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"Patern competitiveness"

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COMMISSION
OF THE EUROPEAN
COMMUNITIES

Briefing note for

Sherpa meeting
London, 5 /6 June

Directorate-General
for Economic and Financial Affairs
II-D-3/II-D-4

Exchange rate movements since 1 September
- implication for competitiveness -

Developments in competitiveness are generally measured in terms of changes in relative prices and/or costs. As it is assumed that in the long-run profitability in the tradables sector plays an important role for a countries external performance, the (manufacturing) unit labour cost variable is probably the most relevant one. A more complete analysis, using other indicators, has been published by DG II as an Annex of the Annual Report. Its conclusions are recalled at the end of this note.[1]

The table below shows: in the first column, the movements in EMS central rates from the 1 September 1992 to 14 May, 1993; in the second column, the accumulated loss in competitiveness between the first quarter 1987 and the second quarter of 1992, measured in relative GDP deflators; in the third column, the accumulated loss in competitiveness between the first quarter 1987 and the second quarter of 1992, measured in relative manufacturing unit labour cost.

	Devaluation against DM since 1 September 1992, central rates*	Real appreciation against EC12 1987:Q1-1992:Q2		1987:Q1-1993-Q1	
		GDP deflator	Unit labour cost manufacturing	GDP deflator	Unit labour cost manufacturing
FF	0	-8.1	-12.4	-1.3	-6.3
BFR	0	-3.9	-8.2	1.5	-2.6
HFL	0	-10.1	-15.4	-5.0	-9.8
DKR	0	-7.6	-5.9	-1.7	-0.4
DM		-6.9	2.2	2.6	14.1
ESC	-13.8	40.9	37.6	44.3	42.6
IRL	-10.0	-12.7	-21.1	-11.7	-21.0
PTA	-21.7	25.9	32.5	19.6	27.5
LIT	-22.9	7.3	2.7	-10.1	-15.3
UKL	-16.0	17.9	16.4	1.9	-1.0
DRA	-8.8	12.4	15.9	14.0	17.6

Source: DG-II estimates, in % * partly indicative, for the DRA change in market rate

Between the beginning of 1987 and the second quarter of 1992, there was a significant cumulative gain of competitiveness, in terms of unit labour costs (a measure of the degree of 'competitive deflation') in IRL (21%), the NL (15.4%), F (12.4%), B (8.2%), and DK (5.9%); a slight loss in IT (2.7%), and D (2.2%); and a significant loss in P (37.6%), E (32.5%), the

1 Annual Economic Report, Annex 4, April 1993

UK (16.4%), and GR (15.9%). (For more detailed information see also the Annual Report 1993 [1]). The series of realignments starting with the 14 September 1992 did not strictly follow the accumulated changes in competitiveness between the ERM period of 'quasi fixed parities' between the last general realignment on 12 January 1987 and the 14 September 1992.

The following calculations have been made on the assumption that the exchange rates of Friday 14 May are taken as representative for the months of May and June, and on the basis of last autumns forecast for unit labour costs. Four groups can be distinguished:

Countries which have not made up the loss in competitiveness compared with the other Community countries, measured in trade weighted unit labour costs in manufacturing, until the second quarter 1993:

Portugal	there remains a gap of	38.8%
Spain	there remains a gap of	21.3%
Greece	there remains a gap of	18.2%

Countries which have gained competitiveness in excess of accumulated losses/gains since 1987:

Ireland	there is a net gain of	23.5%
Italy	there is a net gain of	14.6%
UK	there is a net gain of	1.0%

Countries which have lost some of their earlier competitiveness gains:

Netherlands	there remains a net gain of	9.9%
France	there remains a net gain of	6.1%
Belgium	there remains a net gain of	2.5%
Denmark	there remains a net gain of	1.7%

The last group consists of Germany only, which has accumulated a loss in competitiveness of 14 %.

Reservations:

1. The measures are sensitive to the choice of the starting date:

   The choice of the first quarter of 1987 was made because this was a significant date for the ERM, characterised by the last general realignment before the "New EMS" period. While for the system as such the starting point makes sense, for some countries it might not. For Spain, Portugal, and the UK, their respective ERM entry dates - 19/06/89 Spain, 08/10/90 the UK, 06/04/92 Portugal - could also be chosen. However, Spain and Portugal entered the ERM in conditions of strong economic growth and high inflation. The change in the cyclical position of these economies has since weakened very markedly, implying a need for better competitiveness than at entry if internal balance is to be restored. The UK entered just at the moment when a deep recession was beginning. The size of the output gap in the UK, together with the need for fiscal consolidation, indicates a need for improved competitiveness relative to the entry level. ***Compared with the levels at the respective entry dates the remaining competitiveness gap is minimal for Spain (0.3 %), and Portugal (0.8 %), while the UK has made a remarkable gain (16%).***

2. The measures are sensitive to the choice of the deflator:

While in general cost measures are preferable, for countries - like Portugal - which started off at a very low absolute level of hourly nominal wage costs, compared to other Community countries, the developments in relative unit labour cost might tend to exaggerate potential competitiveness problems.

3. Complementary indicators for external performance:

The cost and price measures used in the analysis above show changes in the value of an index number relative to a starting point in time. These measures do not give information about the absolute level of competitiveness, nor do they say anything about equilibrium levels of real exchange rates.

The conclusions of the study included in the Annual Report, which dealt with various indicators, were the following[2]:

"(i) Germany, Greece, Italy and the UK had obviously registered a competitiveness deterioration until the third quarter of 1992. For Italy and the UK, the depreciation of their nominal exchange rates has probably offset the previous relative cost slippages. For Germany, the realignments and the suspensions of the ERM participation that took place in the third and fourth quarters of 1992 have contributed to a significant increase in that country's relative prices; combined with its relative wage slippage, the real appreciation of the Deutschmark reached 12% in the fourth quarter of 1992 compared to 1991.
(ii) Spain and Portugal have registered a rather important increase in their relative prices, as it is typical in any catching-up process. However, two main question marks remain: whether or not the chosen base period is appropriate for these countries, and whether or not the losses of competitiveness of existing output are being incurred too fast;
(iii) Ireland, France and Denmark enjoy a rather healthy competitiveness position, while the Netherlands and Belgium, arguably, do not face any problems in this field."[3]

It has been proposed, by academics and practitioners alike, to complement the set of indicators by developments in the trade and/or current account, market shares, absolute nominal industrial wage costs, and the like (some of them are summarised in the following table). The assessment of the equilibrium level of the real exchange rate is a complex task, and among the indicators of the cyclical position and/or longer term growth prospects, the rate of unemployment can not be ignored.

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2 Annual Economic Report for 1993, Study No 4, p 178.

3 These results do not fully reflect the exchange market developments after September 1992.

Complementary performance indicators

	Nominal wages in manufacturing per hour, 1990, in DM [1]	Compensation per employee in 1000 USD 1992 [2]	Current account balance in % of GDP [2] average 1981-90	1992	unemployment rate 1992 [2]
F	25.65	38.3	-0.5	0.1	10.1
B	30.05	43.2	-0.1	1.8	8.2
NL	30.36	38.3	3.2	3.9	6.7
DK	30.54	33.1	-2.8	3.0	9.5
D	37.88	42.1*	2.6*	-0.8	7.5
P	7.14	12.0	-4.4	-0.2	4.8
IRL	20.45	31.0	-4.0	6.7	17.8
E	21.88	26.7	-1.0	-3.7	18.0
IT	29.82	35.0	-0.8	-1.9	10.2
UK	24.72	30.1	-1.2	-2.1	10.8
GR	10.49		-4.4	-3.3	7.7
EUR12-			0.2	-0.5	9.5
EUR12+				-0.8	10.1

Source: 1 Institut der Deutschen Wirtschaft, iw-trends 2/1991
2 DG II , compensation figures do not take 1992 realignments into account

* West Germany

Extra-Community competitiveness.

For the Community currencies taken as a group vis-à-vis third currencies[4], the nominal effective exchange rate reached a maximum in August 1992 at 12 % above the level of the first quarter of 1987. During the period from August 1992 until May of 1993, the appreciation of the dollar and of the yen, combined with the impact of the realignments and floating of some Member States' currencies, produced an almost continuous drop in the effective exchange rate of the Community currencies, which are presently (second quarter of 1993) around the same level than in the first quarter of 1987. Since the peak of the third quarter of 1992 to the second quarter of 1993 the depreciation has reached 10.5 %.

The corresponding drops of the real effective exchange rates, i.e. taking into account the inflation differentials, have been somewhat smaller. They range from 8.8 % when relative inflation is measured with unit labour costs in the manufacturing sector to 10 % measured with GDP deflators. Due to a cumulated inflation higher than in the other industrial countries, the real exchange rates for the Community currencies are still higher in the second quarter of 1993 than in the first quarter of 1987. These cumulated losses of competitiveness are still 7.2 % for the unit labour costs in the manufacturing sector, 4.8 % for the export deflators, 3.7 % for the GDP deflators and 2.2 % for the unit labour costs in total economy.

