

# Fiscal Policy Coordination and Competitiveness Surveillance:

## What solutions to what problems?

Daniel Gros and Cinzia Alcidi

*Close coordination of national fiscal policy and surveillance of competitiveness seem highly desirable within a monetary union. But are they also feasible? This note argues that surveillance of competitiveness risks concentrating on symptoms (rising wages in the non-tradable sector), rather than the underlying causes (credit-financed booms). Moreover, the economic rationale for fiscal policy coordination (beyond the strict enforcement of the Stability and Growth Pact – SGP) seems to be weak during normal times. While it makes sense to coordinate the fiscal response of member states to the present crisis, it does not seem appropriate to develop new permanent mechanisms for the coordination of national fiscal policy.*

### 1. Introduction

In June 2010, both the European Commission<sup>1</sup> and the European Central Bank<sup>2</sup> published documents containing ideas for enhancing European economic governance. Both proposals stress the need for stronger surveillance on a country-by-country basis and the

<sup>1</sup> European Commission (2010), *Enhancing economic policy coordination for stability, growth and jobs – Tools for stronger EU economic governance*, Communication from the European Commission to the European Parliament, the European Council, the Council and the European Central Bank, the Economic and Social Committee and the Committee of the Regions, Brussels, June.

<sup>2</sup> European Central Bank (2010), *Reinforcing economic governance in the euro area*, June.

effective enforcement of surveillance through incentives and a wider spectrum of sanctions.

There are two main differences between the two proposals: i) the ECB envisages the creation of an independent fiscal agency while the Commission would keep the surveillance task under its mandate, and ii) while the ECB focuses on fiscal policy and competitiveness surveillance, the Commission's proposal considers broader macroeconomic surveillance aimed at the early identification of macroeconomic imbalances.<sup>3</sup> The official reports refer only to 'harmful' imbalances, without ever providing a definition of what is harmful. The key underlying problem is whether a large surplus could also be considered a 'harmful' imbalance.

Macroeconomic imbalances could be external and internal, symmetric or asymmetric and are associated with a wide range of economic indicators, e.g. current account (im-)balance, net foreign asset position, real effective exchange rate, asset prices and government debt among others. This implies that any surveillance of macroeconomic imbalances would entail a far-reaching inspection of the economic situation of each member country. No single indicator would appear to be sufficient to warrant a finding of 'harmful macroeconomic imbalance'.

<sup>3</sup> The proposals of the ECB and the Commission also differ in their approach to reinforcing the Stability and Growth Pact (SGP) and fiscal discipline, but these aspects are not considered here.

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Daniel Gros is Director and Cinzia Alcidi is Research Fellow at CEPS.

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The Commission's proposal also includes a specific tool to enhance fiscal policy coordination, the so-called 'European semester'.

We argue in this paper that while there are valid arguments for fiscal policy coordination, but that the potential welfare gains should not be overstated – at least under normal circumstances.

Moreover, while there has certainly been a dangerous divergence in competitiveness among member countries, this should be considered as a symptom of divergences in other factors (domestic demand) rather than an independent cause that could be cured simply by direct policy intervention.

Section 1 below focuses on the analysis of fiscal policy coordination in a common currency area under special circumstance and section 2 argues that changes in competitiveness tend to be endogenous and hence largely outside of policy control.

## 2. National fiscal policy and a common currency

The limitations of the euro area's framework for fiscal policy are well known and have been debated for years. Since it had been accepted from the start of EMU that fiscal policy had to remain a national responsibility, there could at most be some voluntary coordination of national fiscal policies, ideally intermediated through the meetings of finance ministers of the euro area, the so-called Eurogroup. According to official rhetoric, the Stability and Growth Pact (SGP) provided a sufficient framework for the coordination of fiscal policy.

From a strictly economic point of view, one could argue that under ordinary circumstances the case for fiscal policy coordination within the eurozone is actually quite weak because the international spill-overs of fiscal policy are of uncertain sign and magnitude. Under ordinary circumstances, a fiscal expansion in any one country has two effects on its partners: a positive one as it increases demand for imports, and a negative one as a fiscal expansion puts pressure on euro area interest rates, which will tend to lower demand in the entire area.<sup>4</sup> Under ordinary circumstances the net spill-over effect of a fiscal expansion in any one member country is thus likely to be small. It could be positive or negative, depending on the relative size of the direct demand channel (itself a function of the importance of trade flows) and the interest channel (depending on the structure of financial markets). Following this argument, national

governments could have interest in seeing that fiscal coordination does not happen.

