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Tradable sectors in Eurozone periphery countries did not underperform in the 2000s

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Tradable sectors in the Eurozone periphery

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Some economists view the Eurozone crisis as driven by the deteriorating competitiveness of periphery countries (see Chen et al. 2012). Specifically, some analysts suggest that low competitiveness in the south is driven by exceptional growth of unit labour costs (Dadush and Stancil 2011). According to this view, increases of wage costs adjusted for productivity differences, or in short adjusted wage costs, made the exports of these countries uncompetitive.

Policy prescriptions to improve competitiveness that are based on this view have therefore focused on how to regain lost export market shares (see, for example, Dadush and Wyne 2012). Structural reforms may help but they take time.[1] In the shorter term, increasing market shares can be achieved by increasing price competitiveness. Typically this is done by depreciating the currency. Since Eurozone countries cannot devalue their currency, policymakers should instead try to restore competitiveness through internal devaluation, i.e. by reducing adjusted wage costs.[2] One estimate for Greece, for example, is that adjusted wage costs need to be reduced by 31%, effectively reaching the level of Turkey (Sinn, 2012).

Large internal devaluations, however, are difficult politically (Siegel 2012) and their economic success controversial (Blanchard, 2012). Achieving an effective reduction in adjusted unit labour costs via wage compression is particularly difficult in a context where several countries, possibly competing for the same export markets, have to do so at the same time. It creates a fallacy of composition effect. Krugman argues that, in order to achieve a reduction of relative wages while avoiding depressing demand, countries mainly have to rely on wage increases elsewhere (Krugman, 2011).

A basic premise underpinning these prescriptions is that exporters from Eurozone crisis countries underperformed. In this article we argue that loss of export competitiveness is likely to be the main determinant of growing current account deficits only for France.[3] In the Southern EZ countries current account deficits reflected an excessive increase in imports. In the run-up to the crisis, exporters from these countries could perform well on the international markets despite the rise in their countries' adjusted wage costs, because the bulk of the rise in wage costs occurred in the non-traded sector.

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[1] Structural reforms are particularly useful in increasing the size of the export sector. From 2002 to 2008, countries in Southern Europe created jobs primarily in activities such as construction and in less productive firms, unable to reach the export markets (Gill and Reiser, 2012).