In a bilateral comparison with the US, the EC competitiveness - as measured by unit labour cost in the manufacturing sector - has been improved by 12.6 % since the third quarter of 1992, but is still 9.3 % deteriorated when the second quarter of 1993 is compared with the first quarter of 1987. Against Japan, the bilateral real exchange rate shows a sharper decrease in the EC relative unit labour costs for the manufacturing sector, which reached 21.7 % from the third quarter of 1992 and 9.1 % from the first quarter of 1987.

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4 A set of informative graphs on the developments of nominal effective exchange rates and competitiveness indicators for the US, Japan, EC12, and the individual Community countries is appended.

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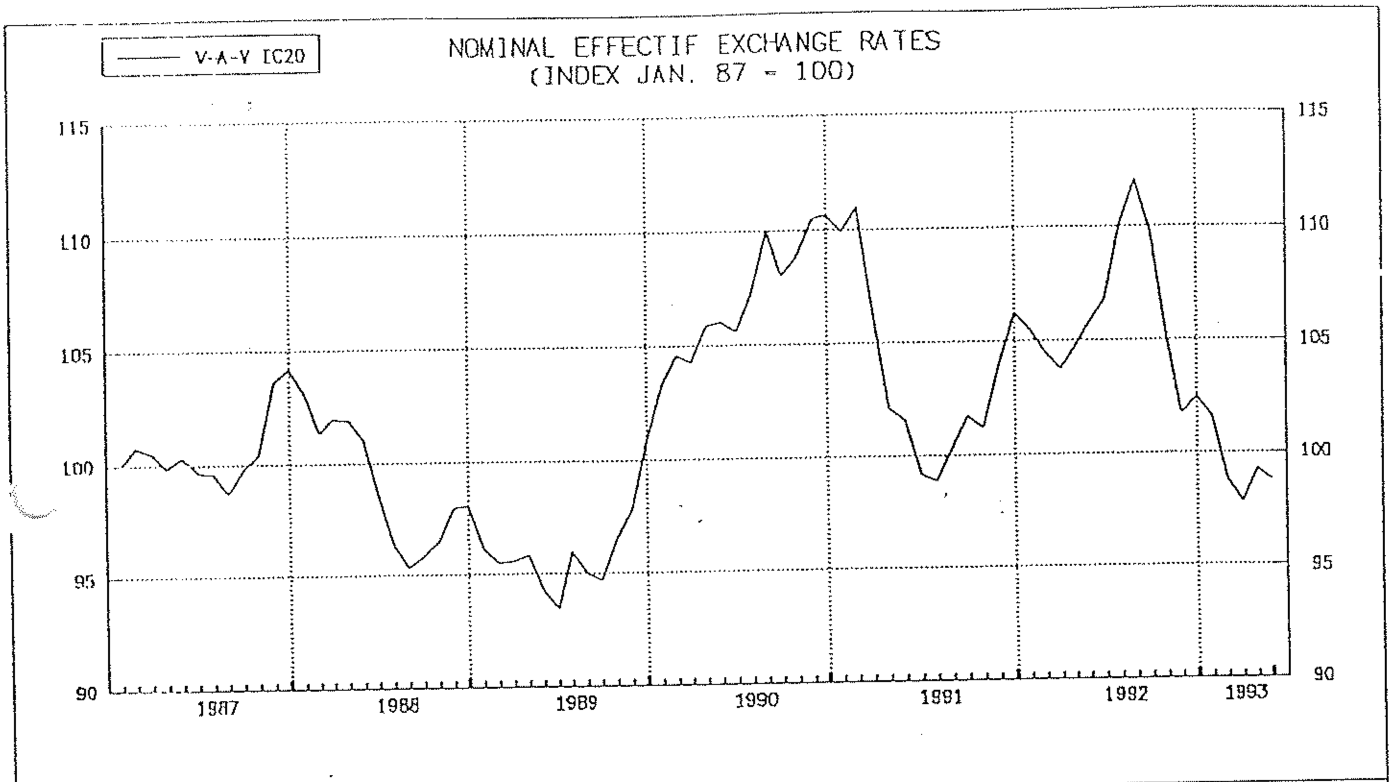
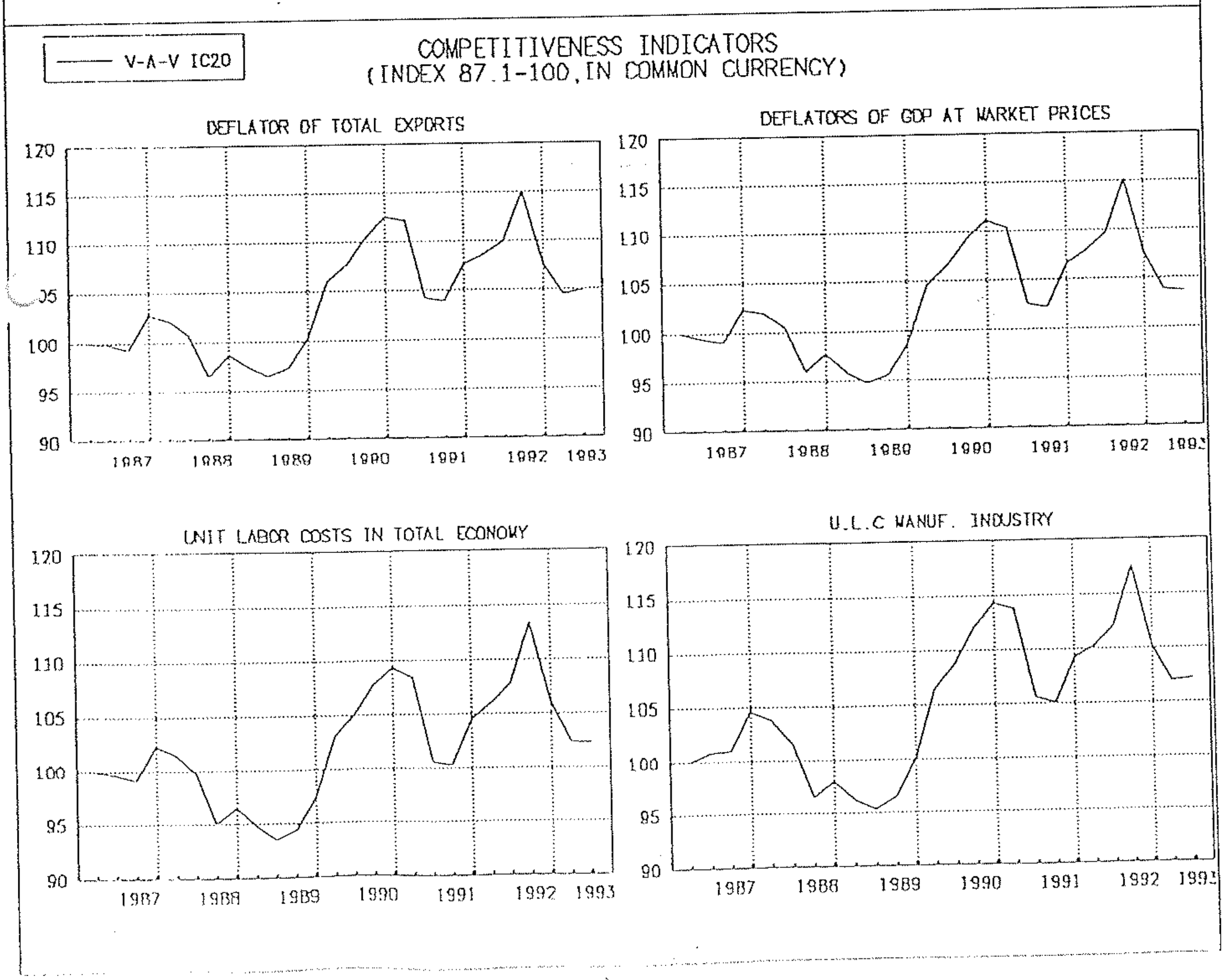
GRAPH 1

