ExecutiveAction Series

PRODUCTIVITY AND COMPETITIVENESS SERIES

Despite the Chaos, Europe's Economies Are Regaining Competitiveness through Improvements in Unit Labor Cost Performance

by Bert Colijn and Bart van Ark

While there remains much to be concerned about when it comes to the economic stability of Europe, there are indications that unit labor costs are retreating in even the most troubled countries — an encouraging sign for future competitiveness. But can gains in productivity and this momentum on the cost side be sustained?

Key Findings

- Since the start of the sovereign-debt crisis, several European countries have strengthened their labor cost competitiveness in manufacturing, which is an encouraging sign for the future.
- Higher productivity through efficiency gains has brought the labor costs per unit of output down substantially in countries like Ireland and Spain, making them more competitive and attractive to business.
- Among the larger European economies, the United Kingdom has seen the largest decreases in unit labor costs in manufacturing, making the British economy more competitive from a cost perspective than Germany, France, or Italy.
- New agreements on higher wages in Germany's manufacturing sector may lead to a further rebalancing of manufacturing competitiveness across European economies.
- In the services sector, however, labor costs per unit of output are still increasing throughout most of Europe, although some countries have even managed large cuts there.
- Exits from the Euro Area would provide temporary relief to less competitive economies because of a sudden drop in labor cost, but only productivity can create competitive advantage in the medium term.
- Major reform plans being proposed and implemented in the labor and product markets of the troubled European economies, including Spain, Portugal, and Greece, should ultimately result in increased labor efficiency and stronger competitiveness.

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Competitiveness Remains a Critical Problem for Europe on Its Way to Recovery

The European economic and competitive landscape has radically changed since the financial crisis began in 2008, as the implications for productivity and competitiveness become more clearly visible. However, the 2008 financial meltdown is not the only reason for the severity of the euro crisis. The chronic problem of eroding competitiveness has certainly contributed to the crisis's intensity and duration.

One clear constraint on strengthening the competitiveness of countries with different productivity levels and/or high labor costs within the Euro Area is that the single currency and common base-interest-rate setting make it impossible to use those instruments for economic and market realignments. In times of recession and crisis, when substantial changes in labor cost or productivity emerge, large distortions arise in the competitive strengths between countries. A weaker exchange rate might help exports for a country with low competitiveness (high costs, low output), but the stronger countries within the currency zone drive up the value of the currency, thereby slowing the recovery in the weaker countries. This is what recently happened within the Euro Area, where countries like Greece and Portugal lost much of their competitiveness relative to, for example, Germany or France.

The most productive economies in Europe, while not that competitive in terms of unit labor costs compared to the rest of the world, are performing relatively well regionally because of technological advantages or because they operate in niche markets. Medium- to high-tech manufacturing activities in Germany, such as the manufacture of motor vehicles and precision tools and machinery, are good examples of sectors in which, despite relatively high labor compensation, the amount of output per hour is sufficiently high to remain competitive with other countries within the Euro Area and beyond. Still, even in those countries, a decrease in unit labor cost is needed to strengthen the competitiveness of the manufacturing sectors in the medium to long run. Since the crisis has already resulted in some important product and labor market reforms in the most troubled countries, it will be interesting to see if these reforms have led individual companies in these economies to reduce their cost of labor per unit produced to become more competitive in global and regional markets.

Productivity is one of the most used measures of long-term economic growth and competitiveness, but it does not tell the whole story for the short and medium term. Competitiveness is not only about productivity, measured as output per unit of labor; it is also about the total cost at which that output is produced. For example, if output rises by 100 units by using 50 additional working hours, but the hourly cost doubles, there is no gain in cost competitiveness. Unit labor cost (ULC)—which primarily measures cost competitiveness and does not address other factors, such as improvements in the supply chain, innovation, changes in protection of intellectual property rights, etc.—does take account of the most important part of most companies' cost performance. ULC combines productivity gains or losses with rises or reductions in nominal labor cost. Specifically, ULC is defined as nominal labor compensation per unit of real output.[1] Since most types of competitiveness do not change much in the short run, a decreasing ULC is usually the first sign that a transition is underway.

