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ECFIN Economic Brief

ECONOMIC ANALYSIS FROM EUROPEAN COMMISSION'S DIRECTORATE GENERAL FOR ECONOMIC AND FINANCIAL AFFAIRS

Securing European competitiveness in a global perspective

*By Anne Bucher and Karl Pichelmann **

Summary

Over the past two decades, European industry was holding its own against both the old world competition from the US and Japan and newer rivals from China or India. But already before the crisis, sluggish productivity growth and growing internal imbalances weighed on Europe's potential to face the overall challenges of globalisation, ageing populations, growing resource limitations and climate change. Thus, the task now is to inject new dynamism into our economies, while continuing with the necessary adjustment, rebalancing and private and public sector deleveraging.

A high-productivity strategy for competitiveness needs to be based on openness and innovation, with investment in R&D and in education and skill formation as major buildings blocks. Calibrated industrial policies within the Single Market framework should foster integrated energy and service markets and green investments. For the peripheral countries, the resumption of downhill capital flows and FDI is essential to re-ignite convergence and integration, with a lasting correction of imbalances requiring further competitiveness adjustments, improvements in the business environment and comprehensive public sector reform in many of them.

Introduction

While the worst of the euro area crisis appears to be behind us with long-term solutions coming into sight, the fall-out continues to weigh heavily on growth and jobs, bringing severe hardship to many. Much remains to be done to repair and improve our economies to restore prosperity and to secure Europe's global position.

Yet, from a bird's eye perspective, Europe is still highly competitive in the world. Its people enjoy one of the highest standards of living on the globe. Indeed, far from being a mercantilist concept, competitiveness means productivity, growth and wealth creation. Thus, our agenda for the competitiveness of Europe's economy is a positive agenda to succeed in the global economy, combining efficiency, integration, stability and solidarity in an unprecedented manner. The EU cannot engage in a race to the bottom in terms of wages or social or environmental standards. We need to marshal our strength and determination, our brainpower and creativity to maintain and further improve high productivity at home and high-quality-based competitiveness in the global market place.

The EU has fared quite well in the globalisation process of the past two decades. The share of our income which we derive from directly or indirectly satisfying final demand in other parts of the world has risen by five percentage points over the past 15 years. Notably, an increased contribution of services to the global value chain has been an important driving factor behind this development and, as a result, Europe's employment record in global activities compares actually quite favourably with the US and East Asia. Being still the world's largest exporter, the EU is well-positioned in the global value chain, not least due to a deeper integration of the EU economies among themselves, in particular with the economies of Central and Eastern Europe.

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But now Europe faces serious challenges to put convergence and integration mechanisms on a renewed sustainable basis, and it must do better to fully exploit its innovative potential in difficult circumstances. Indeed, it runs the risk of falling behind in competitiveness suffering from (i) overall low productivity growth (a worrying feature already before the onset of the crisis, in particular against the background of ageing populations); and (ii) large structural disparities across Member States and weaknesses in underlying growth drivers, in particular in the Mediterranean countries including France. Thus, the challenge is to inject new dynamism into our economies, while continuing with the necessary adjustment, rebalancing, and public and private sector deleveraging.