EFFECTIVE EXCHANGE RATES IN E12





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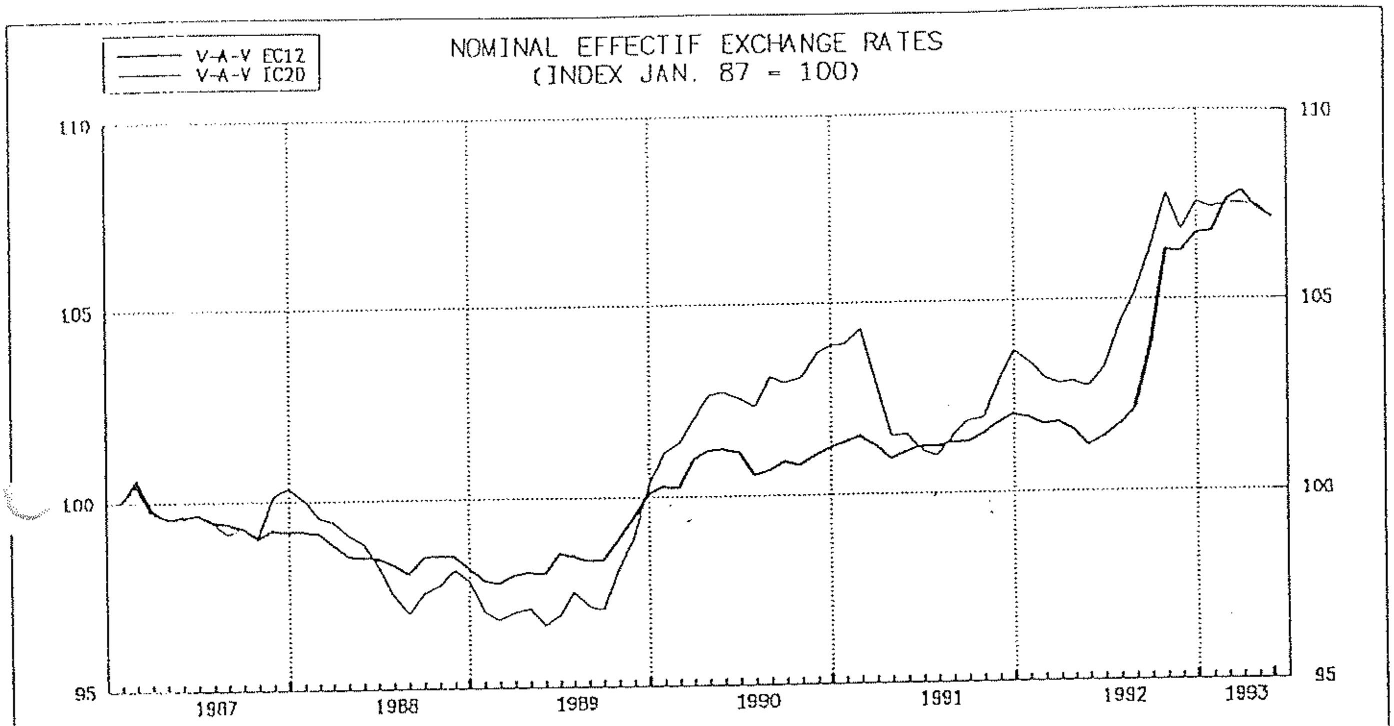
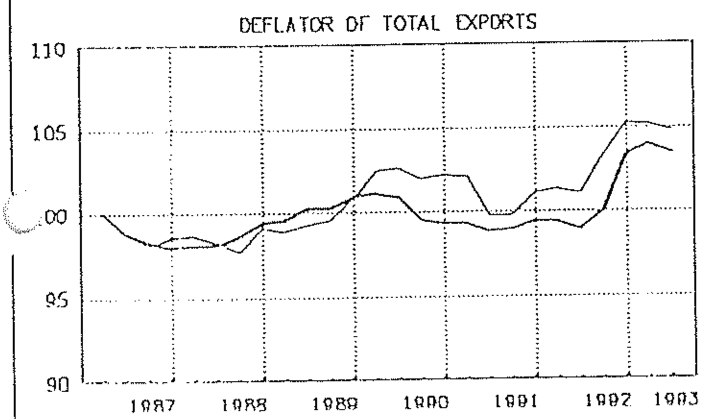
GRAPH 2

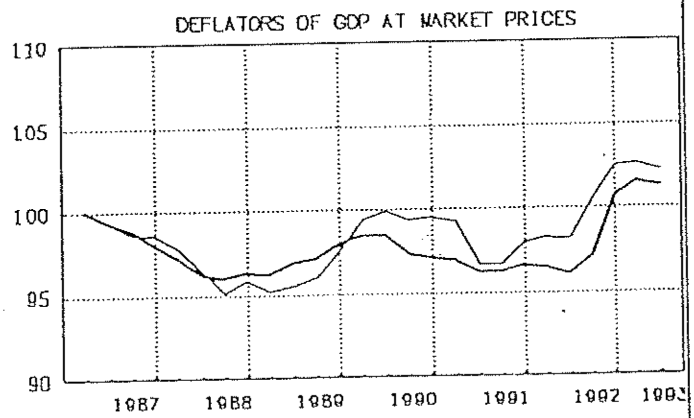
EFFECTIVE EXCHANGE RATES IN BELGIUM

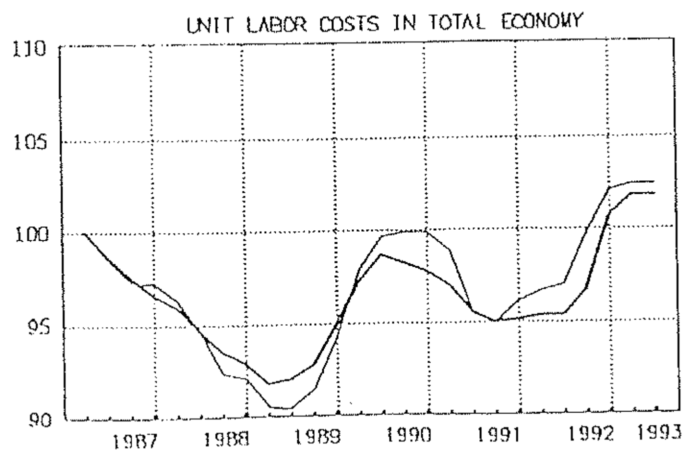


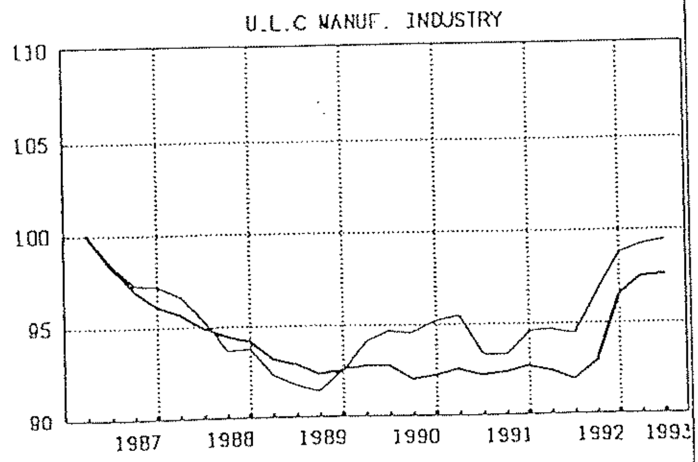
COMPETITIVENESS INDICATORS
(INDEX 87.1-100, IN COMMON CURRENCY)

