Economics
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Productivity woes for the Eurozone periphery

Continued struggle towards sustained growth

- Greece, Portugal, Spain and to a lesser extent Italy made significant adjustments to wages and productivity during the euro-crisis to become more competitive at the cost of high unemployment.
- This so-called internal devaluation has helped exports grow strongly in the aftermath of the crisis, but for Greece and Italy we do not believe this will be enough for a sustained current account balance when domestic demand recovers fully.
- Moreover, although an economic recovery has started for most of the troubled economies, productivity growth is weaker than it was during previous expansions.
- Any regained competitiveness could disappear now that demand is returning as labour costs could grow more rapidly as pressures in the labour market return.
- Overall, the current environment suggests that Unit Labour Costs will increase again as the recovery gets underway, making the tough gains of recent years more of a cyclical phenomenon than a structural one.
- In addition, we see the lack of investment and funding thereof are a key hindrance for further structural improvements in productivity and a more sustainable growth path for peripheral Eurozone countries.

For a sustainable economic recovery in Southern Europe, it is vital that domestic demand recovers while any recently acquired competitive edge will need to be maintained. For this to happen productivity growth would need to strengthen with only moderate rises in labour costs. We consider whether the Southern European economies are on the right track to achieve this and which countries are best positioned to do so.

How sustainable is economic growth in the Eurozone periphery?

The lack of competitiveness in the Eurozone periphery has often been referred to as one of the main causes of the euro crisis. Between the start of the Eurozone in 1999 and the global financial crisis, the southern European countries saw a significant increase in Unit Labour Costs (ULC)[1]. Wages increased significantly with barely any growth in the productivity of workers. Together with increasing domestic demand because of rising wages and large capital inflows, this caused large current account deficits in most southern European economies. That in itself need not be a problem, but in an imperfect monetary union such as the Eurozone, with limited fiscal transfers between countries, this has left economies vulnerable to shifts in investor sentiment and hence in capital flows. As the euro crisis emerged in late 2009, ULC began to fall with a decrease in average real wages and an improvement in productivity. This reduction in relative wages is called an internal devaluation and it is this that has improved the export position of these countries, but also substantially weakened the domestic economy.

[1]The ratio of labour costs per hour to output per hour; ie, the higher costs per worker are to their productivity, the higher the ULC will be. Even though it is a far from conclusive measure of the competitiveness of a country or sector, it is one of the most commonly used competitiveness indicators. For example, the European Commission monitors ULC in the total economy as part of the Macroeconomic Imbalance Procedure, to spot early warning signals on the stability of the Eurozone. This report will focus on ULC in the manufacturing sector as the tradable sector consists of manufacturing for a large part. We also look at the total economy to see the effect on domestic demand in the economy.

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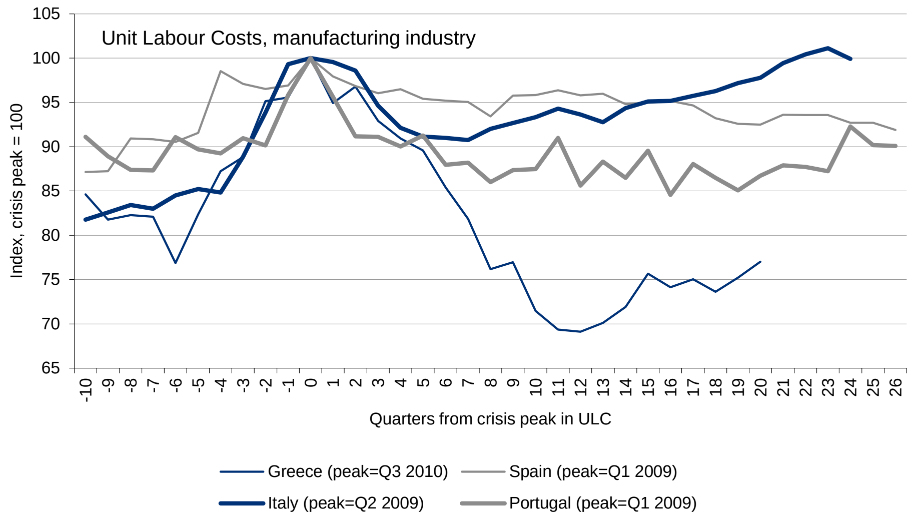
Large current account deficits were created in the Eurozone periphery before the euro crisis…

