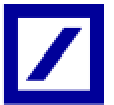

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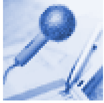


Competitiveness and public-sector finances: Three factors for boosting stability in the euro area

March 2, 2010

Differing growth models have resulted in an increasing disparity between the competitiveness of individual euro area countries over the last few years. These differences affect the growth prospects of these countries and thus on the sustainability of their public finances. What has to be done?

Good economic policy can focus on three factors that link the competitiveness of a country with its budgetary situation.

Factor 1: Budget policy

Large deficits and growing debt levels can be a long-term brake on an economy's competitiveness, can dim its growth prospects and thereby further exacerbate the budget situation.

High interest payments due on high levels of government debt restrict the budgetary options of public-sector institutions. If as a consequence growth-promoting investments (e.g. in education or infrastructure) are not made, this can be a lasting drag on the non-price competitiveness of an economy.

The burden of taxes and social-security contributions continues to rise due to debt service requirements. This reduces the disposable income and assets of households and companies – with the corresponding negative consequences for consumption and investment.

A similar problem for the private investment climate is the state's excessive demand for credit which crowds out private-sector loan demand. Such developments have been looming in the corporate bond market over the last few weeks.

Factor 2: Capital markets

The latest reactions of the capital markets to the budget situations of a number of eurozone countries suggest that a vicious circle may be in motion: if capital market participants are not sufficiently convinced of the competitiveness of an economy this hinders sustainable budget policy. Then there is the risk of disproportionately large increases in interest payments on rising government debt in those countries that lack the will to consolidate their budget, display insufficient competitiveness and feature low trend growth. In the short term this can have a far greater impact on risk premia than absolute debt levels. For example, Spanish government paper is currently yielding nearly 80 basis points over German Bunds, although Spain's debt ratio of 54% is lower than that of Germany (at 73%).

Factor 3: Export orientation

Regardless of domestic budget policy and the capital markets, export orientation can form a link between competitiveness and the debt level.

Countries that are highly competitive and boast a high export share generate a greater volume effect from their comparative advantages. This export orientation leverages growth when a country's companies diversify their target markets globally. In the growth-oriented environment of global markets higher exports can then deliver higher growth and thus boost tax revenues. Structural reforms deliver higher returns for society and the economy and they make reforms capable of gaining majority approval – not least on account of the expanded scope for redistribution they provide.

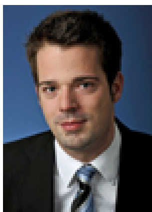
In terms of regional focus, however, there are still major differences between the export-oriented EMU countries. In the past Germany, for example, was a major beneficiary of the growth of the emerging markets. In 2008 more than 27% of all German exports went to countries outside the single European market. In France and Italy this ratio was much lower at 11%, while for Spain global markets were the destination for just 4% of its exports.

New growth impetus or downshifting?

Now there are people claiming that the competitiveness of the leading countries is the reason for the weakness of laggards in the euro area. A comment frequently made is that export-oriented countries should boost their consumption by raising domestic wages. One side-effect would be to close the gap to the laggards. Such proposals may be popular but they do not go far enough as they ultimately focus solely on export orientation. A convincing solution that promotes convergence in competitiveness and fiscal sustainability has to take into account all three factors, however.

The areas that actually require attention are the structural weaknesses of the laggards. So in the short term the confidence of the capital markets has to be reestablished via strict budget consolidation (this means spending cuts and improved tax collection and regulation). In the medium and long term there then has to be a questioning of national growth models whose consumption focus results in protracted stagnation or whose reliance on borrowing has held back growth. There is no alternative for entire economies but to undergo structural change into knowledge-intensive and vigorously service-oriented models with a stronger export focus.

The latest conditions imposed on Greece show that the Commission and the Council interpret their mandate as seeking to ensure that in future the euro area is less heterogeneous and more competitive overall and that they will apply the Lisbon treaty accordingly. Should the plans for a European economic government become concrete, export-oriented countries will have to commit themselves to this course being maintained. It is not the downshifting of the leading group that should be encouraged, but the catching-up of the laggards. More competition between the EMU countries does not have to be a zero-sum game. Their export market is not Europe alone, but the whole world.



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