V-A-V IC20
V-A-V EC12









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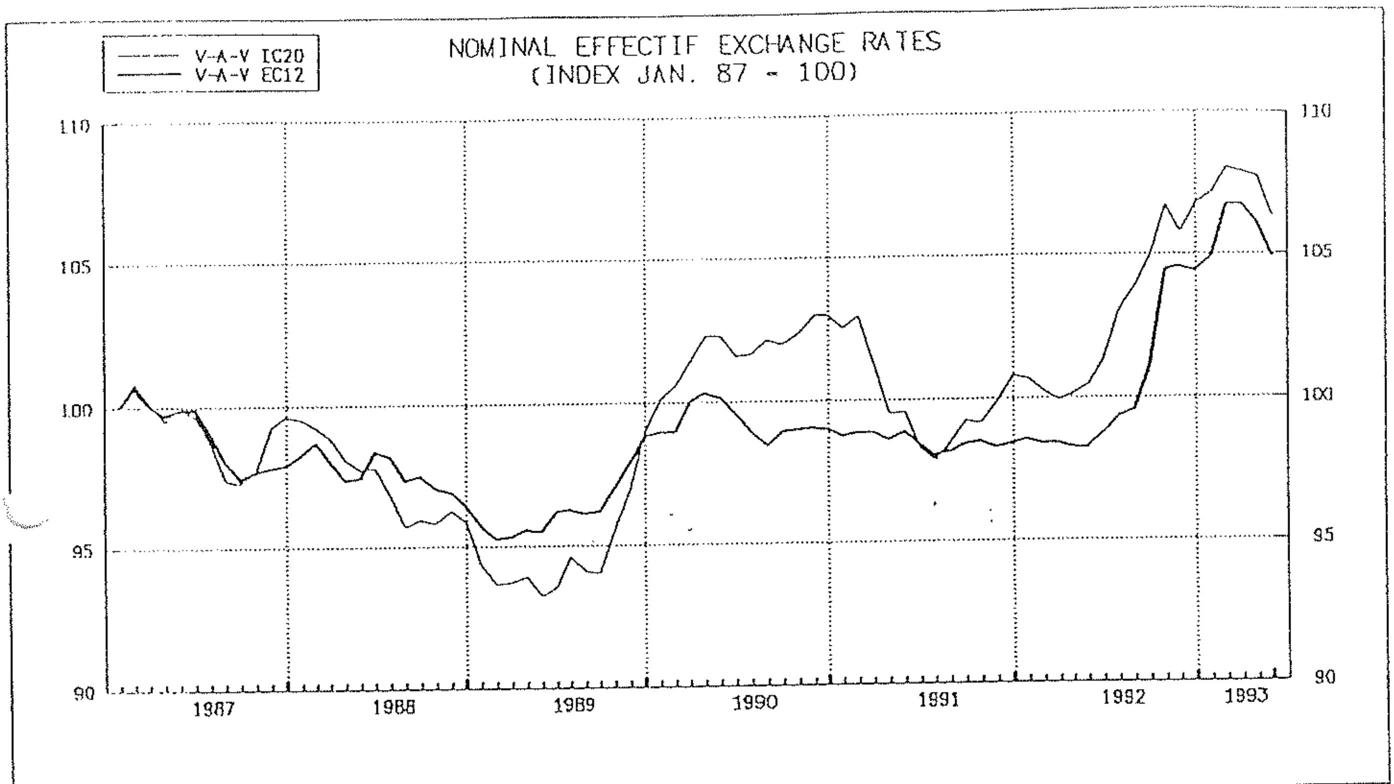
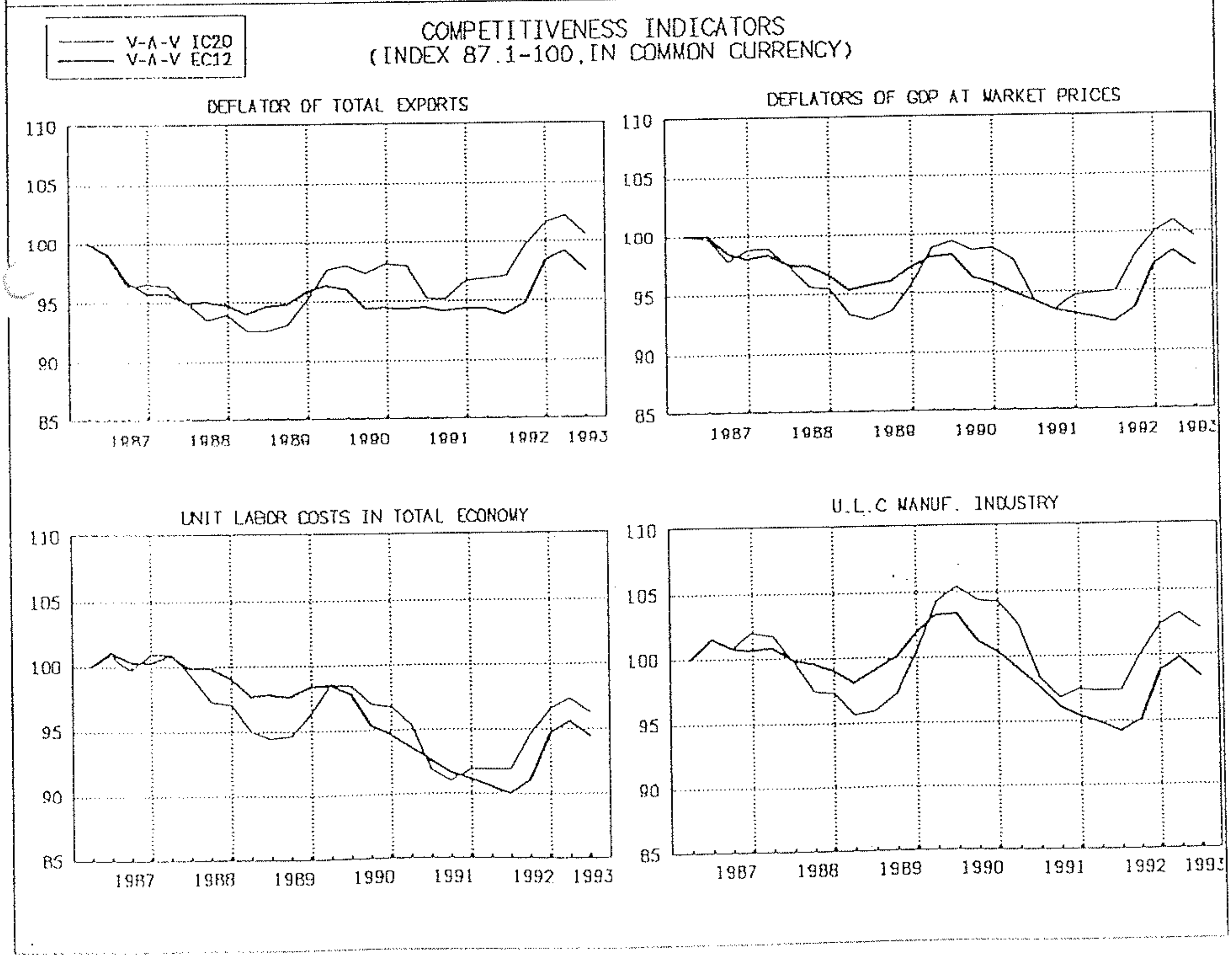
GRAPH 3

EFFECTIVE EXCHANGE RATES IN DENMARK





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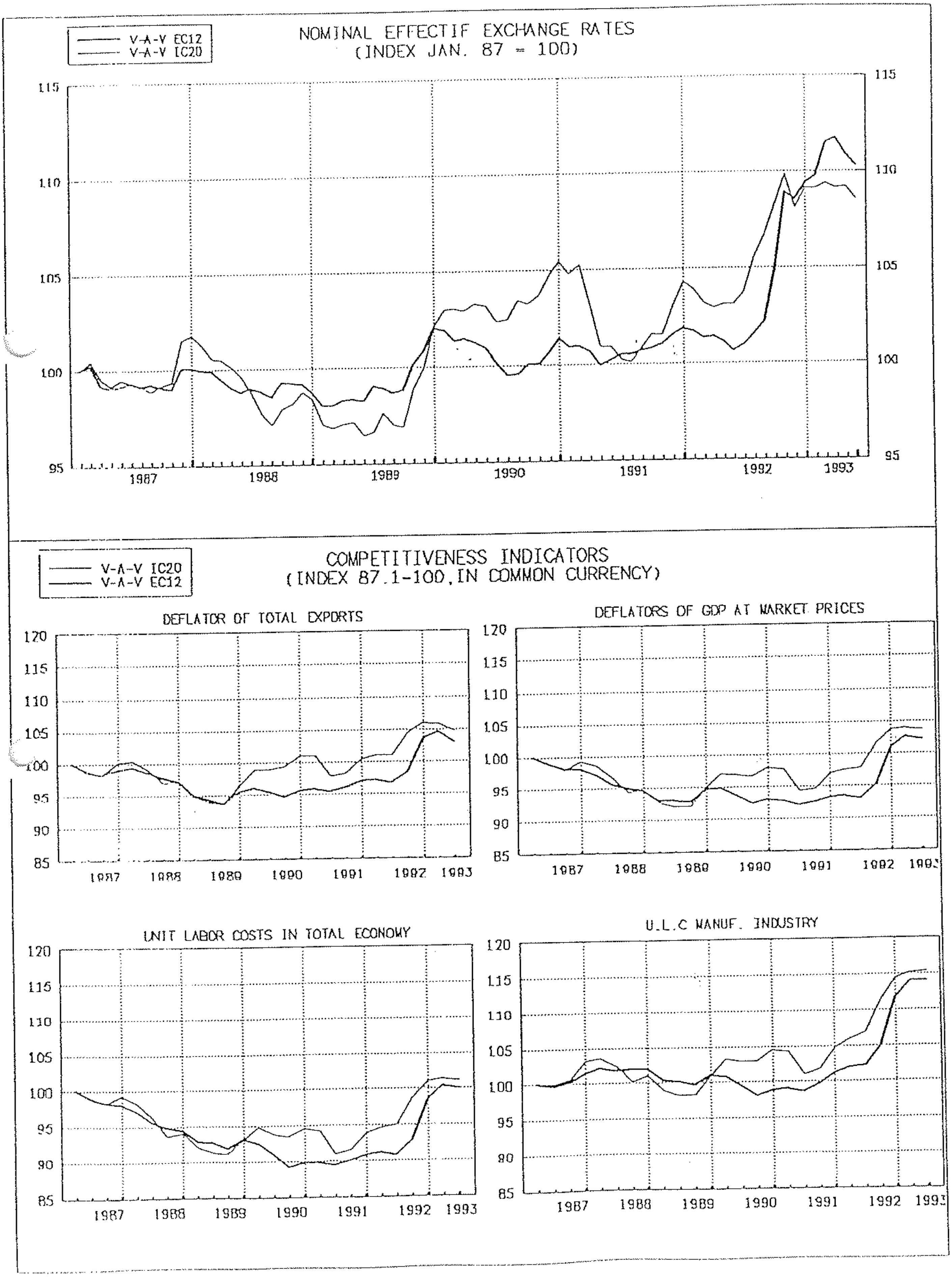
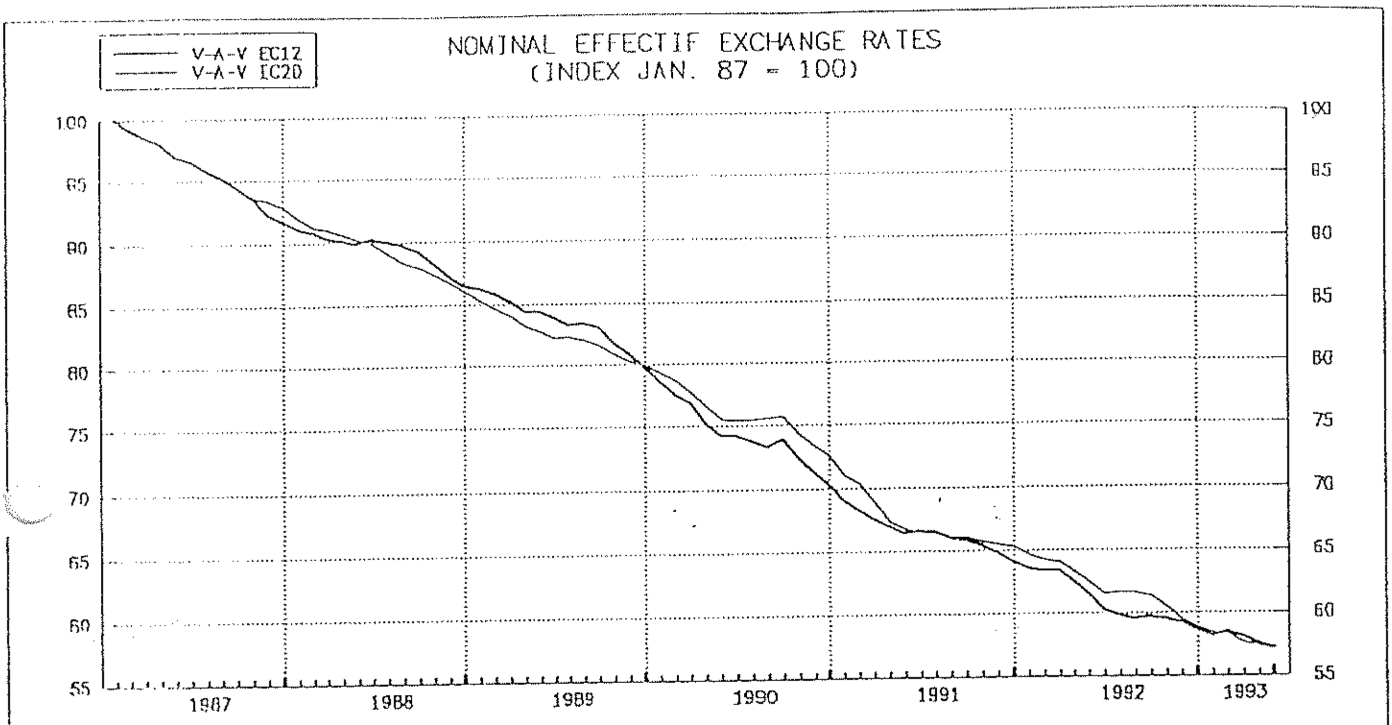
GRAPH 4