…requiring Unit Labour Costs to fall

Improvements in competitiveness in a monetary union come at great cost

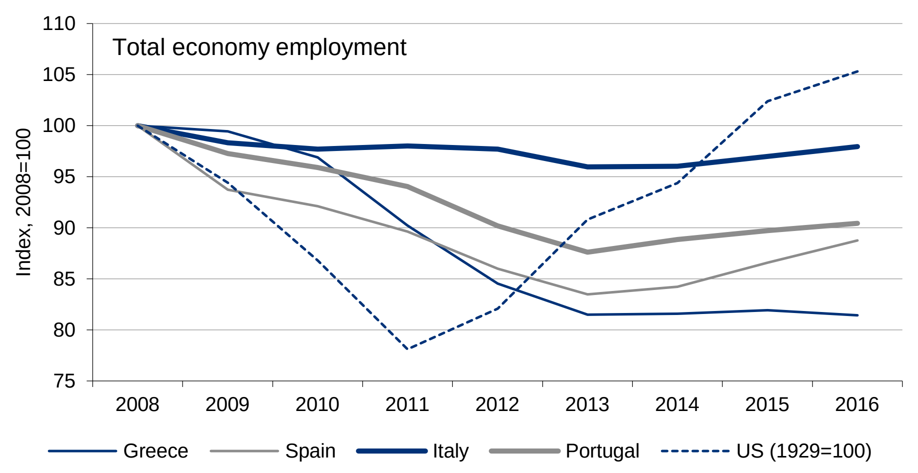
Since the start of the global economic crisis (see Figure 1) Greece, Spain and Portugal have all lowered their ULC, making each country more competitive. This is also evident in the OECD's relative ULC measure, which takes specific trade partners into account. This supports the view that competitiveness improved since the start of the global economic crisis on the back of internal devaluation. Even Italy saw some internal devaluation immediately after the start of the crisis, following which wage growth started to outpace productivity significantly again. This internal devaluation has come at a great cost to employment in the European periphery though. Unemployment has risen to well above 10 percent in both Italy and Portugal and to more than 25 percent in both Greece and Spain. This has subsequently resulted in plummeting domestic demand, which has hurt the economy for several years in a row.

Fig 1 Unit Labour Costs have decreased significantly since the crisis peaked in most southern European economies



Source: ING calculations based on Eurostat data

Fig 2 Employment has failed to recover for far longer than in the US during the Great Depression



Note: Data for 2015 and 2016 is ING forecasts

Source: US Census Bureau, Eurostat, European Commission

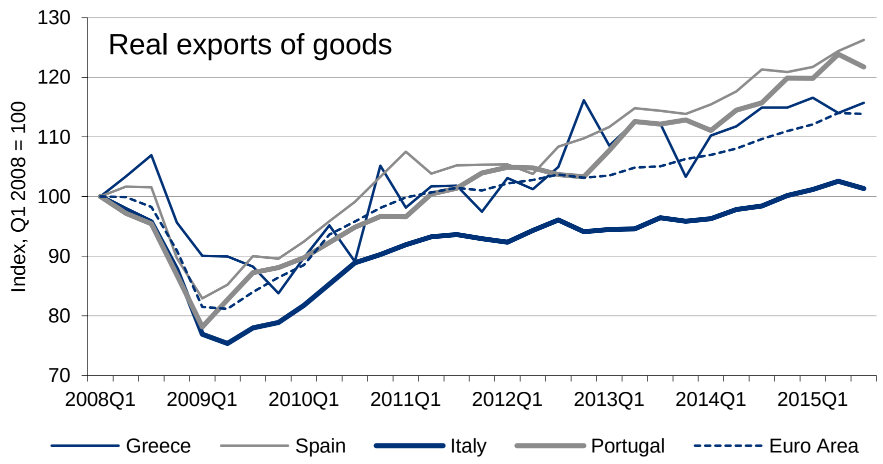
Export growth has been strong and imbalances have largely disappeared

Nevertheless, the improvements in Unit Labour Costs have clearly paid off. The export performance in recent years in Spain and Portugal has been impressive as growth has outpaced even that of the export-powerhouses of Germany and the Netherlands. Spain

ULC improvements have caused exports to go up…

and Portugal now export about 18 percent more goods than they did in 2008, before the global financial crisis (Figure 3). Greece has also seen a strong improvement in the export of goods, at currently 12 percent higher than before the crisis. Unfortunately for Greece, the goods-exporting sector is very small and has not brought significant relief for the overall economy as of yet.