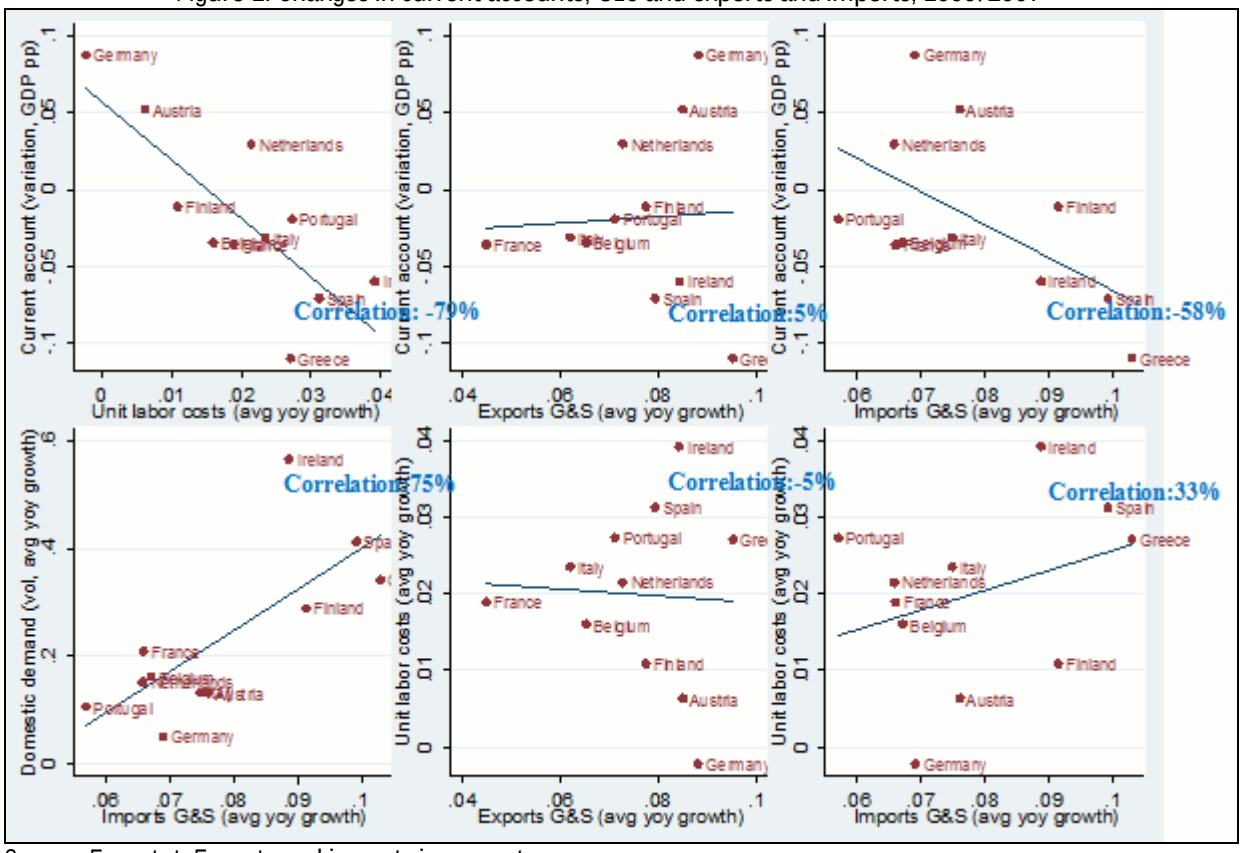
[2] A reduction in adjusted wage costs can be achieved either by increasing value added or by reducing wages. As increasing value added takes time, the reasoning goes, compressing wages may be seen as a viable alternative to deliver results in a shorter time span. In practice, however, reducing wages also takes time.

[3] The strategies of multinational firms may have played a role in the collapse of the French export market share. Indeed to gain access to worldwide markets French MNEs seem to have favored (horizontal) FDI over export. It is not clear to what extent those choices were determined by the lack of cost competiveness of their establishments in France. In the French current account, FDI incomes partially offset the drop in net export revenues, dampening the deterioration of the net external position.

Exporters from Eurozone peripheral countries are competitive on the international markets

While the current account balance in Eurozone countries is highly correlated with adjusted wage costs and imports, this is not the case for exports. The latter are very weakly correlated with both the current account and with the adjusted wage costs. Figure 1 shows indeed that over the period 1997-2007, the correlation between current account variations (measured relative to GDP) and our measure of adjusted wage costs growth, i.e. unit labour costs average year on year growth, was -79% (see top-left panel of Figure 1) and its correlation with imports of goods and services was -58% (see top-right panel of Figure 1). By contrast, the correlation of the current account variations with export of goods and services over the same period of time was a mere 5% (top centre panel of Figure 1). Similarly, the correlation between average year on year growth of unit labour costs with exports was -5% but 33% with imports. Countries with high unit labour costs, such as Portugal, Spain, Ireland and Greece had a growth in exports of goods and services comparable to countries with low unit labour costs, such as Finland, Austria and Germany.

Figure 1. Changes in current accounts, ULC and exports and imports, 1999/2007



Source: Eurostat. Exports and imports in current euros.