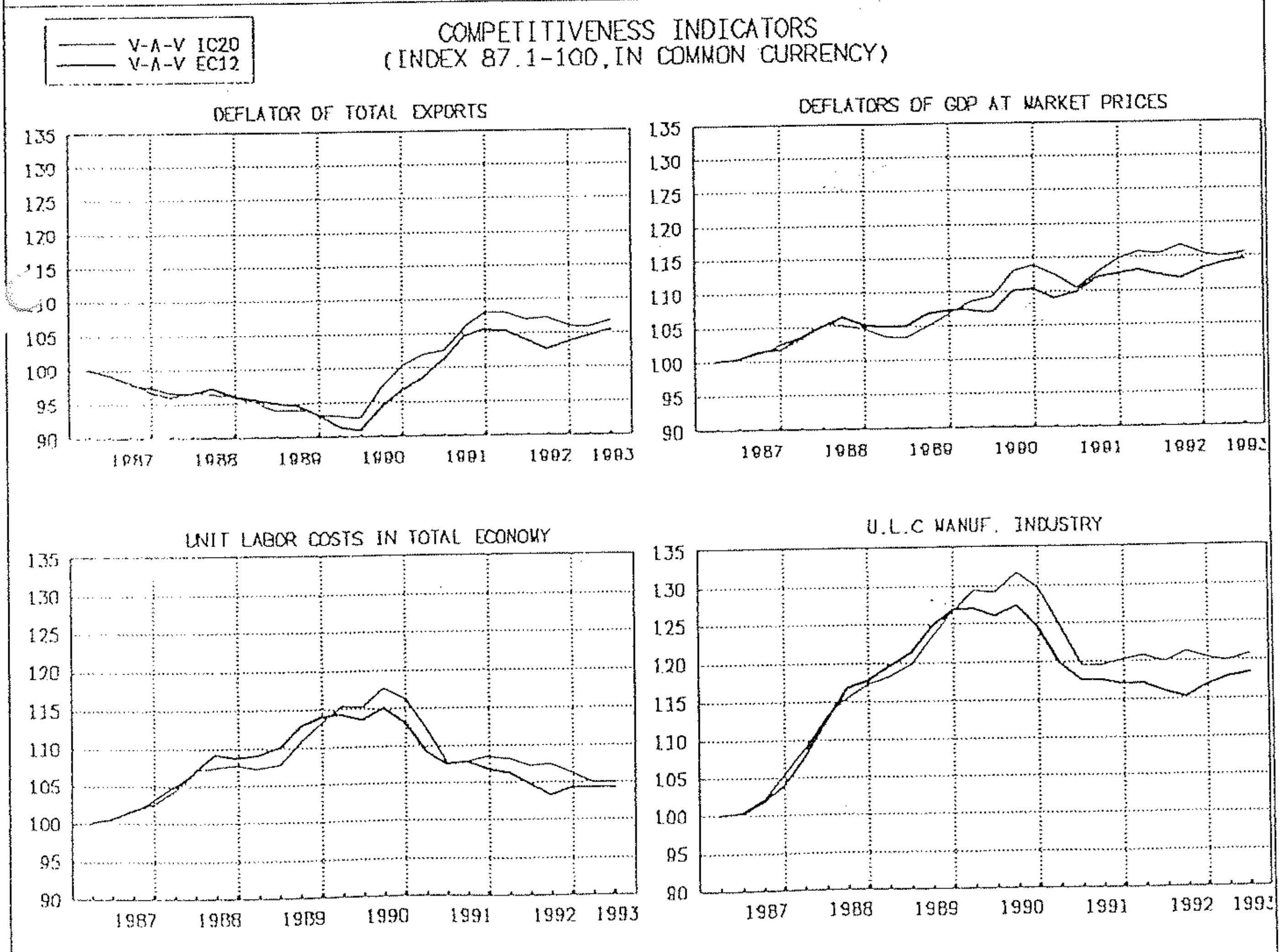
EFFECTIVE EXCHANGE RATES IN GERMANY



GRAPH 5

EFFECTIVE EXCHANGE RATES IN GREECE





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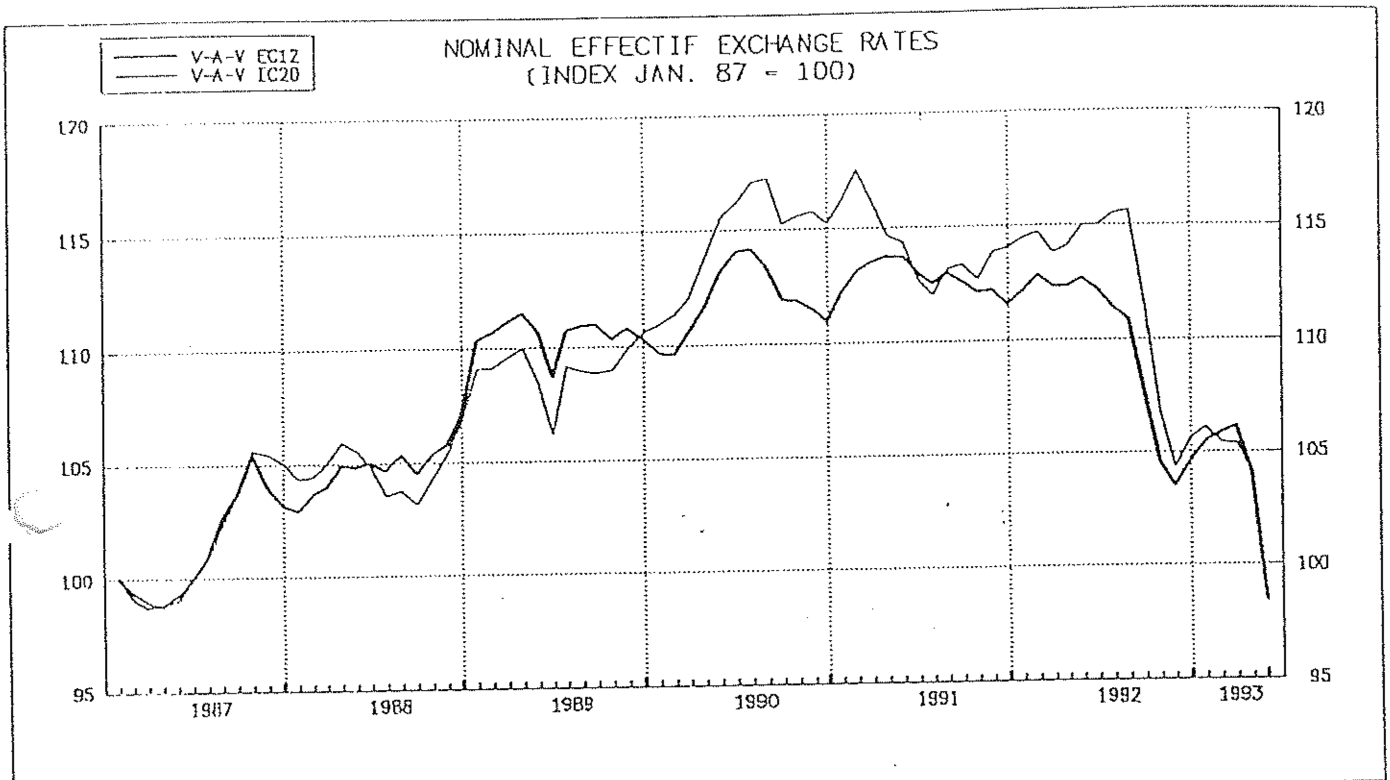