Fig 3 Recovery of exports in the manufacturing sector has been strong in most of the troubled economies



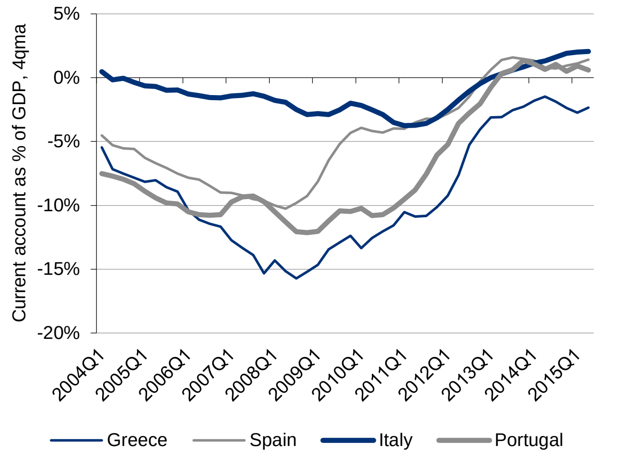
Source: Eurostat, ING

…and current account imbalances have been corrected

Import declines played a large role in the balancing in Greece and Italy though

The recovery of exports has helped reduce current account imbalances. Figure 4 shows that almost all debtor countries of the southern European periphery have seen their deficits decline or even disappear. The question remains, however, whether exports have been responsible for this or whether this stems from austerity and plummeting domestic demand in the light of soaring unemployment and wage cuts. For Greece and Italy, a decrease in imports caused the bulk of the adjustment. While for Spain and Portugal, export growth has carried the bulk of the adjustment and imports are now also recovering (Figure 5). In Greece, a large decline in the export of services (tourism) wiped out the gains in the export of goods from manufacturing. Overall, export growth has therefore played a relatively small role in the adjustments so far in Greece, even though export growth has been strong. To achieve even faster improvements in exports in the Eurozone periphery, it seems that maintaining the current competitive position and continued reforms are necessary. Although it has to be said that with stronger growth in the export markets of the troubled economies, even higher export growth would have been realised.

Fig 4 Improvements in the current account balance are encouraging



Source: Eurostat, ING

Fig 5 Decline in imports has been very important for balance adjustments in Greece and Italy

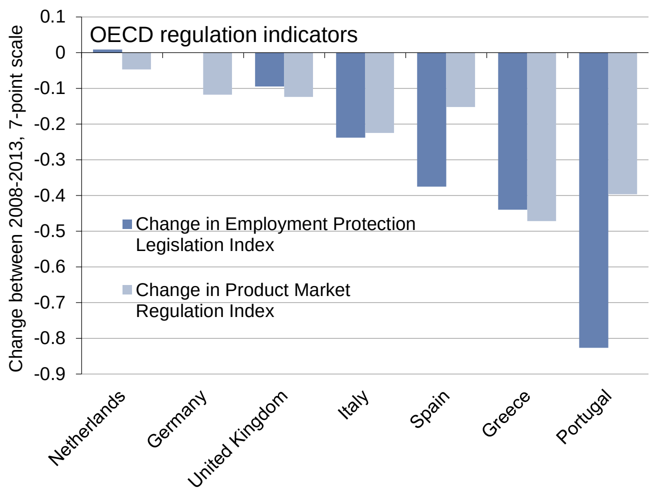
Source: Eurostat, ING

Other competitiveness measures show that further improvements can still be made

Indeed, for the potential of the southern European economies as a production location to be lifted further, there are other factors that need to be addressed. One of the most important factors that the European Commission has pressed on with in an effort to improve business conditions is the regulatory environment in Europe's periphery. As Figure 6 shows, the most progress in making markets more flexible since 2008 has been made in Portugal, Greece and Spain, according to the OECD's Employment Protection Legislation and Product Market Regulation indices. Unfortunately, this still ranks them among the more rigid economies. Greece and Portugal, in particular, are relatively unproductive economies.