Digging deeper into the data confirms the relatively good performance of exporters from Eurozone crisis countries over the first ten years of the monetary union. A forthcoming paper by Gaulier et al. (2012) decomposes goods export growth based on a weighted variance analysis of bilateral export data, disaggregated by product.[4] This decomposition allows quantifying the share of a country's export growth due to sectoral and geographical specialisation as separated from the share of export growth due to domestic dynamics. Put simply, assuming that Country A is "more competitive" in trade than Country B simply because it is growing exports faster is too simplistic. Even using relative performance in terms of market share growth may be prone to misinterpretation. This is because export growth is composed of two different types of effects: "pull" (or compositional) effects and "push" (or performance) effects. Two countries may actually have similarly

[4] Specifically, we estimate: $dlog\ X_{ijkt}=\alpha it+\theta_{jt}+\gamma_{kt}+\varepsilon_{ijkt}$ where α_{it}, θ_{jt} and γ_{kt} are fixed effects by exporter i, importer j and product k specific to time t. The model identifies the export growth of each exporting country as if all exporters had the same geographical and sectorial specialisation. This is important for export data, as export growth rates are affected by structural effects: exporters with strong positions in the most dynamic destination markets or specialized in high growth sectors benefit ceteris paribus from stronger growth. With this methodology, "pure" exporter performance can be assessed separately from geographic and sectorial effects.

competitive bundles of export firms, but overall export performance of one country will be higher than the other in the short-to-medium term because it has a more favourable (at the time) composition of exports, in terms of both geographical markets and sectors.

What does decomposing exports in this way say about the export competitiveness of Eurozone countries? Figure 2 presents the results of such decomposition for Eurozone countries using bilateral trade data at the HS6 level of disaggregation from the BACI database of the CEPII over the period 1999-2007. Contrary to received wisdom, once geographical and specialisation effects are accounted for, export "push" performance of Eurozone countries emerges as very negative only for France and Finland, which lost between 3% and 4% market share yearly. By contrast, the "push" performance for Portugal, Italy, and Greece is similar to that of Germany, with export market share losses below 1% yearly. Finally, Spain's "push" performance is positive, partly offsetting a negative geographical and sectoral specialisation. The positive Spanish "push" performance is confirmed in a Rodríguez et al. (2012) paper which, looking at firm-level data, finds that the large Spanish firms – which represent the bulk of Spanish exports – did not suffer of competitiveness losses in the recent years. Moreover, data for the crisis year 2010-11 show that the export growth in Portugal and Spain was highest among Eurozone countries (Figure 3)

Figure 2. Shift-share analysis of export performance
(avg annual growth rate, 1999-2007)