Figure 1a Productivity developments

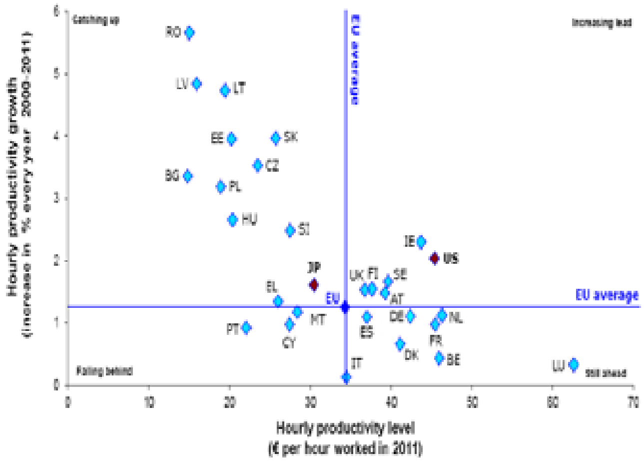
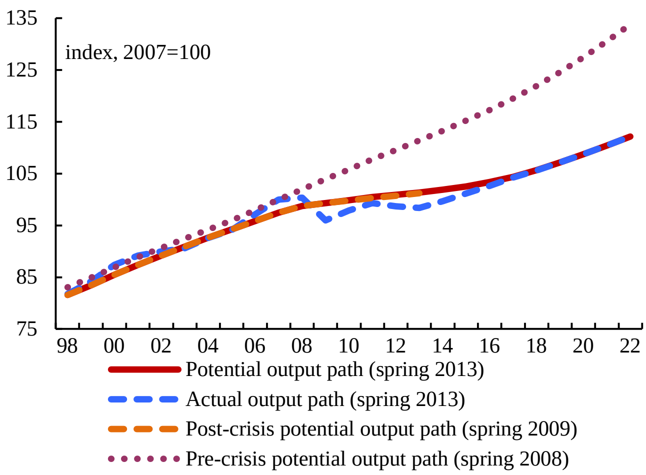


Figure 1b Potential output trends



Source: Commission Spring Forecast 2013

Trends and drivers of competitiveness

The rise of China and other emerging economies has implied an intensification of competition in global markets affecting a broad range of products --from low wage, low skill, to high wage, high skill-- and countries. Overall, the EU has been able to retain its strong international position. However, some Member States have been more successful than others in coping with this challenge. Initial patterns of specialisation and industrial structures in combination with successful innovation and productivity performance may have put some countries at advantage, together with moderate wage policies. In general, though, competitiveness based on quality and product differentiation has proven more sustainable than when based on cost considerations only. Further integration among our own economies has been essential as well. The example of a Germany-led group, including Austria and much of central and Eastern Europe, shows the benefits of building up highly integrated supply-chains to compete successfully in the global marketplace.

Historical experience has proven what economics has always taught: openness and deeper economic integration eventually bring prosperity. This holds true today as well. Therefore we intend to launch negotiations on a ground-breaking comprehensive far-reaching free trade agreement with the US. Generally, in the area of trade policy we strongly adhere to openness, however, without being naïve. It should be possible, for example, to impose reciprocity in public procurement on countries that do not practice this.

The Single Market is one of our biggest economic achievements and we need to further capitalise on this. The "Single Market Act" launched two years ago is made up of 50 proposals and 12 key actions to make life easier for Europe's 22m companies and more than 500m consumers, for example through the creation of a genuine digital single market, the simplification of EU procurement rules, especially for SMEs, better recognition across Europe of professional qualifications, and the full application of the Services Directive. The key actions have been either adopted or work is well advanced. The Single Market Act II (October 2012) identifies further actions and focuses on important economic sectors, namely services and network industries, and on fostering mobility of citizens and business across borders.

Stepping up efforts in the area of further integration and liberalisation of market services is crucial. The competitiveness of exporting firms, mainly manufacturing firms, is determined also by cost and quality of services (telecommunications, energy, transport and distribution services, financial intermediation, business services etc.), not least due to their increased tradability and complementarity to manufacturing exports. Obviously, with a share of more than 70% in gross value-added, the quality and efficiency of services' provision, including in the public sector, is a major driver of competitiveness for the total economy.

Countries operating at the knowledge-technology frontier need to innovate to push out the frontiers, pointing to the fundamental role of competition, tertiary education in world-class universities and R &D investment, in particular in the private sector, and smart technology adoption to close the innovation gap vis-à-vis Europe's leading global competitors. Achieving this goal will not be made easier by tight budget constraints and higher risk premia. Against that backdrop, calibrated industrial policies fostering research and innovation, integrated energy and service markets and green investments are essential, while maintaining and enhancing a competitive level playing field.