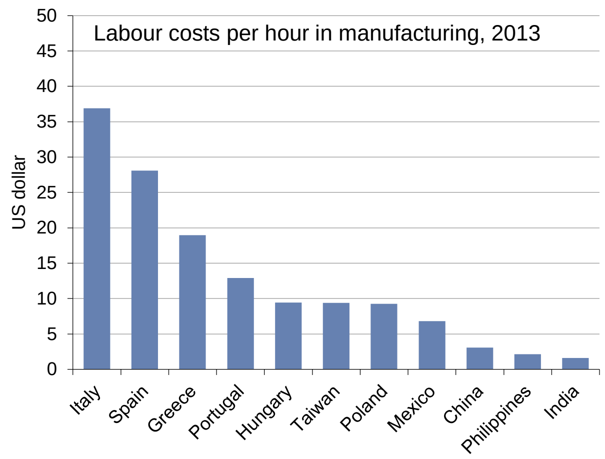
Factors such as flexible labour markets and low labour compensation are key in attracting businesses. Notwithstanding large adjustments, wages in Italy, Greece, Spain and to a lesser extent Portugal are still much higher than average wage levels paid in say Poland or Hungary, let alone India and China (see Figure 7). This means that Greece will not become a 'Mediterranean tiger' that produces low cost products; labour costs are simply too high for that. A combination of managed compensation increases and improving productivity will therefore be key to maintain growth in exports.

Fig 6 More flexible regulation will help the southern European economies



Source: OECD

Fig 7 Labour costs are still far higher than in low-cost countries



Source: The Conference Board International Labor Comparisons Program

Is the improved competitiveness cyclical or structural?

Productivity growth is key for sustained long-term economic growth…

The question is whether this internal devaluation has been structural or cyclical. If ULC continues to decline, it will contribute to further export growth and a sustained rebalancing of the current account. Lowering of wage growth as part of the adjustment process can be cyclical on the back of deteriorating economic circumstances. Once the crisis abates, the risk is that wage growth will increase again as labour market pressures return. For a sustainable increase of ULC, an ongoing improvement of productivity growth is necessary. Unfortunately, it looks like there has been little evidence of structural improvements in productivity growth across peripheral Europe.

…but since the economic recovery has started, productivity growth has faltered

Gains have been made during the global economic crisis period, but the productivity growth seen in recent quarters shows little sign of sustained faster productivity growth in the Eurozone periphery. In fact, productivity growth in the current expansion is lower than it was on average during the pre-2008 expansions[2], as Figure 8 shows. It is debatable when the recovery started, if at all, for Greece and how the most recent period of crisis should be defined in terms of the business cycle, but it has seen a decline in manufacturing sector productivity of almost 13 percent in the past two years when the economy was mostly growing. Portugal started to recover in early 2013 and since then productivity has declined by 3.5 percent. The Spanish economy started recovering in the third quarter of 2013 and has since seen productivity improve more slowly than in previous expansions, while Italy has also seen productivity growth improve, but this only covers two quarters of growth, making it difficult to see any trend emerge even though the past quarters are hopeful.

Fig 8 Most recent performance of Unit Labour Costs has been discouraging

Annualized growth in Unit Labour Costs	Unit labour costs	Output per hour	Compensation per hour
Greece			
Previous expansions	3.6	3	6.7
Crisis years	(2.1)	(0.3)	(2.3)
Current recovery	5.6	(6.6)	(1.4)
Spain			
Previous expansions	2.3	1.2	3.6
Crisis years	(1)	2.3	1.3
Current recovery	(0.7)	0.6	(0.1)
Italy			
Previous expansions	(0.1)	2.5	2.4
Crisis years	2.6	0.5	3.1
Current recovery	(4.7)	4	(0.9)
Portugal			
Previous expansions	0.8	3.7	4.5
Crisis years	(1.5)	3.2	1.6
Current recovery	2.6	(1.4)	1.1

Note: Previous expansions are defined as periods of economic growth between 1995 and 2008 that have not seen two quarters of negative GDP growth in a row. Expansions of fewer than four quarters have not been included. The current recovery is defined as the period since the last recession and crisis years are the years between the last pre-2008 expansion and the beginning of the current recovery.
Source : ING

Labour costs still growing slowly, keeping ULC down…

The reason the ULC of the periphery countries have not increased again since the economic recovery started is that labour costs have continued to grow at a very subdued rate. The trend growth in labour costs has been declining significantly for all countries since the start of the crisis and has not yet picked up much since the start of the recovery. Figure 8 confirms this; showing that labour cost growth has been structurally lower than during previous cycles. In Greece, labour costs have started to decline again since mid-2014 as the crisis flared up once more, but not enough to counter productivity losses. In Portugal, labour costs have increased only moderately, but overall ULC has increased. Spanish wages in the manufacturing sector increased only modestly. This is a positive

[2] Data starting in 1995.

sign for the longer term growth performance of the fourth-largest Eurozone economy as this both spurs a recovery of domestic demand and maintains competitiveness gains, therefore helping both exports and domestic demand grow. Recent quarters only saw modest gains in productivity though, indicating that gains could become more difficult.