Anglo-Saxon-Style Labor Markets Are Leading the Way Toward Competitiveness Gains

Since the start of the global financial crisis in 2008, the countries with the most flexible labor markets have been the most successful at quickly reducing their labor costs per unit of output (Chart 1 on page 3).[2] Based on quarterly estimates, Ireland lowered its unit labor costs by 6.3 percent between 2008 and 2011—the most of any Euro Area country. Within Europe, Ireland's success was only rivaled by the Eastern European countries that increased their competitiveness in labor intensive sectors because of their flexible labor markets and faster productivity growth performance. Latvia and Lithuania have decreased unit labor costs since the start of the crisis by more than 5 percent, while Hungary is the European leader with a decrease of 11.7 percent.

Among the larger European countries, unit labor cost performance differs substantially. The United Kingdom, with less government-mandated job security protection for employees compared to continental European countries, has rapidly adjusted to the more difficult competitive

1 Nominal labor compensation refers the growth of total labor compensation paid in the economy, irrespective of it being the result of a change in the labor force or an increase in wage cost per worker. Real output is the growth in GDP adjusted for changes in inflation. Alternatively, unit labor cost reflects labor compensation per hour worked relative to output per hour worked. Though widely used, unit labor cost should still be interpreted as a partial measure of cost competitiveness because it only deals with labor cost and takes no account of many other costs during production, such as transportation costs, capital or intermediate input costs, etc..

2 Flexibility in the labor market refers to the lower level of regulatory protection of employees, which makes it easier to adapt an organization's workforce to the demands of production.

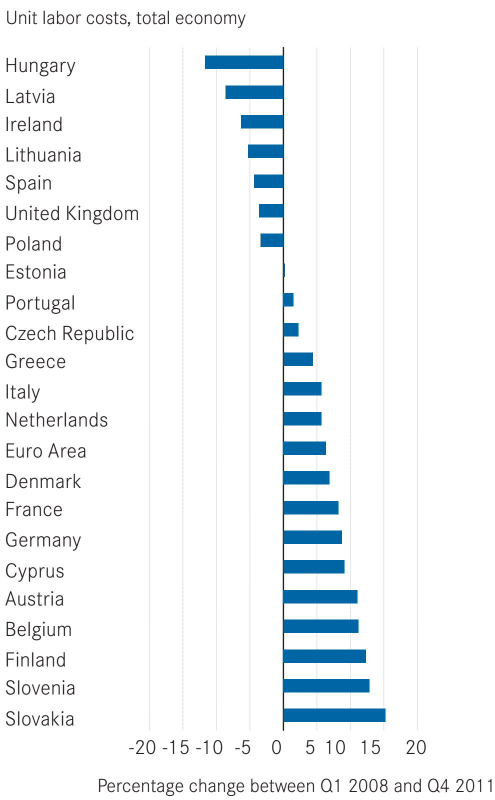
environment. Unit labor costs have decreased by 3.6 percent since the start of the financial crisis. This stands in stark contrast to the continental European countries, where France and Germany have both seen an increase in unit labor costs of 8.2 percent and 8.7 percent, respectively. This result shows that the *Kurzarbeit* initiative that the Germans used to keep people employed throughout the crisis may have resulted in lower unemployment on the one hand, but also in the higher unit cost performance of its workforce on the other.[3]

Critical to future competitiveness is whether the unit labor costs in the most troubled economies, which include Greece, Portugal, Italy, and Spain, are actually falling. As their products cannot be made more attractive through an adjustment of the exchange rate, a reduction in labor costs or a rise in productivity are the only routes to regain competitiveness. Even though labor compensation per hour worked has come down in Ireland, Portugal, and Spain (Chart 2), the often rigid labor markets have not been able to let total labor compensation adjust quickly enough to match declining output, leaving too many workers on their payrolls. The exception is Spain, which saw a decrease in ULC of 4.4 percent, which was possible because of the large amount of part-time workers in the economy. Greece, Portugal, and Italy have seen their ULC increase by 4.4, 1.5, and 5.6 percent, respectively, between 2008 and 2011 (Chart 1).

