-c+m)=1/(s+m)	Marginal propensity to import (m)	Marginal propensity to consume (c)
Greece	2.5	0.20	0.92
Ireland	1.3	0.57	0.82
Portugal	1.7	0.60	0.99
Cyprus	1.0	0.82	0.86

Note: The marginal savings rate, s, is computed as the ratio of the increment in private savings relative to the increment in GDP over the period 2002-07; similarly the marginal propensity to import, m, is computed as the ratio of the increment in imports relative to the increment in GDP over the same period.

Sources: European Commission Services (AMECO database) and authors' own calculations.

Source: European Commission Services (AMECO), 2013.

The fiscal adjustment: theory and practice (II)

- Fiscal adjustment has been most visible challenge
- Greece off track because lack of recognition of large multiplier.
- Revenues planned to increase, but fell by large amount.
- => need to continuously cut expenditure.
- Other countries multiplier much less of a problem; hence fiscal plans more realistic.

Note*:* Cyprus is excluded, as the IMF plan only started in 2013. In the case of Ireland, the year before the start of the adjustment plan was characterised by a large fiscal deficit to bailout the Irish financial sector. **Sources***:* IMF and authors' own calculations.

The fiscal adjustment: theory and practice (III)

- Logic says: high fiscal multiplier means that high deficit at start of programme should have produced boom.
- Not the case!
- Why other components of demand down (investment).
- If one looks at the fiscal adjustment over the entire cycle (2007-2013) no negative effect for IRL, PT.
- => Continuing output gap due to fall in investment
- Greece different: fiscal adjustment large (in structural balance terms).

Note*:* Cyprus is excluded, as the IMF plan only started in 2013. In the case of Ireland, the year before the start of the adjustment plan was characterised by a large fiscal deficit to bailout the Irish financial sector. **Sources***:* IMF and authors' own calculations.

Putting the fiscal adjustment in perspective: the *2007* – 2013 cycle (I)

- Ireland, Portugal and Cyprus actually had an "expansionary" fiscal policy over the entire period (2007-13)
- The reduction in the deficit for Greece was minor (<3%)