But the reasons for slow growth in wages could well be temporary…

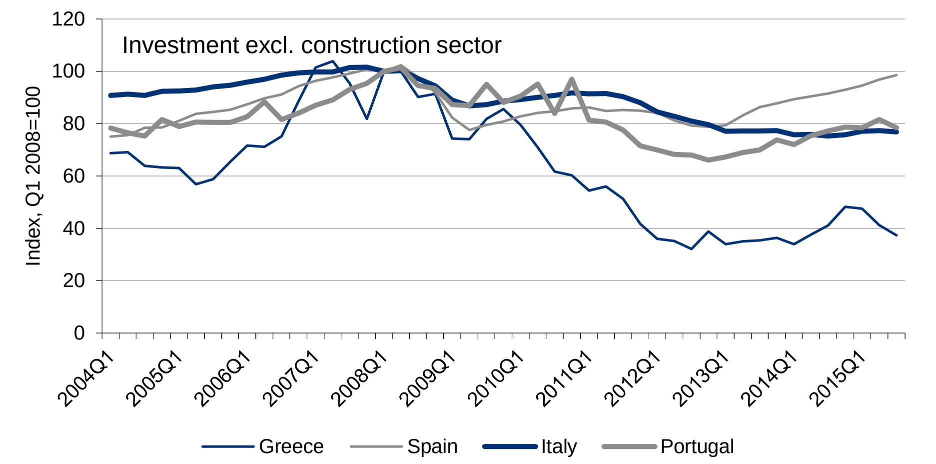
The reasons labour costs are currently keeping ULC down are multiple, but most are likely to be temporary. The prolonged crisis has caused downward pressure on wages as unemployment rates soared; this will at some point reverse. Inflation has also been negative in some countries, making it easy to postpone wage increases for businesses. Now that the recession in peripheral European countries is waning and demand is returning, the risk is that the regained competitiveness will disappear as labour costs start growing at a significantly faster pace than productivity again, as in the pre-crisis period. The main structural factor that helps wage competitiveness is the fact that labour market reforms make the wage-setting process more flexible, allowing for a structural decline in labour costs.

Investment is key for the recovery of productivity in the periphery

…making investment key for long-term strength in ULC in the Eurozone periphery

Maintaining productivity growth now that an economic recovery in the Eurozone periphery has started could also be a more difficult challenge than during crisis times. Improving productivity by shedding workers during a recession is one thing, but to grow both employment and output while output rises more quickly is productivity growth of a different nature. This usually requires investment to improve the efficiency of workers and investment is something that unfortunately is still lacking in Spain, Greece, Portugal and Italy. As Figure 9 shows, investment is still more than 20 percent below the peak in Italy and Portugal and about 60 percent below peak in Greece. Spain is the positive exception as it has almost seen investment recover. Foreign direct investment has fallen strongly as well, as doubts about Eurozone membership resulted in declining FDI. Portugal is a positive exception in that regard, as it has continued to see FDI increase, although domestic investment has fallen significantly.

Fig 9 Investment remains weak, but Spain has seen an encouraging recovery recently