Under ordinary circumstances, it is thus difficult to argue that closer fiscal policy coordination would yield large welfare gains.

However, under present, special, circumstances, the interest rate is effectively very close to the lower bound, and the interest channel mentioned above seems to have lost its importance. The euro area is not yet in a classic liquidity trap that renders monetary policy ineffective, but it is clear that interest rates and central bank liquidity injection are no longer the main factor affecting the availability of credit.<sup>5</sup> The official interest rate has been at 1% since May 2009, and, as shown in Figure 1, while M1 has been increasing rapidly since the beginning of the crisis, loans to households and non-financial enterprises have been at best stable or even declining.

This whole situation implies that under the present, special circumstances, since the interest rate channel does not work, the spill-overs from fiscal policy are going to be unambiguously positive. And they are potentially quite large according to macroeconomic theory, which suggests that fiscal policy multipliers are larger under the hypothesis that agents are liquidity constrained because they are likely to spend, rather than save any additional unit of income they receive and the number of constrained agents increases in times of economic recession.

However if national policy-makers do not recognise the unambiguous positive spill-overs, fiscal policy could be insufficiently expansive. This is the reason why theory would predict that in the absence of policy coordination, aggregate fiscal policy could be too restrictive in the aftermath of a financial crisis. This consideration constitutes a simple justification of the initiative taken by the Commission in December 2008 to coordinate a joint fiscal policy response to the developing recession (whose severity was only gradually becoming apparent). This so-called European Recovery Programme was duly endorsed by the European Council a few days later.

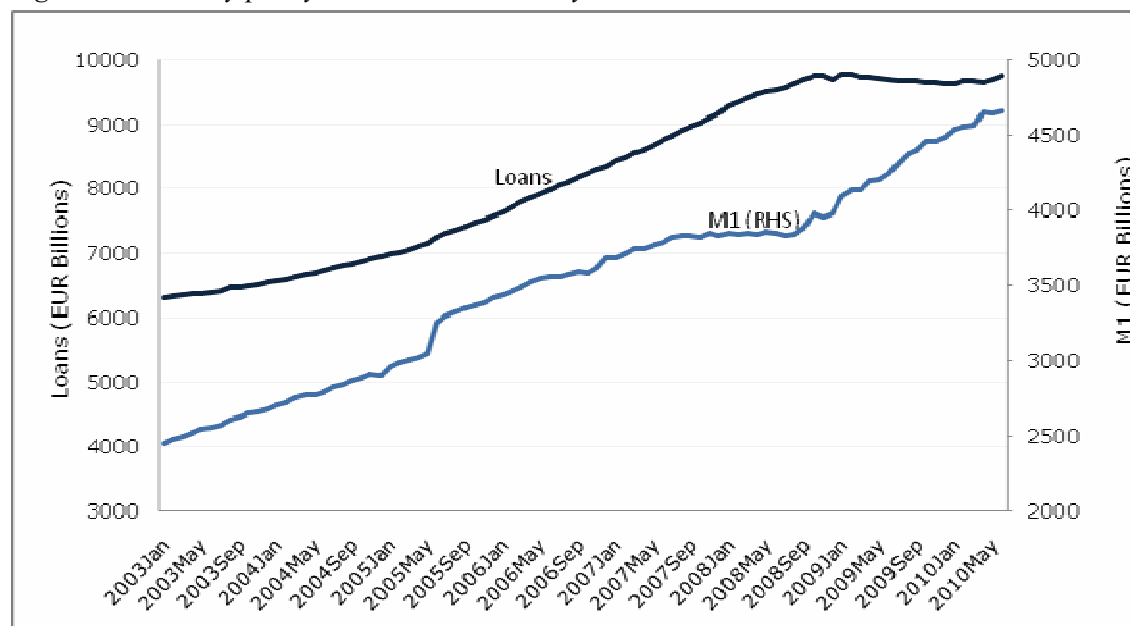
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<sup>4</sup> See Belke & Gros (2009).

