Senior European Experts

Competitiveness in the European Union

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Introduction

The global financial crisis and the related eurozone crisis have highlighted differences in competitiveness between EU Member States. In the absence of the ability to devalue, countries within a common currency, such as the euro, need to be competitive with one another. A lack of competitiveness undermines the common currency and can only be addressed through measures, such as wage freezes and benefit cuts, which are politically difficult and painful for those affected and through fiscal transfers in which the more prosperous countries provide help to the less prosperous but which may also be politically difficult in the prosperous countries. The latter approach may result in further declines in competitiveness because of a lack of incentive to adopt the painful measures referred to above.

But competitiveness is not just an issue for countries in the eurozone; non-euro countries such as UK cannot ignore the issue either. They need to be competitive with the best economic performers in the EU whether they share the same currency or not, particularly if those economies are the ones they trade with most frequently. For the countries outside the eurozone, the possibility of devaluation is extremely important because it enables them to stay competitive, though devaluation is far from being an ideal solution. All the Member States of the EU need to be competitive with the major economies outside the EU (see below).

This paper, an introduction to a complex subject, looks at the issue of competitiveness inside the EU, including the eurozone specifically and in respect of the UK, and at how competitive the EU is with major economies in the rest of the world.

What is competitiveness?

Competitiveness is about the ability of a company or a country to sell goods or services in the market compared to the ability of other companies or countries to sell in the same market. How competitive a company or a country is depends on a range of factors – including labour costs; regulatory burden; productivity; skills; innovation; infrastructure; and other factors.

Over the last 20 years many countries have sought to improve their relative competitiveness because globalisation (*i.e.* the opening up of markets, the availability of transport and the increased mobility of labour) has meant that to prevent, or arrest, economic decline countries must substantially improve their economic performance.

Competitiveness can be measured in many ways; between companies it is usual to focus on price and quality. Price is not the sole factor in many markets, a customer may pay more for a better product or service, and a price advantage can be lost if quality deteriorates or a company fails to innovate. For countries, measuring competitiveness is more complicated. It can be hard to assess the value of (say) of a country having a number of globally respected universities as compared to another country whose universities are of a lower standard but (say) whose motorway system is more extensive.

The EU uses 26 factors covering topics such as productivity, innovation in the private sector and numbers of science and engineering graduates, to measure country competitiveness enabling it to gain a fairly accurate picture of the competitiveness of each Member State.[1]

Competitiveness within the Eurozone

One widely used indicator of competitiveness is the comparison of nominal labour costs in various countries. Statistics from the European Commission show the increase in nominal labour costs in the EU, in the euro area as a whole and in individual eurozone countries (along with the UK) for the period 2000-2010.[2]

The striking figure is that for Germany; a six per cent increase means that in reality German wages fell over the decade from 2000, making Germany formidably competitive compared to other eurozone countries. It is worth noting too that while there were big increases in labour costs in Estonia and Slovenia, these countries started from a far lower base. Labour costs have fallen in Greece since 2010 but other eurozone countries have struggled to reduce their labour costs.

How competitive is the UK?

The UK is rated as successful against the basket of indicators used by the EU and that is encouraging but the fact that, as the table above shows, the rise in labour costs in the UK was greater than in all but the three eurozone members who joined the EU in 2004 and in Greece shows that the UK became less competitive against the bulk of the eurozone between 2000 and 2010 according to this all-important benchmark.

In the Global Competitiveness Index, a ranking based on a basket of indicators analysed by the World Economic Forum, the UK is eighth out of the 144 participating countries in 2012/13.[3] But this is not the full picture as the Index ranks Britain down in 110th place for its macroeconomic environment and 127th place for the scale of its public debt (high numbers indicating a relatively poor position when compared to other countries).[4] And we should not forget that the UK was second overall in this index in 2006/07. Other indices assess the UK's performance against different metrics; that published by TheCityUK, for example, looks at the competitiveness of financial services and the attractiveness of the UK as a location for financial service providers.[5]

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1 European Commission, *Member States Competitiveness Performance and Policies (2011 Report)*, SEC (2011) 1187 final, 14 October 2011

2 See annex

3 Klaus Schwab (ed.), *The Global Competitiveness Report 2012-2013*, World Economic Forum, 27 August 2012, p. 13

4 *Ibid.*, p. 22

5 *http://www.thecityuk.com/*

Sterling floats freely on international exchanges and its rise or fall against other currencies matters because it affects the price of exports to overseas buyers and the price of imports in the UK domestic market. Devaluing your currency is one way of increasing competitiveness against other countries; sterling has been devalued several times since 1945.

Sterling appreciated against the euro as a result of the rise in UK interest rates in 2006 and 2007 (the Bank of England was responding to inflationary pressures) but it remained within a range of five per cent of £1 = €1.45 in the period 2003-07.[6] The global financial crisis triggered a sharp fall in the value of the pound against the euro – at one point the fall was about 25 per cent – but since then the gap has narrowed so that the depreciation is roughly 15 percent from the €1.45 rate. Sterling's value against the euro is of great importance because over 40 per cent of UK exports go to the eurozone.