However, Greece and Portugal have recently seen a turning point in their ULC. Greece has managed to bring its costs down by more than 5 percent in 2010 and 2011, a sign that cost competitiveness is beginning to improve in those countries. Another important observation is that the countries

Chart 1

Large shifts in unit labor costs have occurred since the start of the crisis

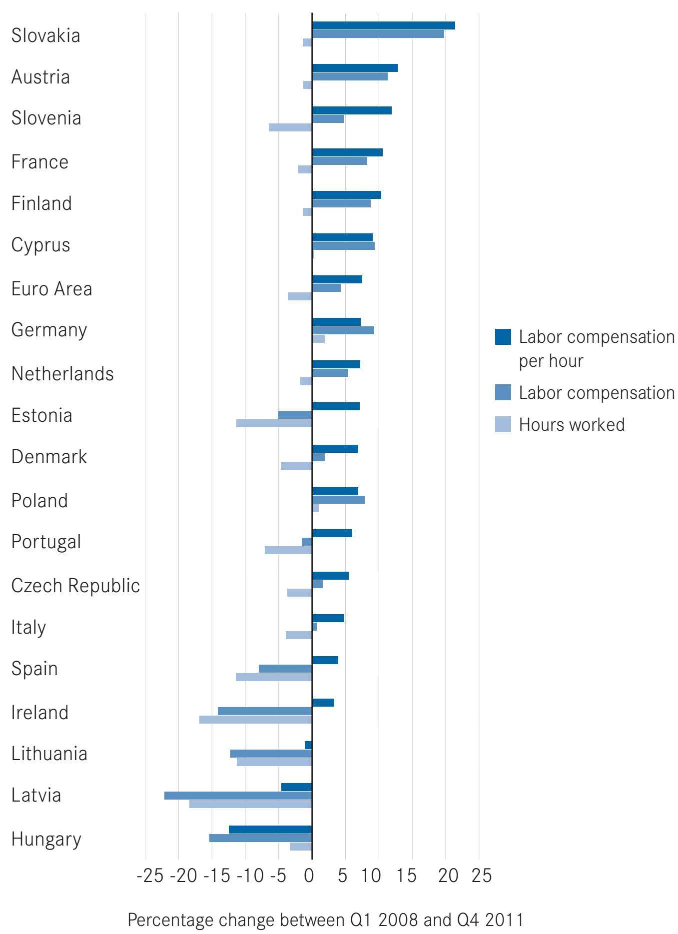


Note: Latest data for Ireland, Netherlands, Poland, Portugal, and the United Kingdom are Q3 2011.

Source: The Conference Board

Chart 2

As labor compensation is more rigid than employment, labor compensation per hour has increased in most countries



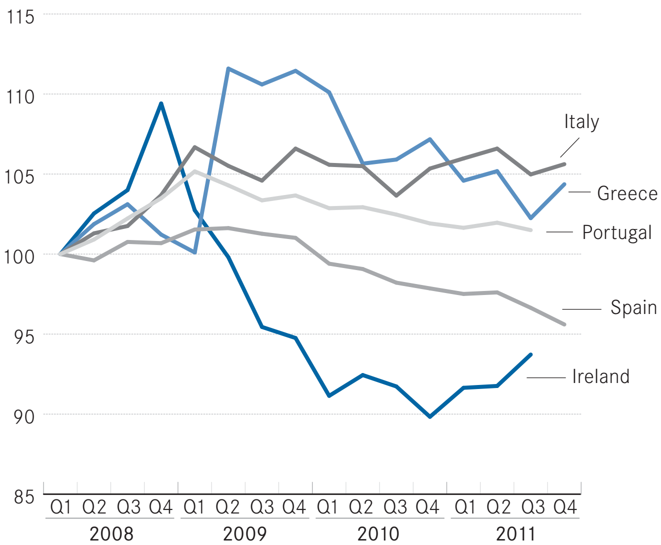
Note: Data for Denmark, Ireland, Netherlands, Poland, and Portugal are for Q3 2011.

Source: The Conference Board

3 The *Kurzarbeit* initiative allowed workers to remain employed while their working hours were temporarily reduced under a government program that paid subsidies to workers.

Chart 3

Portugal and Greece are now making improvements in unit labor costs



Source: The Conference Board

that have started bringing down their unit labor costs have been hindered by the exacerbation of the financial crisis. When the crisis heated up in the summer of 2011, it became more difficult to decrease ULC because output started declining for most countries (Chart 3).