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<sup>5</sup> This does not mean that the ECB not play an important role. On the contrary, the extraordinary measures used by the ECB are vital for the European interbank system or at least some segments of it.

Figure 1. Monetary policy and credit availability



Note: Loans includes loans to non-financial corporation and households.

Source: ECB (Statistical Warehouse).

This episode might have constituted an example of how fiscal coordination should work. Looking ahead, however, the key question is whether the euro area (or the entire EU) needs a tighter permanent framework for fiscal policy coordination (besides the SGP). As stated earlier, however, this does not seem to be the case during ‘normal times’. Therefore, it does not seem advisable to create new permanent mechanisms for fiscal policy coordination. There is a significant risk that it would become irrelevant as soon as the effects of the crisis have worn off.

### 3. A misguided fixation on competitiveness

The President of the European Central Bank is said to show at each meeting of the European Council a graph depicting the evolution of relative wage costs across the 16 member countries of the euro area. The charts used by J-C Trichet and many others almost invariably use the start of EMU as the base year. These standard measures of competitiveness suggest that the countries now in difficulties (Spain, Ireland, Greece and Portugal) have over the last ten years lost competitiveness by around 20% relative to Germany. In other words, since 1999, wage costs have increased by about 20% less in Germany than elsewhere in peripheral Europe. The conclusion seems to be straightforward: the southern euro area members have to reduce their wage costs to claw back the loss of competitiveness since the start of EMU.

The concern about divergences has also reached not only the ECB and the European Commission, as

mentioned earlier, but also the Task Force under EU President Herman Van Rompuy that is supposed to come up with fundamental reforms to the rules for economic policy coordination within the EU. A key proposal at the first meeting of this Task Force was to develop competitiveness indicators and then force member countries to take ‘remedial action’ should the EU find large divergences in the indicators. A similar approach is indicated in the documents of the ECB and the European Commission. However, this approach risks leading policy-makers in the wrong direction.

A first point is obviously that competitiveness, usually measured as relative unit labour costs, is a relative concept. The gain of one country means a loss of another. The logical conclusion would be that if one wants to restore the competitiveness of some member countries (e.g. Spain, Greece), others (Germany in the first instance) must accept a deterioration in theirs: the adjustment might come about either through wage increases in the lower labour costs or cuts in the countries with too high costs. There is some consensus among officials that no country should be forced to increase wages and everybody gains if structural reforms increase productivity. The latter is certainly true, but it does not solve the fundamental fact that the relative unit labour costs of a country goes down if those of another countries go up.

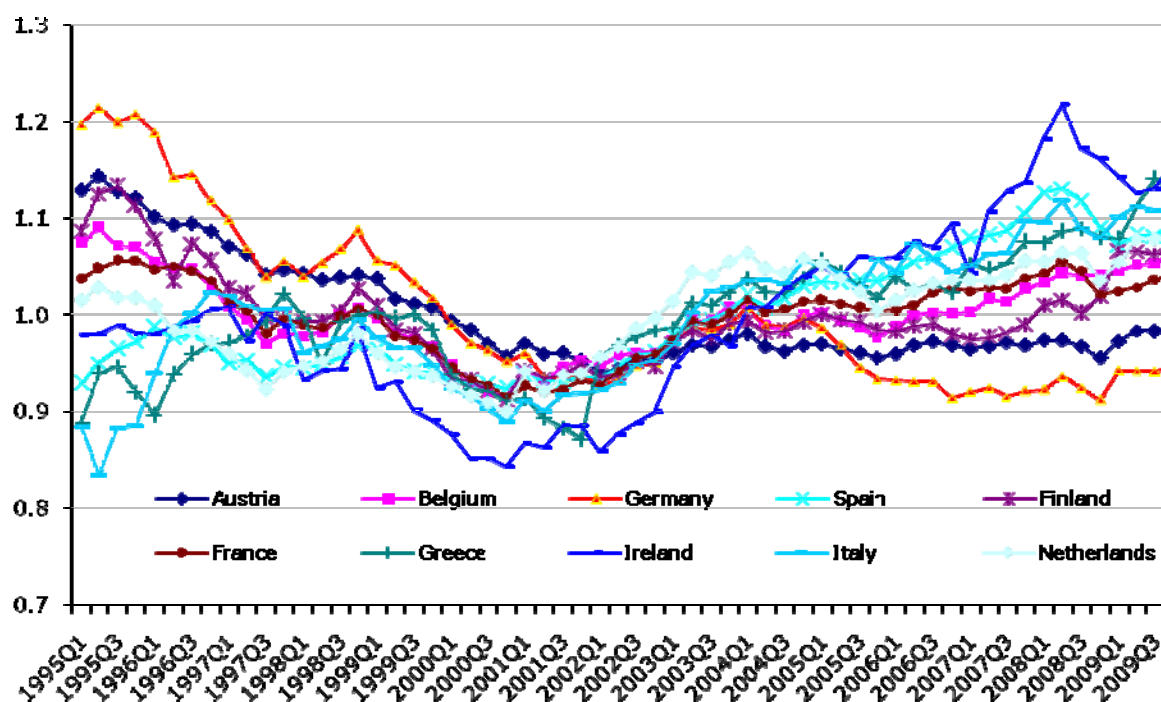
A second point is that it is always difficult to determine the proper base year. It is implicitly often assumed that the start of EMU is the best base, but this does not seem to be the case. Figure 2 shows the evolution of the unit labour cost in the euro area

