Box 5

REBALANCING OF COMPETITIVENESS WITHIN THE EURO AREA AND ITS IMPLICATIONS FOR INFLATION

The need for a rebalancing of competitiveness positions

The period since 1999 has seen substantial losses in the price and cost competitiveness of several euro area countries.[1] These losses in relative price and cost competitiveness are, for instance, reflected in HICP inflation rates or in growth rates of unit labour costs that have been persistently above the euro area average (see Charts A and B). Such above average increases in prices and costs can be attributed partly to the normal process of real and nominal convergence that was triggered by the different levels of economic development at the start of Stage Three of EMU.[2] In several euro area countries, however, these increases reflected losses in competitiveness which were, and still are, associated with nominal excesses fuelled, for instance, by wage growth that has been persistently out of line with sustainable productivity gains, or by increases in public and private sector debt that have been persistently out of line with income developments and created excess demand.[3] With the start of the crisis, the losses in competitiveness turned out to be particularly detrimental to employment wherever they were associated with large current account or fiscal deficits, or with housing bubbles. In this respect, the losses in price and cost competitiveness in a number of countries are part of a wider set of macroeconomic imbalances (see Box 7, entitled "The 2012 macroeconomic imbalance procedure").

The bursting of the housing bubble in several countries and the more general reassessment of growth prospects and fiscal positions by markets in the wake of the financial crisis revealed the need for a process of major economic adjustment. Chart A shows that, when comparing developments up to 2007 with those up to 2011, average differentials in annual unit labour cost growth relative to the euro area have already come down somewhat in a few countries which recorded losses in competitiveness. However, while part of the correction seen thus far reflects countries' structural measures to correct relative price and cost developments on a more lasting basis, part of it also reflects labour shedding in low productivity sectors, which pushed up aggregate productivity in several countries. Chart B demonstrates a similar pattern for average annual HICP inflation differentials, which rose in the years up to 2007, but have adjusted more recently towards lower differentials.

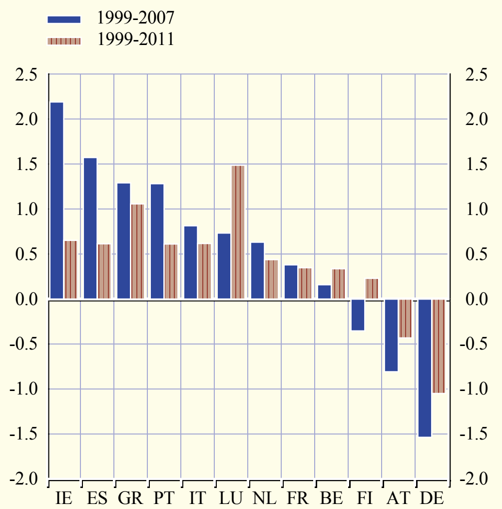
1 The box mainly refers to the 12 EU Member States that had joined the euro area by 2001, i.e. Belgium, Germany, Ireland, Greece, Spain, France, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland. Those Member States that have joined the euro area more recently are excluded, given that issues of real and nominal convergence play an important role in explaining inflation differentials in those countries.

2 Empirical work that has tried to quantify catching-up effects (in the form of Balassa-Samuelson effects) has been unable to find unambiguous evidence of such effects at play after the start of Stage Three of EMU. Earlier studies on the Balassa-Samuelson effect in the euro area (e.g. Hofmann, B. and Remsperger, H. "Inflation differentials among the euro area countries: potential causes and consequences", conference paper presented at the 2005 ASSA annual meeting; and Katsimi, M., "Inflation divergence in the euro area: the Balassa-Samuelson effect", *Applied Economics Letters*, Vol. 11, No 5, pp. 329-332) did not find any significant contribution of cross-country price convergence to national inflation rates in Stage Three of EMU. Some Balassa-Samuelson effects in a group of euro area countries between 1992 and 2001 were set out in Wagner, M., "The Balassa-Samuelson effect in East and West, differences and similarities", *Economic Series*, No 180, Institute for Advanced Studies, Vienna, 2005.

3 See the article entitled "Monitoring labour cost developments across euro area countries", *Monthly Bulletin*, ECB, November 2008; and, for a sectoral view, the box entitled "A sectoral account perspective of imbalances in the euro area", *Monthly Bulletin*, ECB, February 2012.