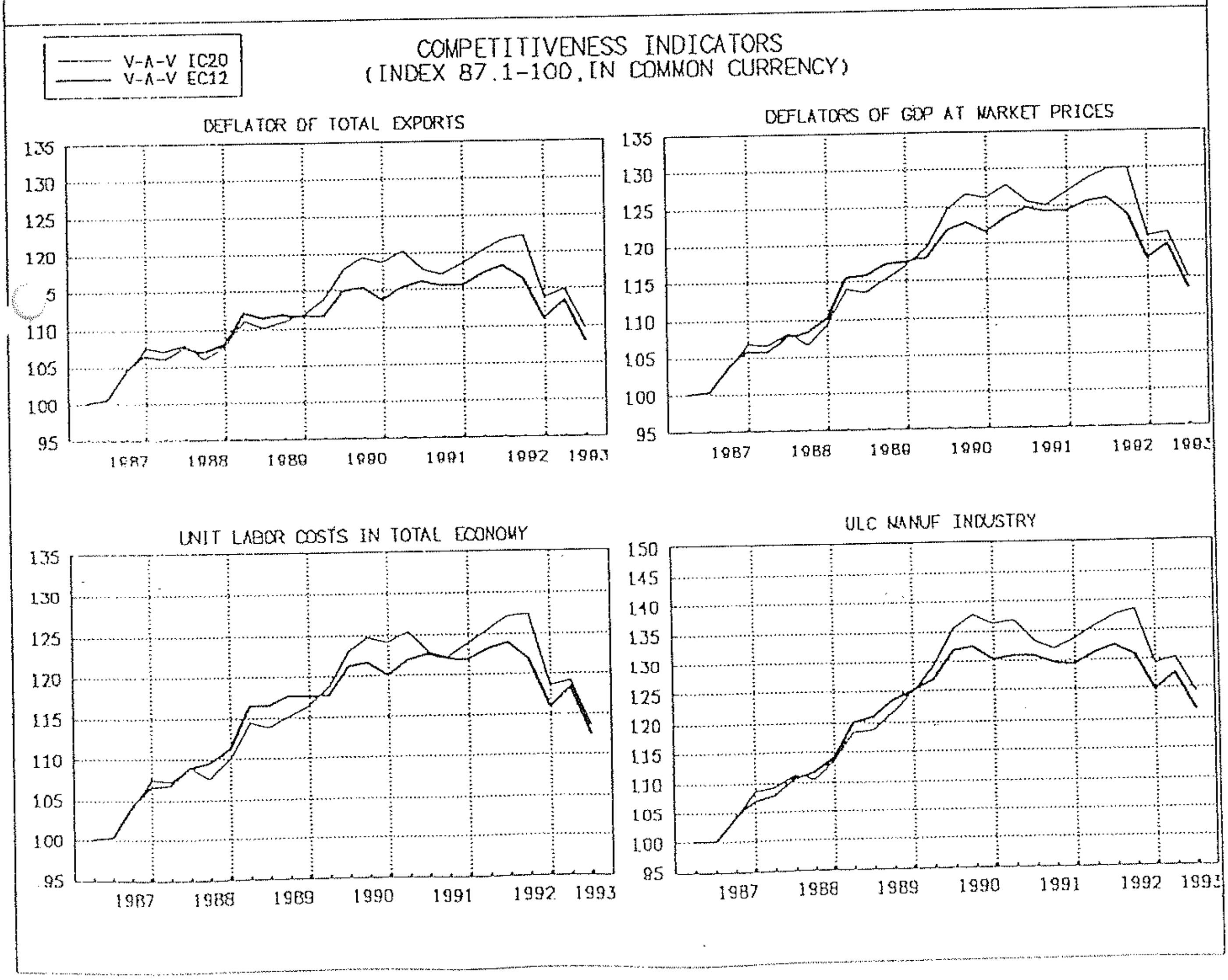
GRAPH 6

EFFECTIVE EXCHANGE RATES IN SPAIN





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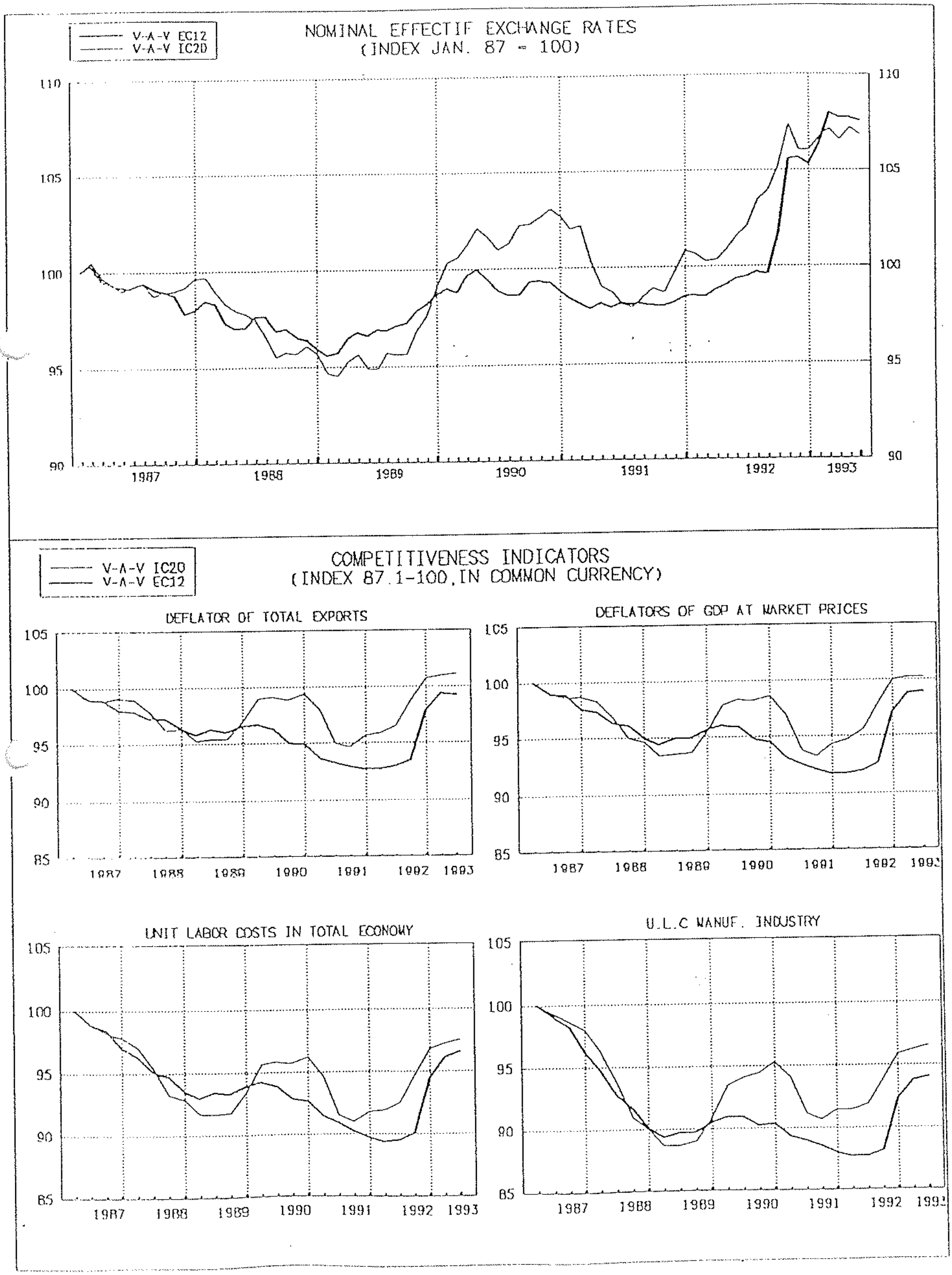
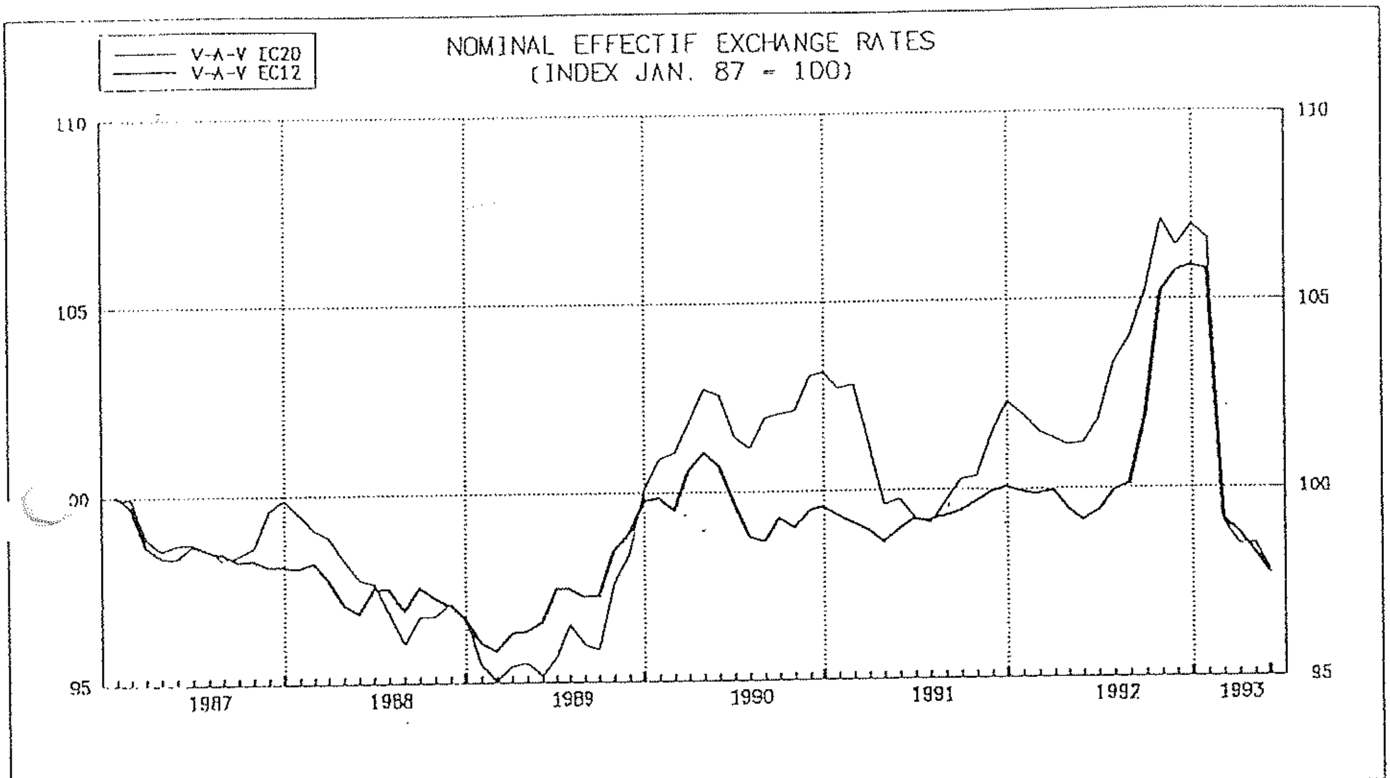
GRAPH 7