The EU and international competitiveness

Five out of the top 10 countries in the Global Competitiveness Index are EU Member States (Finland, Sweden, Netherlands, Germany and the UK; numbers 3, 4, 5, 6 and 8 respectively). This is comforting but of course such league tables do not stay static. The key issue for the EU is not the position today but what will happen over the next 50 years.

The difficulty for the EU is that it is not competitive at present against many existing industrialised economies (such as those of Japan and the USA) on many indicators. For example, on productivity the gap between the EU and its main trading partners widened over the decade between the Millennium and 2010.[7] In the case of the USA, the gap is about 13 per cent; this would appear to be related to education and skill levels in the EU compared to the US.[8] The EU needs to improve its performance now as the challenge from the rapidly developing countries is growing all the time.

The European Commission has predicted that, without reform, the EU economy will grow at just 1.5 per cent a year over the decade 2010-2020; IMF data suggests growth of a minimum of 7.8 per cent a year in China, 1.5 per cent in Brazil, 3.7 per cent in Russia, 4.9 per cent in India and 2.6 per cent in South Africa.[9] And a whole tier of countries are coming up rapidly alongside the BRIC countries – such as Chile, Indonesia and Thailand – with the IMF predicting growth rates of at least four per cent a year between now and 2017. The British Government has claimed that there is a serious danger that no single EU country will be among the world's top 10 economies after 2050, although the EU as a whole would still be amongst the top three global economies.[10] But growth and competitiveness are not synonymous.

Assessment

Assessing competitiveness is not easy and league tables change over time. The EU and its Member States clearly have significant challenges at the present time, although this is close to an historic low point in terms of economic performance.

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[6] See Oanda, 'Historical Exchange Rates', December 2012

[7] European Commission, *Europe 2020: A European strategy for smart, sustainable and inclusive growth*, COM (2010) 2020, 3 March 2010, p. 7

[8] Werner Roeger, Janos Varga & Jan in 't Veld, *How to close the productivity gap between the US and Europe: A quantitative assessment using a semi-endogenous growth model*, European Commission Economic Papers 399, 20 January 2010

[9] See International Monetary Fund, *World Economic Outlook October 2012: Coping with High Debt and Sluggish Growth*, 13 October 2012

[10] Cited in HM Government, *Let's choose growth: Why we need reform to unlock Europe's potential*, 29 March 2011, p. 2

The prospects for an improvement in competitiveness in the eurozone now depend on the willingness of member governments (and their electorates) to put up with the measures necessary to make them more competitive. Most eurozone countries need to be more competitive with Germany (or Germany to be less competitive; see below); after its long period of wage restraint (between 2001 and 2009 wages fell in real terms by 6.3 per cent) wages are now rising again ahead of prices.[11] This change will ease the burden on other eurozone countries as they implement austerity and other measures to increase their competitiveness against Germany but they still have a long way to go as several of them are uncompetitive in many different ways, such as in the time it takes to establish a company or the levels of private sector investment in research and development. Germany may no longer be gaining competitiveness against other eurozone states as it would be hard for any country to sustain a continuing real-terms fall in wages when the economy is growing (and because of external pressures on Germany to allow its economy to expand at home) but other eurozone countries have a long way to go before they can match German competitiveness.

A June 2012 International Monetary Fund study suggested that structural reforms in labour markets, pensions and in productivity in the eurozone members could increase growth by up to 4.5 per cent.[12]

The rebalancing of the eurozone economy to deal with the debt and deficit problems, to reduce the structural imbalances that have built up between Germany and the southern members and to address the question of how to make fiscal transfers in a monetary union all require policy co-ordination at the eurozone level.

The EU as a whole has a programme – Europe 2020, described in other Senior Experts' papers – to improve its competitiveness and there is considerable political awareness of the problems now and in the future (as well as scepticism about how effective such a programme is likely to be). Recent initiatives have included the Single Market Act, a package of deregulatory and reform measures for the EU, and its successor, Single Market Act II. The issue is about whether the political will exists to implement the necessary reforms.

In the UK, despite its relative success against both the EU's competitiveness indicators and those of other bodies, significant problems remain because of the scale of public and private indebtedness, the sizeable geographic differences in economic performance between north and south and an on-going failure to address skills shortages.

December 2012

[11] Hans Boeckler Foundation estimate cited in 'German wages rise most in almost four years', Annika Breidthardt & Rene Wagner, *Reuters*, 29 October 2012

[12] Bergljot Barkbu, Jesmin Rahman & Rodrigo Valdés, *Faster Growth in Europe Now*, IMF Staff Discussion Note SDN/12/07, 18 June 2012

ANNEX

Rise in nominal labour costs

Compiled from *Member States competitiveness performance and policies: Reinforcing competitiveness*, 2011 edition, SEC (2011) 1187[13]

Country	Increase
EU27	14%
Euro area	20%
UK	33%
Austria	N/A
Belgium	23%
Cyprus	32%
Estonia	66%
Finland	22%
France	23%
Germany	6%
Greece	37%
Ireland	27%
Italy	31%
Luxembourg	32%
Malta	29%
Netherlands	23%
Portugal	25%
Slovakia	33%
Slovenia	53%
Spain	29%

[13] Austria omitted (no figures available)

Senior European Experts

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