countries, but to eliminate the bias induced by the choice of the year base, the index (as provided by the ECB) has been re-scaled, dividing it by its average over the period 1995-2010.

Interestingly the figure shows the existence of a node in 2003 rather than in 1999-2000. This highlights the fact that 1999-2000, which is usually taken as the base year, might not have been an equilibrium itself. 2003, appears to be year of the smallest cross-country differences if one takes the long-term average as the equilibrium concept. Prior to 2003, Germany seems to have been 'uncompetitive' and after 2003, some countries like Ireland and Spain, where bubbles started

to emerge, experienced a significant loss in competitiveness. Choosing the base period carefully is important. Most analysis that use 1999-2000 as the base conclude that the countries now in difficulties have lost about 25-30% in terms of unit labour costs relative to Germany. Using 2003 as the base year yields a substantially smaller estimate of the divergence, namely about 15%. The purpose of these simple considerations was not to show that 2003 is unambiguously the proper base year, but simply to show how difficult it becomes in practice to measure divergences in competitiveness.

Figure 2. Real harmonised competitiveness indicator unit labour cost (ULC) in total economy deflated



Note: ECB EER-21 group of currencies and Euro area 16 country currencies (FR, BE, LU, NL, DE, IT, IE, PT, ES, FI, AT, GR, SI, AU, CA, CN, DK, HK, JP, NO, SG, KR, SE, CH, GB, US, CY, CZ, EE, HU, LV, LT, MT, PL, SK, BG, RO)

To get rid of the year-base bias, the original index has been re-scaled by using its long-term (1995-2010) average.