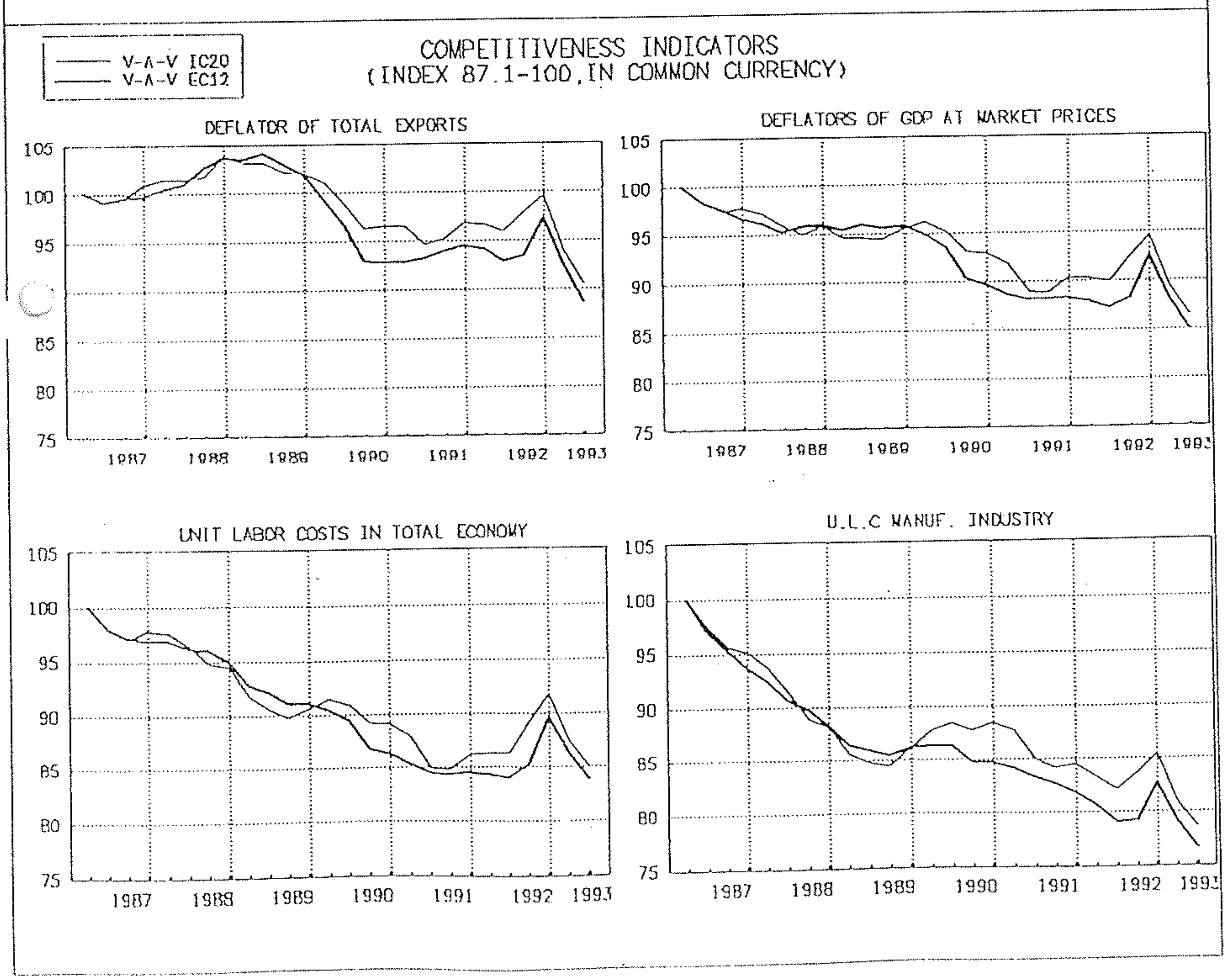
EFFECTIVE EXCHANGE RATES IN FRANCE



GRAPH 8

EFFECTIVE EXCHANGE RATES IN IRELAND





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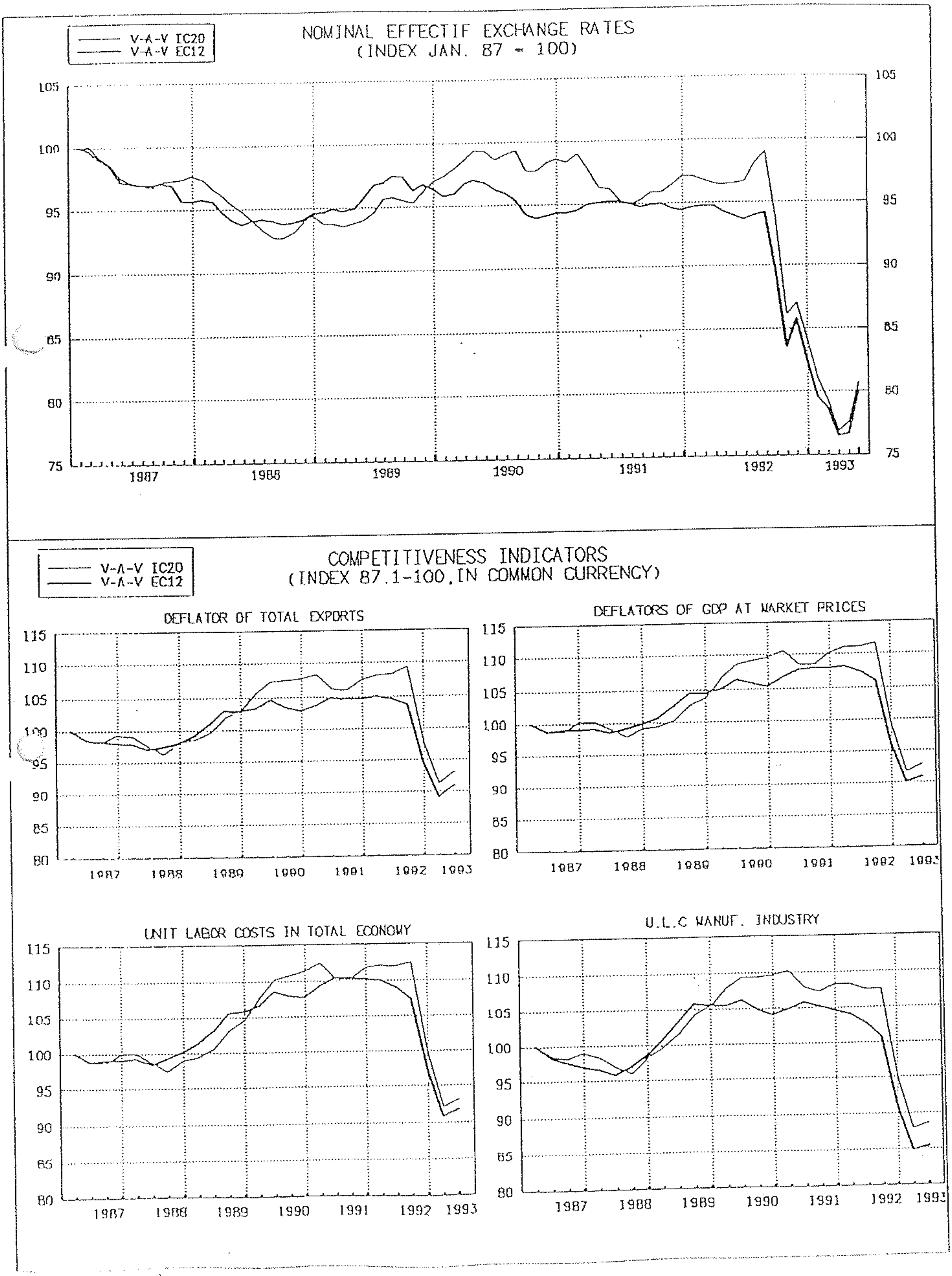
GRAPH 9