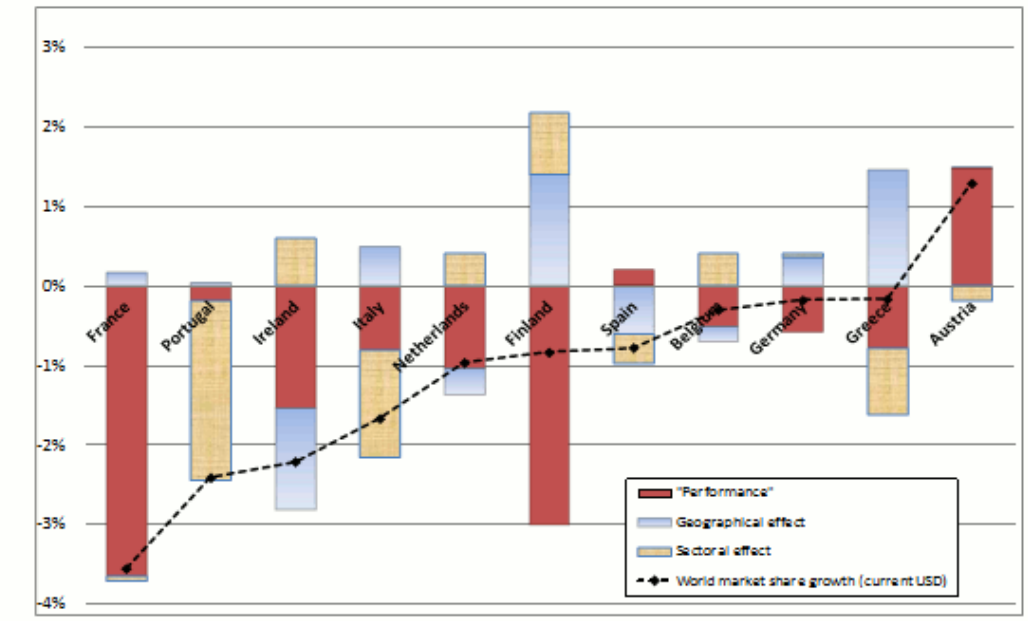
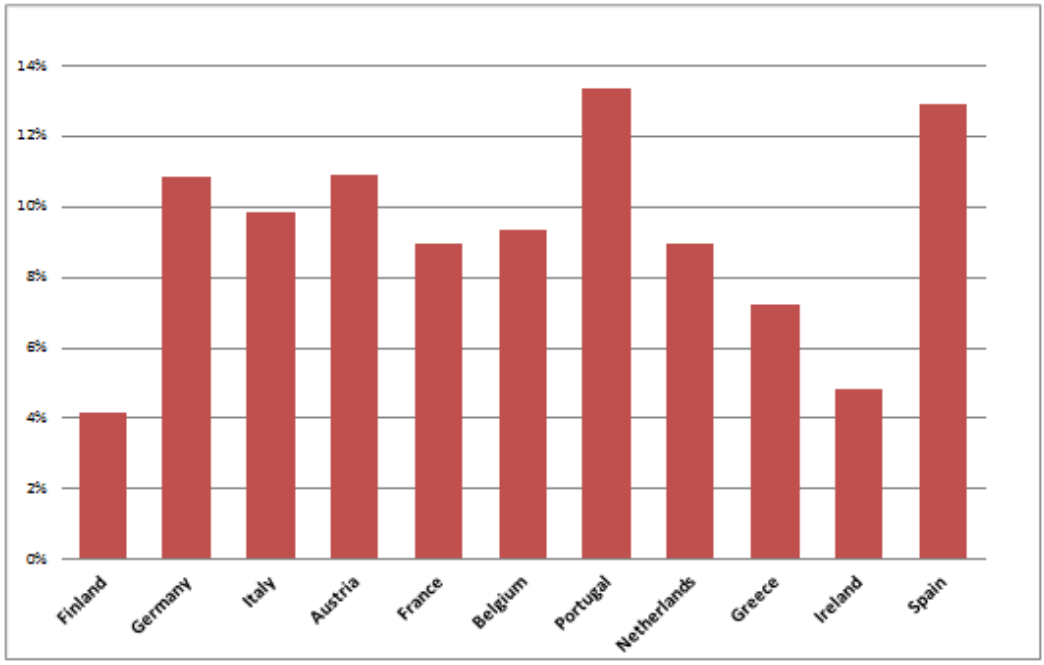