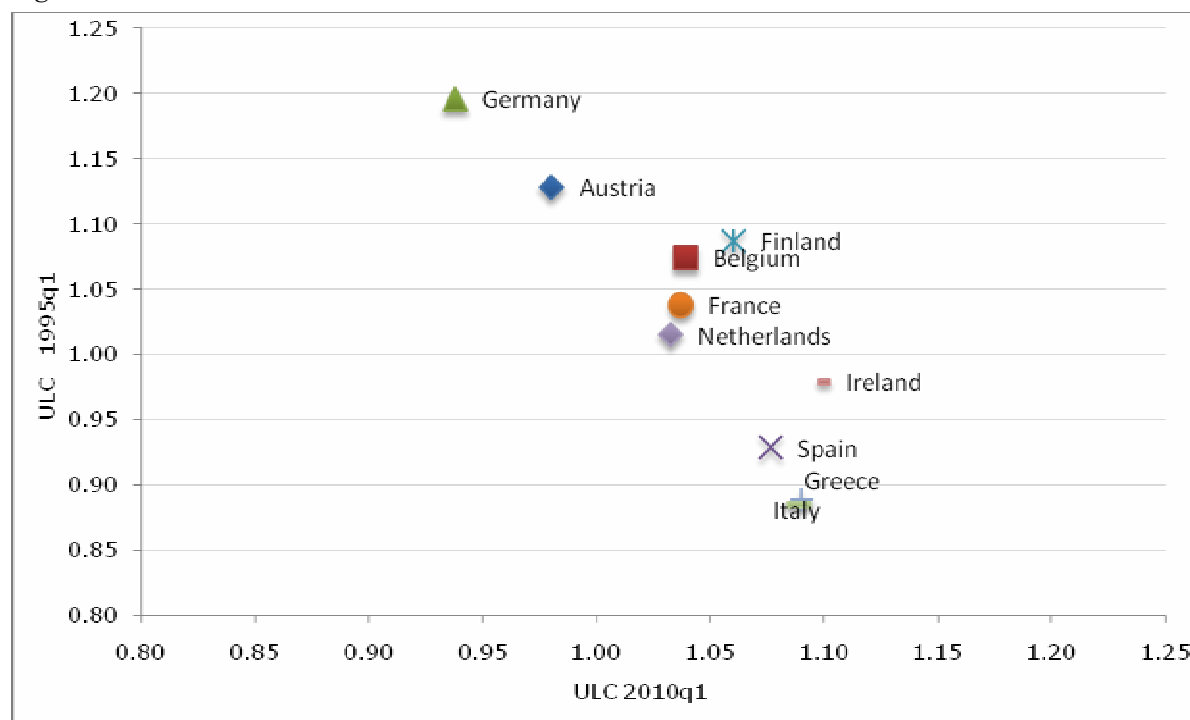
Source: ECB Statistical Warehouse and own computation.

Moreover, there is some evidence that the divergences of the competitiveness indicators today constitute a mirror image of the divergences that existed during the early 1990s.

Figure 3 shows a scatter plot of the competitiveness indicator of euro area member countries in 1995 and in 2010. It is apparent that there is a strong correlation between the two. Countries that had a high labour cost indicator (notably Germany and Austria) in 1994 have experience a strong increase in competitiveness (a fall

in their relative unit labour costs) and those countries with the best position in 1994 now have the highest cost. Baldwin at al. (2010) argue the 'imbalances' that appeared within the eurozone over the first decade of EMU were mainly due to the basic asymmetry that German unification introduced into the European economy at the start of the 1990s. The implication of this analysis is that the next decade might well bring a swing of the pendulum back towards equilibrium.

Figure 3. Unit labour costs in 1995 and in 2010



Note: ECB EER-21 group of currencies and euro area 16 country currencies (FR, BE, LU, NL, DE, IT, IE, PT, ES, FI, AT, GR, SI, AU, CA, CN, DK, HK, JP, NO, SG, KR, SE, CH, GB, US, CY, CZ, EE, HU, LV, LT, MT, PL, SK, BG, RO)

As in Figure 2, the original ULC index has been re-scaled by using its long-term (1995-2010) average.

Source: ECB Statistical Warehouse and own computation.

Even assuming that an agreement within the euro area can be found on how to assign the desired future losses and gains in competitiveness across countries, one has to keep in mind that member countries are not centrally planned economies. There is little government can do in a market economy to force lower wages in the private sector. Governments can of course enforce wage cuts in the public sector. This is being done on a large scale in Greece and Spain, for example. But there is little empirical evidence that public sector wages have a economically significant impact on wage growth in the private sector.<sup>6</sup>

So which one is the way forward? The natural answer is higher productivity. However, even assuming that governments were able to find the structural reforms that yield quick increases in productivity, it is not always clear that higher productivity leads to increased competitiveness.<sup>7</sup> The opposite often holds across the EU: some of the countries that had the highest growth

<sup>6</sup> See ECB (2009) and Lamo et al. (2008) for empirical studies, which find econometrically significant effects, but the orders of magnitude remain so small that any politically feasible autonomous change in public wages would have only a negligible impact on private sector wages.

<sup>7</sup> EU cross-country data on competitiveness and productivity do not show any significant positive correlation.

in labour productivity were also the ones that lost the most competitiveness. How can these two facts be reconciled? After all, higher productivity should bring lower unit labour costs.