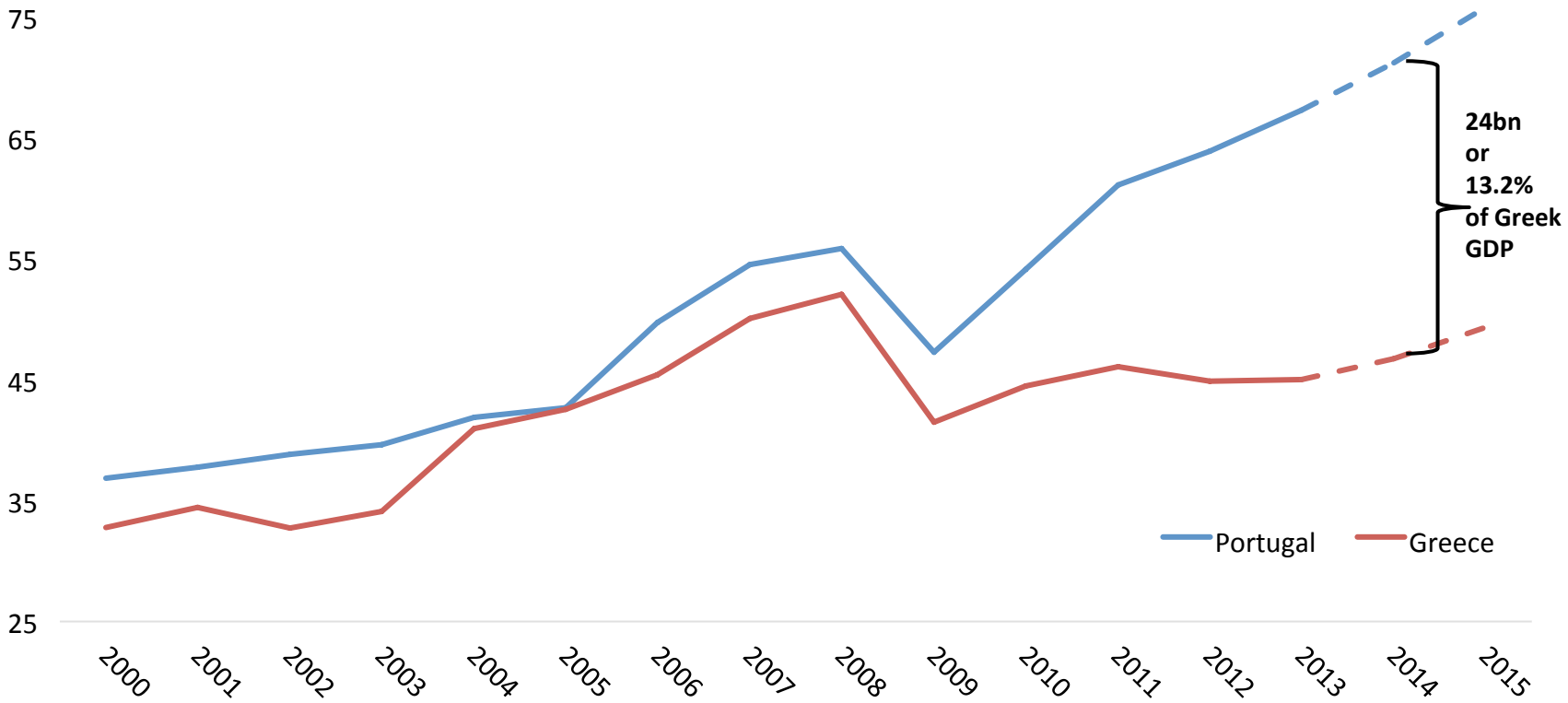
Changes in exogenous demand components (07/13)

Country	Fiscal balance	Real GDP	Investment	Exports	Imports
Ireland	-7.36	-6.99	-12.2	15.81	1.25
Greece	2.66*	-23.29	-11.91	-1.56	13.25
Portugal	-2.70	-7.09	-8.07	7.18	2.71
Cyprus	-11.78	-7.88	-8.11	-2.34	7.57

Note: *The Greek fiscal balance in 2013 is taken from the Troika's programme review the data of AMECO database, which includes the cost of banks' recapitalisation. **Source**: Own calculations based on AMECO, 2013.

The key role of exports: PT vs GR (III)

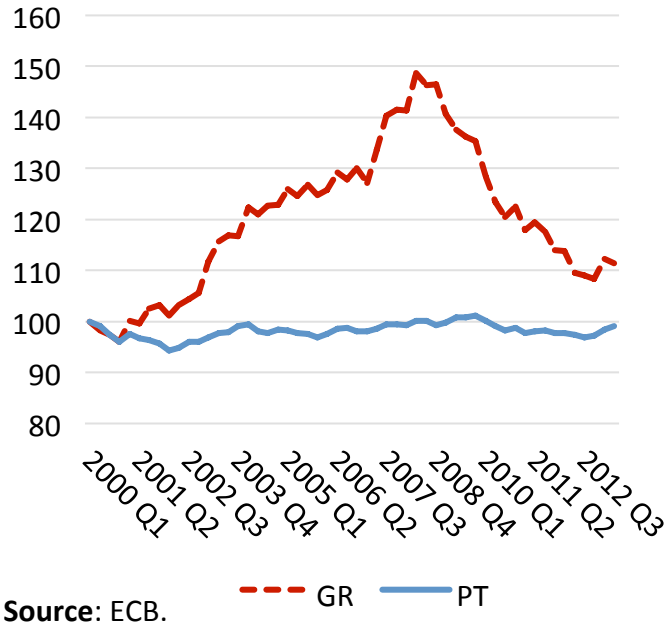
Exports of goods and services excluding oil (€ bn)



Source: European Commission Services (AMECO), 2013.