Figure 3. Exports of goods and services (annual growth), 2010-11

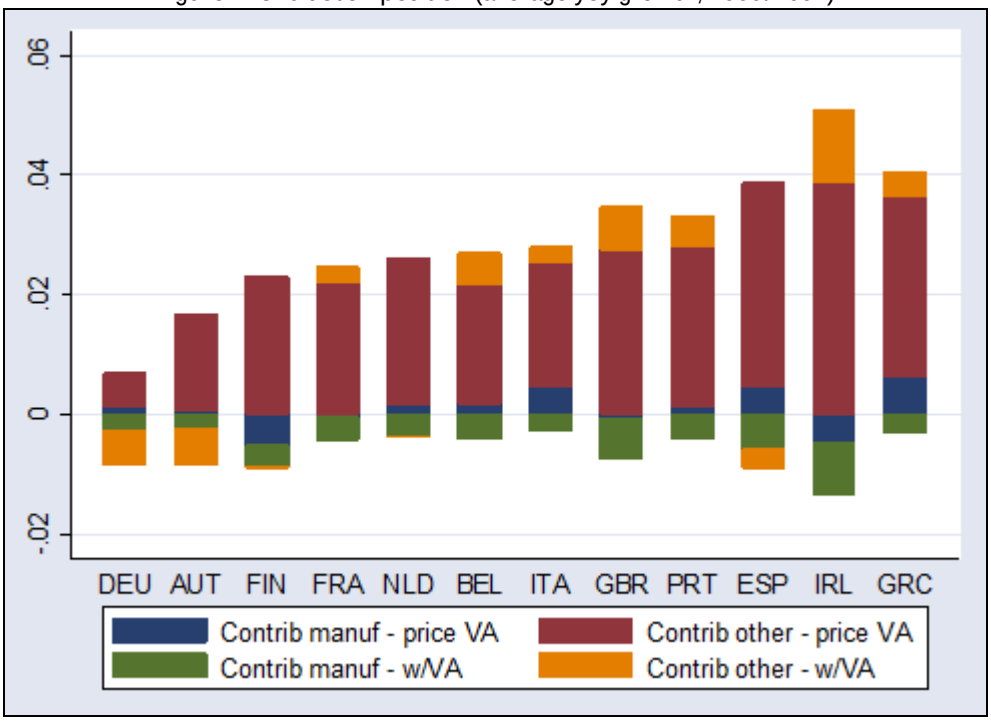


The current account deterioration of crisis countries reflects a demand shock and not a deterioration of the exporters' supply-side productivity

How can we reconcile good export performance with rising wage costs in the periphery of the Eurozone? Normally, we think of unit labour costs as total labour costs divided by real GDP. However, we can also define them as the share of total labour compensation in value added times the price of value added (Felipe and Kumar, 2011).[5] Using this decomposition allows us to see that changes in wage costs may result from any of the following two mechanisms: either changes in the allocation of value added (VA, at current prices) between labour and capital, or from changes in price competitiveness (the price of VA). Figure 4 shows the results of such decomposition, further separating the manufacturing sector from the rest of goods and services. Broadly speaking, we assimilate the manufacturing sector to the tradable sector and the rest of the economy to the non-tradable sector. We are aware that this is a simplification, as for some Eurozone countries a large share of exports is in services (i.e. 82% for Cyprus, 77% for Luxembourg, 56% for Greece and 53% for Malta). Yet, we find that the bulk of the appreciation in unit labour costs is due to price developments in the non-tradable sector, with the effect being largest in the crisis-countries of the Eurozone.

5 $ULC = \frac{\text{labor compensation}}{VA} price_{VA}$

Figure 4. ULC decomposition (average yoy growth, 1999/2007)



Source: EU-KLEMS, Gaulier and Vicard (2012)

These developments are easy to explain if we consider that European financial integration during the monetary union led to an inflow of capital to the peripheral countries of the Eurozone (see, for example, Lane and Pels 2012). The inflow of capital boosted domestic demand. The increase in demand in turn pushed the prices of non-tradables while also leading to an increase of imports. Exports were largely unaffected by the shock in domestic demand because they respond primarily to foreign demand and exogenous international prices. Put simply, rising unit labour costs were not a cause but a symptom of the demand shock triggered by the inflow of capital and they were not associated with losses in exporters' competitiveness.

What policy priorities for the unwinding?

Whether we believe in the underperformance of the tradable sector in Eurozone peripheral countries or not matters greatly for identifying the priorities for policy action. Our analysis suggests that existing exporters from the periphery are competitive enough to respond positively to foreign demand increases. Accordingly, demand for tradables should be a key policy concern. As exports from the Eurozone periphery are largely sold within the continent, sustaining EU internal demand, and possibly boosting it in surplus countries, is as important as reducing imports in crisis countries and expanding their export base. While wage and employment reallocations from unproductive areas of the economy to more efficient uses may help boosting overall productivity, simultaneously imposing harsh wage compression in several countries could have the perverse effect of making the adjustment through demand reductions and prices - which is already taking place – more painful and socially untenable.

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