The capacity to innovate and compete internationally is closely linked to firm level productivity: more productive firms are more likely to export; at the same time, exporting firms being exposed to international competition are likely to become more innovative and productive. One important structural feature is firm's size. Small companies tend to display lower levels of productivity. Small is not always beautiful and firms don't have to stay small. Compared to the US, the firm structure in the EU is skewed with a higher weight of smaller firms, while firm entry rates are broadly comparable. That is why our efforts should address obstacles for firms to grow: this means tackling lack of financing and possible regulation with lock-in effects, including labour market and taxation that can act as a barrier to firms' growth. Overall, we need to implement smart regulation to achieve our objectives while minimising possible side effects on output and employment.

Obviously, cost considerations enter the competitiveness equation as well, come they in the form of direct input prices or regulatory cost. Energy prices are a case in point. European gas and electricity prices for both households and industries are higher than in the United States. The disparity has been persistent over time and is likely to widen following the development of domestic shale gas production in the USA. However, EU industries are more energy efficient and have been able to improve their performance over the past years. Notably, the better performances of the EU industries cannot be explained by a different manufacturing structure, the share of energy intensive sectors in Gross Value Added is actually bigger in the EU (9% in 2009) than in the US (8% in 2009)). In the future, the EU needs to avoid unnecessary energy costs, through (i) boosting energy efficiency, which will lower energy costs and boost know-how which can be sold elsewhere; (ii) improving our energy security, through re-balancing our energy mix; (iii) improving the efficiency of our energy markets through reducing the fragmentation of the EU energy markets along national and regional lines.

Matching efficiency and integration with fairness has been a characteristic of Europe's successful model for growth and prosperity. Indeed, with 7% of the world's population and 25% of its GDP, the EU accounts for about half of the world's social spending. However, it would be a mistake to see this only from the perspective of a burden that the economy has to carry. Fairness and equity promotes trust and social cohesion, and thereby it promotes positive attitudes towards openness, innovation, adaptation and change. And it would also be a mistake to overlook the significant changes welfare and social models have undergone over the past two decades, moving away from passive social-protection to capacitating and activating social-support systems. In that way, provided that reforms continue, they can be an asset in the competitiveness challenge, not an obstacle to growth and prosperity.

Broad enrolment in first-class education and training is key for full participation in the world of work and society in general. Our biggest competitive advantage in the world is the skills of our population, fostered by our model of education financing and access, and we need to ensure high levels of investment in that respect. Notably, upward economic mobility has been higher in several European countries than in the US; and students are less indebted. It will be essential to build on this, offering strong incentives for young people to invest into a better future. We must not allow the crisis to produce a lost-generation and, indeed, rates of youngsters neither in employment, education and training are alarmingly high. Therefore, we need bold action at both the EU and country-level to tackle this problem.

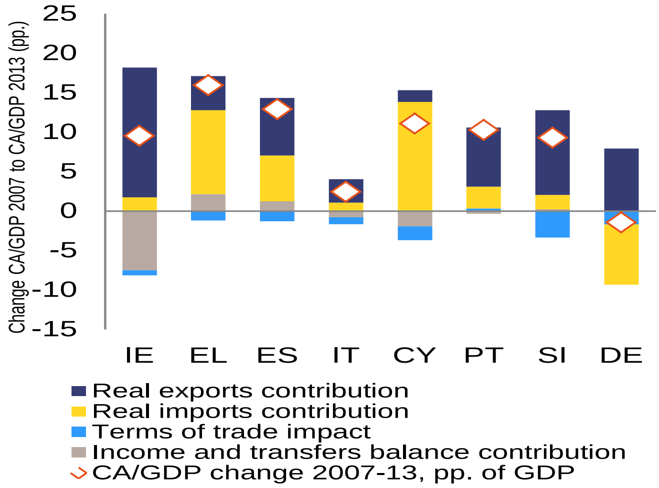
Rebalancing in the euro area

The competitiveness challenges are even more pronounced for some of the vulnerable countries with the largest adjustment needs. With the benefit of hindsight, we now know that the excess savings from weak domestic absorption in the surplus countries which were channelled into the peripheral European economies often were not invested in the most productive sectors. This biased the economic structures of the deficit countries towards an unsustainable relative expansion of low-productivity sectors such as construction and public administration. The pre-crisis area thus aggravated structural productivity differences in the euro area and accentuated weaknesses in underlying growth drivers.