There are at least two possible explanations. The first is that an increase in productivity tends to be sector-specific, and the tradable sector tends to perform better in terms of productivity than the non-tradable sector. Following a standard Balassa-Samuelson argument, increases in productivity in the tradable sector that justify increases in wages in that sector can result in a loss of competitiveness of the country as whole by inducing a wage increase also in the non-tradable sector, especially if the non-tradable sector is large. In fact, the competitiveness indicator for surveillance is for the whole economy.

The second explanation is that improvements in productivity are easily overwhelmed by changes in wages: improvements in productivity growth are already large if they consist of fractions of a percentage point while wage increases are of a much larger magnitude.

So the real question is: what drives wages? Country-level data suggest that the largest increase in wages are in general associated with the strongest increase in domestic demand over the last decade (e.g. Spain, Greece).

But what is the chicken and what is the egg here? Are wages driving demand or vice versa? Most of the loss of competitiveness in peripheral Europe arose once unemployment there had been much reduced. The measured loss of competitiveness in peripheral Europe over the last decade should thus not be ascribed to a lack of structural reforms or unreasonable trade unions, but rather to booms in domestic demand, fuelled mainly by the easy availability of cheap credit for consumption (Greece) and construction (Spain, Ireland). This excessive consumption and construction demand led to an excess demand for labour, especially in the protected sectors (e.g. services), thus driving up wage costs.

Viewing competitiveness as an endogenous ‘symptom’, rather than an autonomous factor has two implications:

- 1) If excessive domestic demand was the problem, the solution should now be on its way. International capital markets have already curtailed credit to these countries. The sharp fiscal retrenchment that has now started throughout peripheral Europe should contribute further to a sharp deceleration, maybe even outright fall, in domestic demand in these countries. If labour markets are flexible, this should result in lower wages. This is the key condition: flexibility of labour markets on the way down as much as on the way up. Adjustment in the deficit countries would of course be much easier if wages were to increase in Germany. But this might happen soon since unemployment is actually going down in Germany and, given that in the past, wages in Germany have tended to increase (moderately) when unemployment remained low.
- 2) The appropriate policy response to a loss of competitiveness (which is judged to be ‘harmful’) should be to focus on domestic demand, not on wage developments or specific aspects of the labour market. In the case of Spain, for example, it would have been necessary to restrain the pace of housing construction (e.g. by auctioning off only a limited number of building permits), rather than trying to meddle with the labour market in the midst of a domestic demand boom.

The proposition that governments ‘need to do something about competitiveness’ might lead to an excessively activist approach to economic policy coordination under which governments and the EU institutions constantly try to influence wage-setting in the private sector. This might work partially in the present crisis situation (e.g. in Greece, Spain), but will not be able to prevent future divergences in competitiveness if domestic demand diverges again.

Structural reforms are always useful, but increasing productivity takes a long time and does not always translate into higher competitiveness.

What is needed in southern Europe is the acceptance that domestic demand has to fall to a level that allows the country to live without further capital inflows. Once this is done, it should be sufficient to allow labour markets to work until the system finds its new equilibrium.

## 4. Conclusions

Avoiding ‘harmful’ macroeconomic imbalances is of course desirable. However, no official document has ever spelt out how one would determine that an existing imbalance is ‘harmful’ (to whom?). In reality what is meant by the reference to ‘harmful imbalances’ is that – ex post – it is clear that the Southern European euro area members would today be better off if they had somehow maintained a more competitiveness position and kept their external deficits lower. Large external deficits always put a country in a delicate position when there is a ‘sudden stop’ to the capital inflows. Experience has shown that this can happen even within a monetary union and that such ‘sudden stops’ can create dangerous dislocations in financial markets with effects on the entire euro area. There is thus an economic case to be made for avoiding the build-up of large deficits that might create difficulties Europe if financial markets stop financing them.

However, the best policy response seems not to place a narrow focus on competitiveness indicators, but rather on the prevention of underlying causes of the imbalance, which are usually divergences in domestic demand (often driven by credit-financed real estate and/or consumption booms).

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