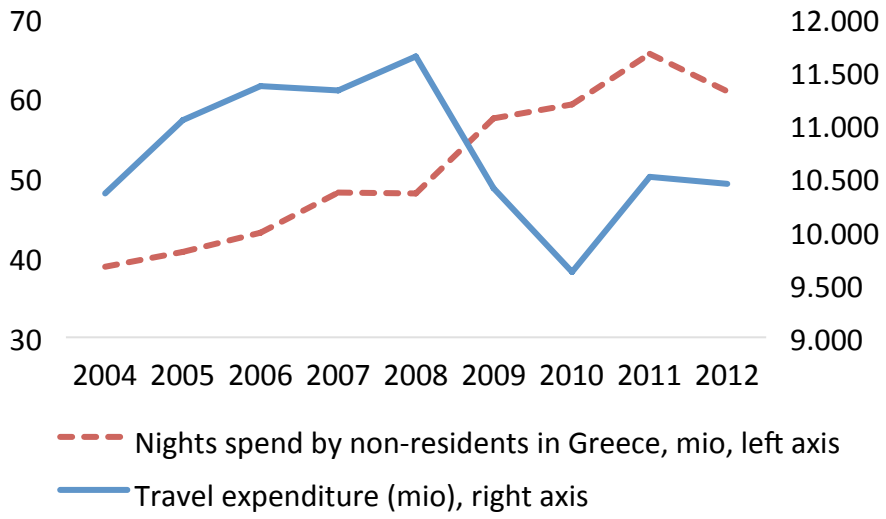
The key role of exports: PT vs GR (II)

Competitiveness indicator (ULC)



Source: ECB.