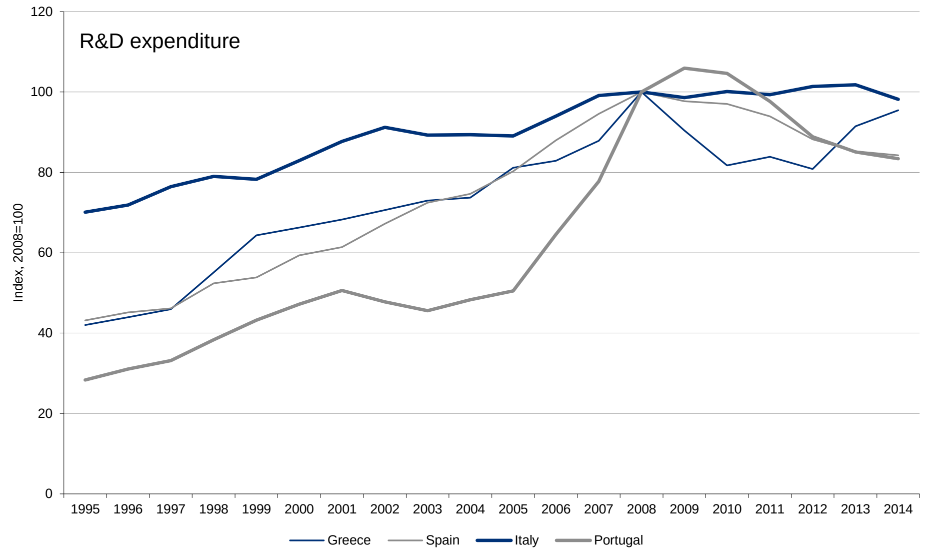


Source: Eurostat, ING

Investment has not recovered strongly though, making productivity gains tough

One of the most important drivers of investment for future productivity growth, R&D, is showing equally poor signs of recovery. Italy has held up R&D investment relatively well, but Spain and Portugal are still seeing R&D investment declines, currently more than 15 percent below pre-crisis levels. Even now that the larger risks relating to a Eurozone exit have declined, investing is not yet very attractive as domestic demand is still way below its 2008 peak. This is causing a vicious circle of investment in the Eurozone periphery. As labour costs are still very low and unemployment is high in the aftermath of the crisis, this makes a substitution of labour for capital attractive, which hurts productivity growth and long-term prospects of sustainable growth. Overall, the current environment seems to suggest that ULC is likely to increase again in the coming period of recovery, making the tough gains of recent years more of a cyclical than a structural phenomenon.

Fig 10 R&D expenditure drives productivity growth, but has weakened since 2008



Source: Eurostat, ING

Are the southern European economies on the right track to achieve sustainable growth?

Spain is leading the peripheral countries, but all show mixed strength in terms of structural improvements

The differences between countries in the periphery are large. Spain has seen investment recover reasonably well, with balanced growth in both labour costs and productivity. This helps towards a sustainable growth path in the coming years. Recent performance in exports has helped Spain and Portugal improve their current account balance, but productivity performance in both countries is still far lower than during pre-crisis years, creating risk of a reversal of the improvements of recent years. Italy and Greece have not seen investment return and have improved their current account balance mainly through decreasing imports. As ULC is increasing in Greece, this warrants the biggest concern. In Italy, ULC has increased during the crisis, but now that the recovery has started, ULC has started to decrease somewhat. Together with prime minister Renzi's reform programme this creates hope, but it is far too early to call a turnaround in competitiveness.

Poor productivity growth means that the risk of a return in current account imbalances is realistic

The poor performance in productivity growth in the current recovery means that the risk of a return in current account imbalances is realistic. Especially for Greece and Italy, a balanced current account with full recovery of domestic demand seems to be quite distant. This means that either the recovery of domestic demand will take a long time, or that the current account deficit will start to increase again. Even though the Macroeconomic Imbalances Procedure demands action by national governments in case excessive imbalances occur, this could result in uncertainty among investors in volatile economic times. A current account without large imbalances is therefore preferable, but without productivity improvements, it is unlikely that both exports and domestic demand can recover together, slowing down the recovery of the economy and the decline of unemployment.

Sustainable growth needs balanced recovery of competitiveness and domestic demand…

For a sustainable growth path to be achieved, where the Eurozone periphery maintains its competitiveness but also recovers domestic demand by improving wages and employment, it is key that labour productivity growth improves substantially. As businesses have been deleveraging significantly in recent years and investment, especially in R&D, has faltered, it seems unlikely that structural improvements in productivity are just around the corner. Besides, as capital is currently hard to come by

For which a quick return of investments in the Eurozone periphery is key

and labour is abundant, capital-labour substitution is working against competitiveness improvements. It is therefore important that regulatory changes will work towards improving productivity, including continued improvements in labour- and product market legislation, but also regulation that helps investment in the Eurozone periphery. Recent proposals for a European capital market union would help, but would take a while to show significant effect. It is therefore also important that short-term investment growth is stimulated, something the Juncker plan attempts to do. It seems, however, that also at an individual country level, investments need to be made to increase the chances of sustained productivity increases. Without significant help, strong long-term growth could be difficult to obtain in most southern European economies.

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