Europe's Manufacturing Sector Is Building Strength

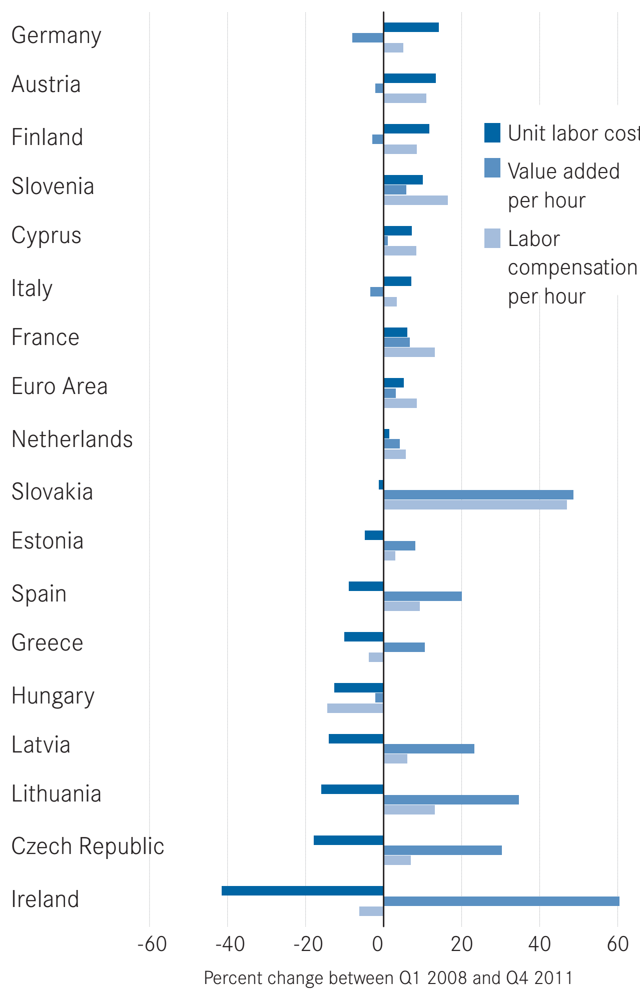
When it comes to cost performance for the manufacturing sector, which is most vulnerable to the perils of the Euro Area and the global economy through trade, the variations have been extreme compared to Europe's service sector. Chart 4 shows large swings, both increases and decreases, in labor compensation per unit of output in manufacturing. Ireland is the top performer in increasing competitiveness, with a large 41.5 percent decrease in unit labor cost—one unit produced in manufacturing now costs just over half of what it cost before the start of the 2008 crisis. This drop in ULC makes Ireland the most efficient Euro Area manufacturing country by far, outperforming even Poland and other low-wage countries that are known to attract a good share of offshoring activity (Chart 5 on page 5). The reason for the Irish increase in competitiveness can mainly be found in its increasing share of the high-tech and chemical manufacturing sectors, which have seen a substantial increase in value added. Traditional manufacturing sectors like food and beverage production have performed less well, causing a structural shift in the country's manufacturing sector.[4] It is very possible that similar effects have occurred in smaller open economies like Slovakia and Lithuania.

Germany, Finland, and Austria are on the other side of the spectrum, having seen their unit labor costs increase substantially in recent years. Both Germany and Austria have used *Kurzarbeit* to prevent a surge in unemployment.

Chart 4

Most troubled economies have seen value added per hour increase during the crisis

Changes in ULC for manufacturing



Note: Data for the Euro Area, Ireland, and the Netherlands are for Q3 2011.

Source: The Conference Board

4 Eddie Casey, Unit Labour Costs in Irish Manufacturing, *Quarterly Economic Commentary*, The Economic and Social Research Institute, Summer 2012 (www.esri.ie/UserFiles/publications/RN20120201.pdf).

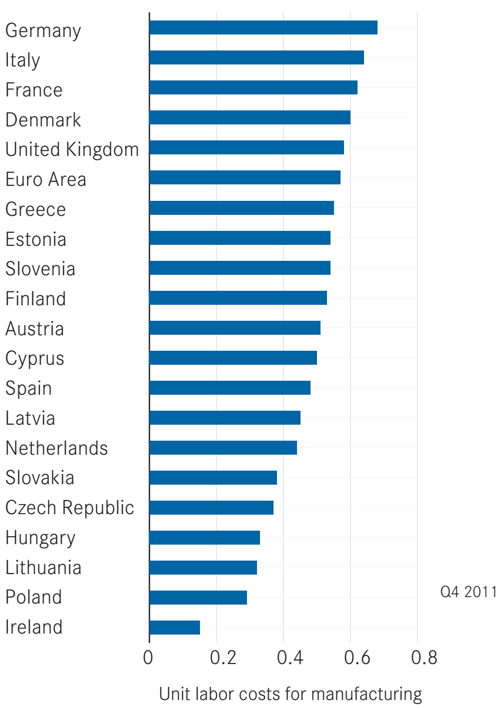
This has resulted in a reduction in value added per hour in manufacturing and an increase in labor compensation per hour. France and Italy also saw their unit labor costs increase, albeit more slowly than Germany and Austria. Hence Ireland, Spain, Greece, and the Baltic countries regained competitiveness against the European core countries in the manufacturing sector, which is also a bright spot for the troubled countries of Europe.