Chart A Average annual increase in unit labour costs relative to the euro area average

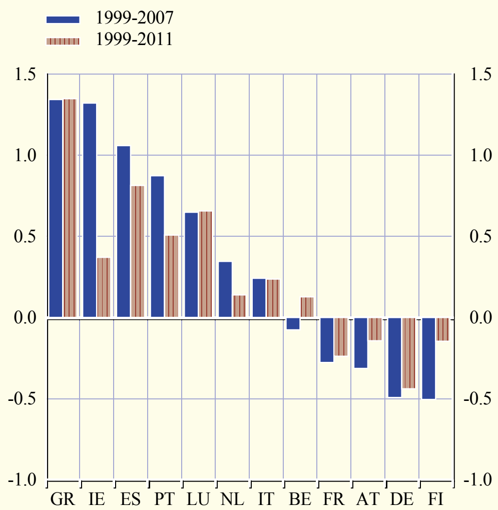
(percentage points)



Sources: Eurostat and ECB calculations.
Notes: Countries are grouped in descending order for the period 1999-07. The data for Greece only cover the periods 2001-07 and 2001-11. The chart only covers the 12 EU Member States that had joined the euro area by 2001.

Chart B Average annual HICP inflation differentials relative to the euro area average

(percentage points)



Sources: Eurostat and ECB calculations.
Notes: Countries are grouped in descending order for the period 1999-2007. The data for Greece only cover the periods 2001-07 and 2001-11. The chart only covers the 12 EU Member States that had joined the euro area by 2001.

Charts A and B also show that there is still a substantial need for rebalancing in order to restore competitiveness positions. To continue the rebalancing process, countries will need to engage in courageous measures to enhance both price and non-price competitiveness. In this respect, the set of measures, and the degree to which they are used, may vary across countries. A significant genuine reduction in unit labour costs (lower wages and/or higher productivity) and excess profit margins are particularly urgent in countries with high unemployment and low competition.

First, flexibility in the wage determination process has to be strengthened in several euro area countries. Second, permanent increases in labour productivity strengthen competitiveness adjustment, as they lower unit labour costs and increase potential output at the same time. Productivity gains strengthen not only price competitiveness, but also non-price competitiveness. However, raising productivity (by way of process and product innovation, labour force skills, or business environment factors) typically requires courageous policy action on structural reforms (e.g. the liberalisation of closed professions and immigration, the reorientation of spending towards education and research and development, reforms of key framework conditions, such as amending judicial and regulatory frameworks to enhance their business friendliness, etc.). Such reforms are often hindered by privileged groups and vested interests, and can take considerable time to have visible effects. Third, excessive profit margins, which are particularly prevalent in domestically oriented sectors (predominantly services sectors), limit competition. Structural reform measures can address excessive rents by removing obstacles to both domestic and international competition, in particular in the sheltered professions, for instance by removing high entry barriers for new firms (and generally reducing red tape).

Rebalancing competitiveness across euro area countries implies that price and cost growth in countries that have previously seen excesses in this respect need to be significantly lower than the euro area average during a transition phase. At the same time, several of the euro area economies that increased their competitiveness in the past are likely to temporarily experience price and cost growth above the euro area average. However, the more competitive countries need to avoid – also in this transition phase – excessive wage increases that would lead to higher unemployment.

Maintaining price stability in the euro area as a whole

It is the ECB's mandate to keep prices in the euro area as a whole stable over the medium term. Inflation rates in individual countries, or specific inflation differentials resulting from the rebalancing of individual euro area countries' positions in terms of competitiveness, cannot be tackled by the single monetary policy. However, by focusing on its primary objective of maintaining price stability for the euro area as a whole, the ECB's monetary policy contributes to an anchoring of longer-term inflation expectations in individual euro area countries.

The design of the ECB's monetary policy framework takes the existence of inflation differentials across countries into account. The Governing Council of the ECB has defined price stability as a year-on-year increase in the HICP for the euro area of below 2%. It aims to keep annual HICP inflation below, but close to, 2% over the medium term. The definition of price stability provides a sufficient margin for inflation differentials in the euro area.

As noted above, national policy-makers need to introduce structural reforms to restore competitiveness positions. As a natural consequence of the rebalancing of competitiveness positions, relative prices between competitors inside the monetary union will change over time and return the euro area to a more stable equilibrium. This is a desirable process, during which the Governing Council's aim of keeping inflation below, but close to, 2% over the medium term, will provide a clear anchor for medium-term inflation expectations throughout the euro area as a whole. Maintaining price stability in the euro area as a whole over the medium term is the best possible contribution the ECB can make to a smooth adjustment process.