Adjustment requires large structural shifts in these economies from non-tradable to tradable sectors in an economically and socially costly process of reallocation. At the same time, given their share in the total economy, productivity improvements in domestically-oriented industries and businesses are essential as well. Enhancing competition among domestic-market oriented firms exerts downwards pressure on prices and rents; this not only supports the purchasing power of households, it also contributes to rebalancing as the outputs of these sectors are often intermediate inputs to production for exports.

Since the outbreak of the crisis, current account deficits in the vulnerable countries have been significantly reduced and cost and non-cost competitiveness has improved. This adjustment came on the back of sharp contractions in domestic demand but also, more recently, on stronger export performance. The progress appears robust in the sense that it will probably not fade away quickly when economic conditions improve. While this may be considered good news, the downside of it is that it is based on structurally depressed income levels.

Figure 2 Changes in current account balances



Thus, determined continuation of structural reforms is required to pave the way towards resumption of sustainable growth and long-lasting, not easily eroded competitiveness gains. Financial market normalisation is an essential precondition and should guarantee that access to finance for productive investment and activities, including exporting, are available. Better functioning product, labour and services markets, together with improvements in public administration, are instrumental smoothing the necessary further reallocation towards the tradable sectors, supported by appropriate changes in relative costs and prices, as well as better integration into euro area value chains.

However, even on an optimistic note with respect to structural catching-up, intra-area divergences and only slowly converging per capita incomes are likely to persist over the medium-term, but not to a degree that a north-south divide risks turning economically and socially explosive. The resumption of downhill capital flows should foster the convergence process, with broad structural reforms and the establishment of the banking union conducive to avoid misallocations as happened in the past, in particular during the bubble years before the crisis. Last but not least, European solidarity will continue to come into play in the form of structural and cohesion fund support, with acceptance by contributors certainly enhanced when efficient use by recipients is better ensured.

More dynamic domestic demand in the surplus could contribute to the rebalancing of external positions in the euro area, and provide some easing of the adjustment pressure in the deficit countries. Of course, this cannot mean to make the surplus countries less competitive, but they need to adopt measures boosting their productivity, mainly in the non-tradable sectors, and with it their domestic demand. Anyway, reductions in surpluses may only contribute to, but not accomplish, the necessary rebalancing in the deficit countries. Moreover, it should be noted that current accounts are measured against global trade. In fact, surplus countries have seen a shift in their exports towards countries outside the euro area.

Concluding remarks

Five years after the onset of the financial crisis, Europe's economic situation is still fragile. Unemployment continues to rise and growth remains sluggish and uneven, reflecting public and private balance-sheet problems and still impaired transmission of monetary policy. Strong action has been taken at both the national and the EU level to restore stability and confidence and, as a result, the tail risk of euro area break-up has all but vanished. Now Europe needs to firmly stay on course to exit the crisis with consistent policies for a fully functioning financial sector, including the establishment of a banking union, and growth-friendly differentiated fiscal consolidation.

At the same time, and with the same determination, the long-term structural competitiveness challenge needs to be addressed in order to put Europe back on the path to sustainable growth and prosperity. Indeed, worries are running high in many quarters that Europe has embarked on long-term economic decline, drifting apart internally and falling behind globally. These concerns should not be easily dismissed; and while, to paraphrase Mark Twain, the news of the demise of the European model are clearly exaggerated, decisive steps must be taken towards reinforcing the EU's high-productivity strategy to succeed in international markets based upon openness, integration, and innovation, with investment in R&D and education and skill formation as major building blocks. Rebalancing needs to progress further in the euro area. Competitiveness has improved and current account deficits in the most vulnerable countries have been almost eliminated, albeit at structurally depressed income levels; thus determined continuation with productivity-focused structural reforms is essential.

Europe possesses unique strengths to strive in the global economy and to retain a quality of life which is envied by much of the rest of the world. We can make it happen, but it will not happen by chance.