Of the larger countries, the United Kingdom also shows extraordinary movement in its manufacturing ULC performance. British firms drastically cut employment and managed to bring labor compensation down. As output contracted less slowly than expected, this means that labor cost per unit of output dropped during the crisis. The United Kingdom, which was less competitive than Germany, Italy, and France before the start of the crisis, now shows lower labor cost levels per unit of output than its main rivals, giving it an advantage in manufacturing for the middle to long term (Chart 6). Another country that has been keeping its manufacturing ULC under control is the Netherlands. Even though the Netherlands also used an hour reduction program during the recession, it managed to keep its manufacturing ULC growth very limited and increase its value added per hour. Therefore, the Netherlands strengthened its cost competitiveness compared to most European countries and certainly compared to its immediate neighbors (Chart 5).

Chart 5

Ireland is the most cost effective country for manufacturing in Europe, outperforming countries like Poland

Ratio, labor compensation over gross value added



Note: Data for the Euro Area, Ireland, Netherlands, Poland, and the United Kingdom are Q3 2011.

Source: The Conference Board

The past two years have actually seen an improvement in unit labor costs across the entire Euro Area. With a 3.9 percent decline, it seems that the manufacturing sector is on the right path to becoming more efficient and competitive, However, on average, unit labor costs are still higher than at the start of the crisis of 2008, so there is still room for improvement.

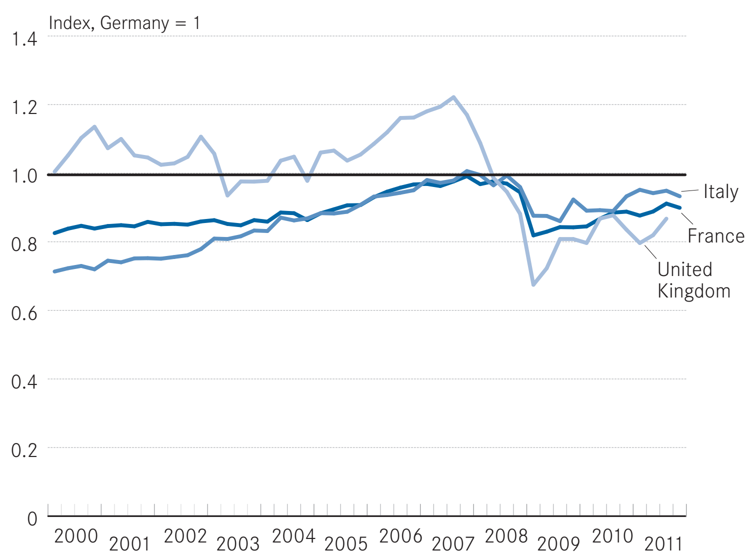
The European Service Sector Remains the Weak Performer

It should be no surprise that the service sector is more labor intensive and has higher ULC than the manufacturing sector. The sector also produces a larger proportion of non-tradables than manufacturing (i.e., output that is not easily traded on international markets). As a result, ULC is less a measure of global or regional competitiveness and more a measure of the fundamental health of a given economy. In critical service market industries, very few countries have been able to decrease unit labor costs since the start of

Chart 6

Germany has lost cost competitiveness since the start of the crisis

Unit labor costs, manufacturing



Source: The Conference Board

the recession.[5] Of the larger countries, only Spain and the United Kingdom have managed to substantially decrease ULC in this sector, while others have seen rapid increases due to decreased output and limited employment adjustments. Germany and France are among the countries that saw their unit labor costs rise, but only to a limited extent when compared to Greece and Ireland. While Ireland saw a very large decrease in manufacturing ULC due to significant restructuring, it experienced a dramatic rise of 24.3 percent in its ULC in the service sector. Productivity declined substantially, but labor compensation per hour increased even more, resulting in much less cost effectiveness in the sector (Chart 7). Greece had managed to decrease its unit labor costs dramatically in the 2000s, but the 26.4 percent increase since 2008 also set the Greek service sector back considerably in terms of competitiveness. Even though labor compensation fell sharply in 2009, it started rising again in 2010, and it is now at a higher level than at the start of the 2008 crisis.