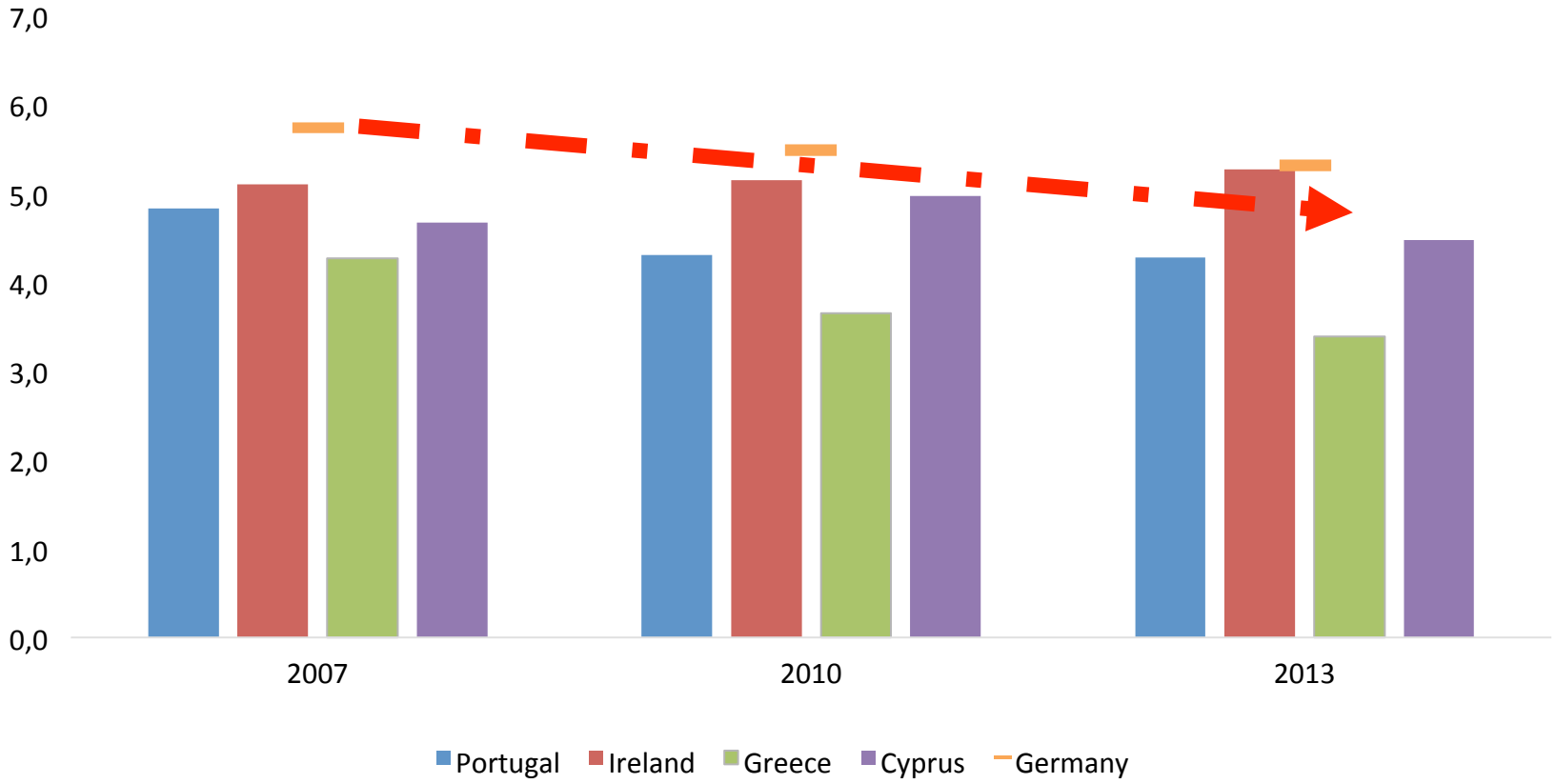
Development in Greek travel services



Source: Authors' calculation based on Eurostat data

- What makes GR special is the lack of growth in exports despite a considerable fall in wages.
- Explanation (partial)? Greek export base in commodities + lack of structural reforms plus low elasticity tourism.

Little sign of deep reforms anywhere
Public Institutions Index, 1-7 (best)



Conclusion

- What went right: Quick adjustment
- What went right after a while: Slow adjustment in euro
- What went wrong: Greece
- Why?
- Excessive concentration on fiscal adjustment, special economic structure, lack of structural reforms.

Conclusion:

Competitiveness as measured by ULC or prices not everything.

Note*:* Cyprus is excluded, as the IMF plan only started in 2013. In the case of Ireland, the year before the start of the adjustment plan was characterised by a large fiscal deficit to bailout the Irish financial sector. **Sources***:* IMF and authors' own calculations.

APPENDIX

Cost-Benefit Analysis: 2009-2014

Country	Cumulated unemployment cost, calculated based on:		Cumulated Output gap	Cumulated current account balances as % of exports
	Levels	Increase over baseline	Over baseline	
Ireland	70.5	47.6	-11.3	16.7
Greece	90.6	44.7	-45.5	-123.4
Cyprus	48.5	24.3	-4.9	-6.5
Portugal	69.6	25.4	-16.1	-56.7
GIPSY	**78.9**	**40.6**	**-21.7**	**-98.3**
BELL	**67.9**	**31.5**	**-17.8**	**-2.1**

Note: The cumulated unemployment rate is calculated as the sum of the unemployment rates between 2009-2014. The average unemployment rate, taken over the calm years of 2005-2007, constitutes the baseline of our calculation. The cumulated output gap is derived from the sum of annual output gaps over baseline. The output gap is defined as actual GDP less potential GDP as percent of potential GDP. The cumulated change in current account is calculated as the sum of current account balances (2009-2014) above the baseline (average of 2005-2007).All values are given as an average of the GIIPS and the BELL states and represent net present values, i.e. a 5% discount rate has been applied. **Source**: Own calculations based on AMECO, and Eurostat 2013.