When looking at the underlying drivers of the changes in the service sector, it becomes clear that many countries have struggled to keep up output growth since 2008, while only a few have brought down their labor compensation per hour worked during this period. This is related to the much slower response of labor markets in mostly nontradable services compared to the tradable manufacturing sector. Spain is a very positive exception here. It has seen an increase in productivity in the service sector accompanied by a very small increase in labor compensation per hour. The amount of hours worked has been reduced more than the loss in value added which means that the efficiency in the service sector in Spain is starting to improve (Chart 7).

Labor Market Reforms Are Helping Put Europe's Troubled Countries Back on Track

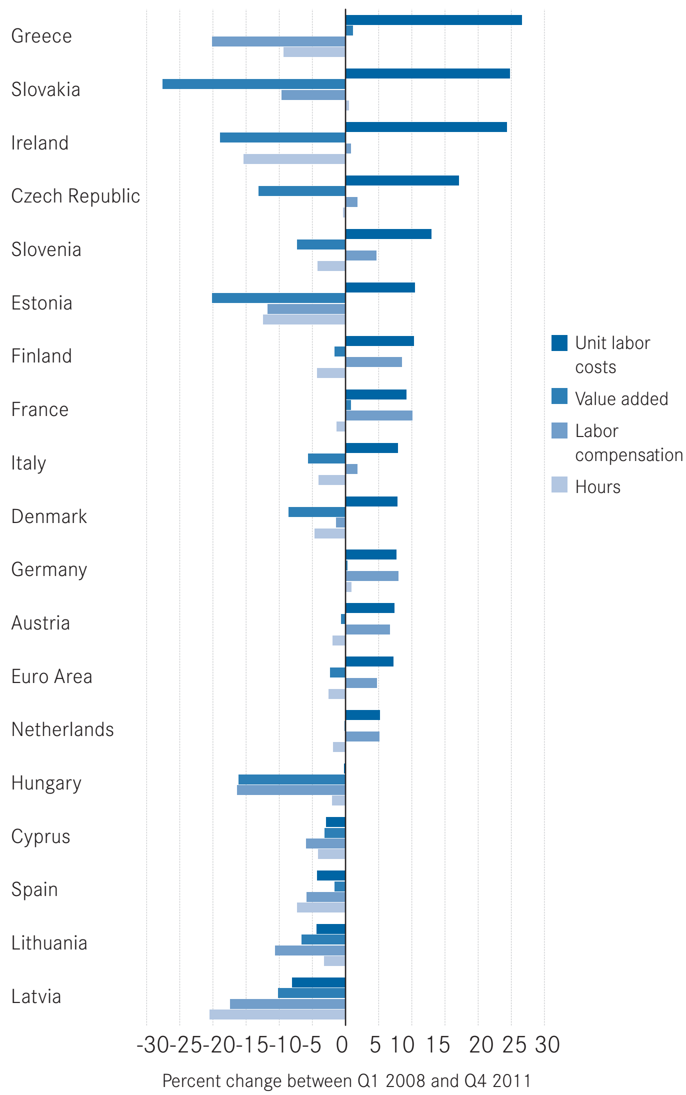
While the depressed state of the troubled European economies seems to be endless, with confidence and investment remaining low and draconic austerity measures being implemented, there are some green shoots sprouting. The economies that have been fundamentally uncompetitive, both internally and externally, for so long are beginning to see turnarounds in cost effectiveness that provide hope for further improvements. Some of the labor market and product regulations that have been constraining efficiency are now being revised and improved upon, leading to signs of improvement in overall competitiveness.

Ireland is, by and large, the country that has made the most improvements in manufacturing, making it the cheapest manufacturer in all of Europe. In services, however, Ireland has actually lost competitive strength, and restructuring in that sector continues to lag. Spain has made large gains across both manufacturing and services sectors, even before its most recent reforms to strengthen labor market flexibility further by reducing the dichotomy between temporary and permanent labor. The shaking out of less productive activity, along with wage decreases and employment reductions, has

Chart 7

The service sector has seen some large increases in ULC, which are a reflection of more rigid regulation

Changes in ULC in the service sector



Note: Data for Denmark, the Euro Area, Ireland, and the Netherlands are for Q3 2011. Greece data for hours are for total employment.

Source: The Conference Board

5 The service sector includes wholesale and retail trade, transportation, accommodation and food services.

drawn little attention, but it is a very important step toward a healthier and more competitive economy.

Among the larger economies, Germany and France have seen their unit labor costs increase since the start of the recession in both manufacturing and services. The fact that other European countries improved their unit labor costs in relative terms might help soften the competitive imbalances in the pan-European economy. The United Kingdom, on the other hand, has been able to aggressively cut its unit labor costs across industries, which sets those industries up for a stronger competitive position for the coming years.

Italy, Greece, and Portugal are countries that seem to have had the most difficulty in increasing their competitive performance during the current crisis. In the past two years, however, Greece and Portugal have started to make some competitive gains, even though the level of labor cost per unit is still higher than it was before the crisis started back in 2008. As wages are less flexible than output, it is often difficult to improve cost competitiveness in times of recession, unless crisis conditions force countries into more drastic action (as in the cases of Ireland and Spain). Changing labor regulations that make it easier to adjust the workforce to the demands of the market would help countries with more rigid labor markets regain competitiveness.

Lower unit labor costs are one factor that can hasten the return to competitiveness for the troubled European economies. If these countries are able to make large gains in ULCs, they can regain market share—a step in the right direction. Since there is no relief through exchange rate adjustments in a single currency zone, regaining cost competitiveness through labor cost reductions is a long and painful road to recovery.

Over the longer term, the main driver of economic expansion will be productivity growth through innovation rather than a drop in input costs (e.g., labor). An increase in output per hour is best reached by spurring innovation. In the meantime, as the sovereign debt crisis continues to keep European leaders awake at night, decreasing unit labor costs in the troubled countries are the first steps toward recovery.

Would an Exit from the Euro Area Help a Recovery in Competitiveness?

Early in 2012, in light of greater financial instability in the most troubled economies in Europe, and Greece in particular, a debate started about whether those troubled countries would benefit from exiting the Euro Area. The theory is that the relief from a common currency and mandated base short-term interest rates would allow an exiting country to more quickly realign its economic structure and strengthen competitiveness.

To test the possible effect of countries returning to their own currencies (or, alternatively, to common currencies for two or three smaller blocks of countries that are more aligned in terms of economic conditions), The Conference Board looked at three scenarios dealing with the impact on productivity, labor compensation, and unit labor cost for the troubled economies and the rest of Europe.

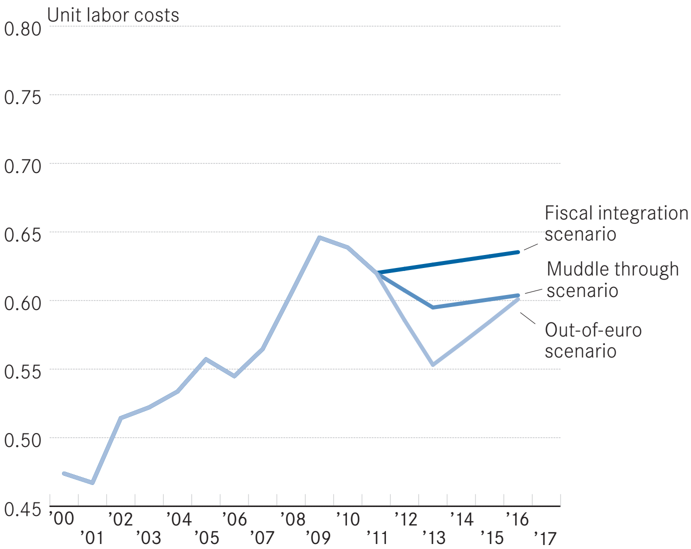
The scenarios examined are a “country out of euro” scenario, in which a country breaks loose from the monetary union and returns to its own currency. The second is the “muddle through” scenario that depicts what happens when the country stays in the Euro, but no fundamental solutions to the problems in the Euro Area are found. “Fiscal integration,” the third scenario, describes how more fundamental changes could lead to coordinated and more centralized fiscal policies within the Euro Area.

In the “country out-of-euro” scenario, the exiting country will initially benefit from the huge devaluation of its new currency, and unit labor costs will therefore fall rapidly in the first and second year, which will improve competitiveness. In the years immediately following the exit, cheap exports will result in a boost to the economy that will set GDP and labor compensation back on a growth path. As labor compensation is likely to grow more quickly than GDP in this scenario, ULC will likely be about the same or higher than if the country had stayed in the euro for five years (Chart 8 on page 8), resulting in stagnating or decline competitiveness.

The rest of Europe will be affected by increased uncertainty about the exit, but the remaining member countries are unlikely to experience any real output shock, unless the country that leaves is one of the larger economies (e.g., Spain or Italy). A larger economy leaving the monetary zone would lead to a prolonged recession and a slow recovery across Europe as uncertainty about the monetary union s future grows. Labor compensation rises at a subdued pace in this scenario due to the high unemployment rate and ULC remains more or less at the same level (Chart 9 on page 8).

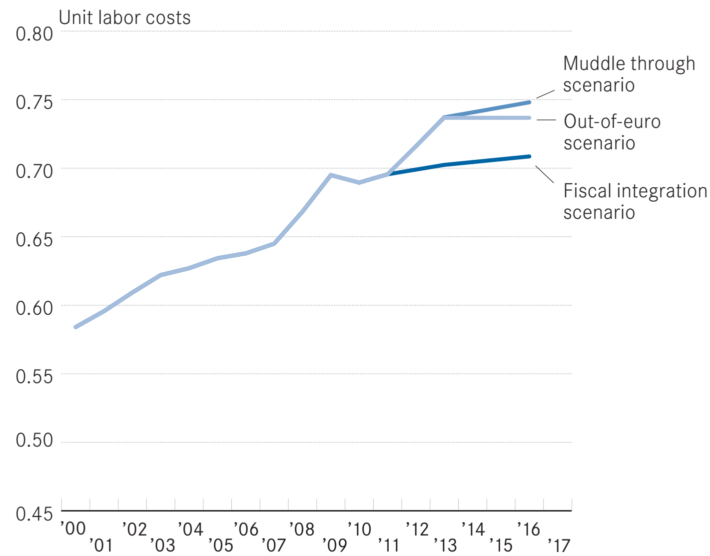
In the muddle through scenario, the country remains in the Euro zone but no true breakthroughs or long-term solutions for the Euro Area are found. This leads to low growth in the troubled economy due to severe austerity and lack of confidence in the country, which curbs investment. Labor compensation is likely to contract more quickly in the short

Chart 8
Greek scenario:
A Euro Area exit would only provide temporary relief



Source: The Conference Board

Chart 9
Euro Area scenario:
Euro country exits will keep cost competitiveness weak



Source: The Conference Board

run, and therefore ULC will come down in the first years, but when slow growth returns, labor compensation is likely to outpace output growth, resulting in slight increases in labor costs per unit of output produced.

The rest of Europe will also experience an output contraction in the first two years as well, due to harsh austerity measures and high levels of uncertainty. As labor compensation is likely to continue growing moderately, ULC will continue to increase and weaken European labor competitiveness. In the long run, GDP growth will return, albeit very slowly, and labor compensation is likely to match that growth. This results in very slow ULC growth, which is not bad for competitiveness, since inflation is likely to outpace ULC growth and therefore the real cost of labor declines.

In the “fiscal integration” scenario, the country remains in the euro and far-reaching agreements on a banking union, Eurobonds, and more fiscal integration are reached. This may result in a boost of investment and an increase in labor compensation as employment increases. The increase of both would lead to a slight rise in ULC, which is still good for longer-term competitiveness as investments in the economy result in more sustainable growth. In the long run, the scenario results in GDP catching up after its earlier large collapse. Labor compensation will slightly outpace output growth and this will result in almost flat ULC and no further gains in cost competitiveness.

More important, the return of investments will boost the recovery of the rest of Europe in the long term. The long-term result is healthy 3 percent output growth, as well as labor compensation growth that only slightly outpaces output growth. This is still modest, given the high unemployment the Euro Area still faces and corrections for inflation. As investment returns, productivity increases and leads to a healthy recovery of competitiveness.

In conclusion, an exit would not help countries in the medium to long term because it would only result in a brief increase in competitiveness that would later evaporate. Even though there are very large differences between countries in the effects on output, hours, and compensation, the effect on ULC would, in the long run, be rather small. For sustainable competitiveness growth in the long term, simply hollowing out labor costs is not enough. Labor productivity growth is the key. A fiscally integrated Europe would eventually attract more investment, which would, in turn, result in increased labor productivity and more innovation. The combined effect of this acivity would trigger a balanced, long-term increase in competitiveness of both the troubled country contemplating exit and the rest of Europe.

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