EFFECTIVE EXCHANGE RATES IN ITALY



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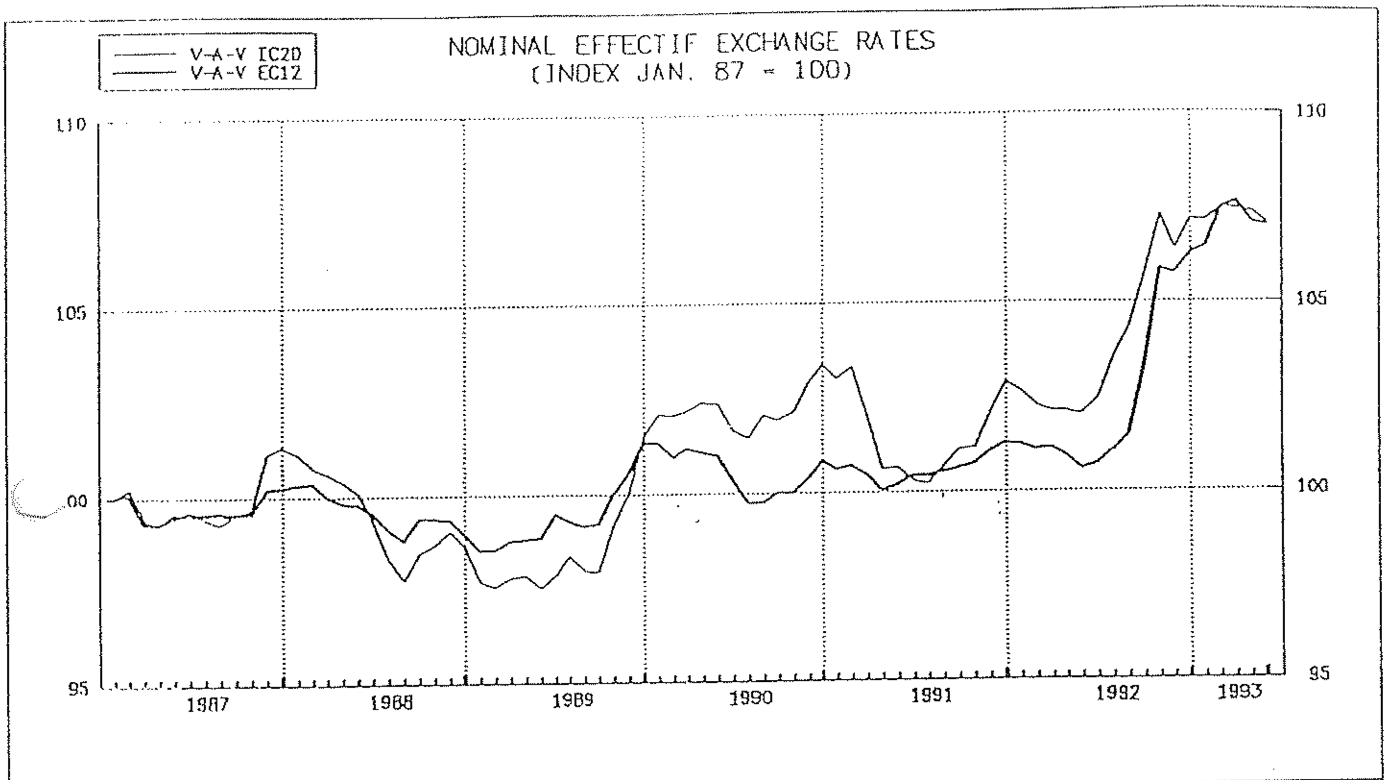
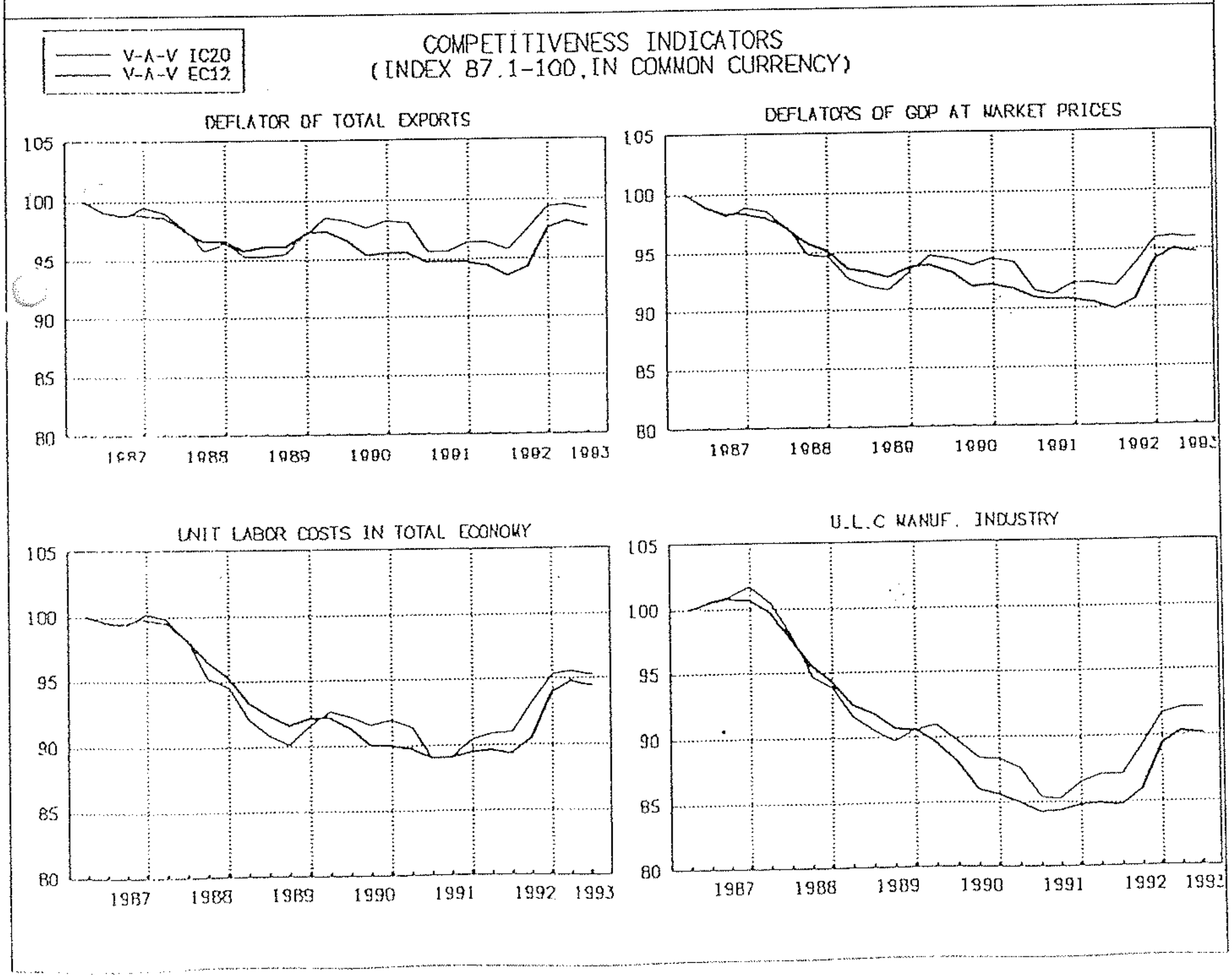
GRAPH 10

EFFECTIVE EXCHANGE RATES IN NETHERLANDS





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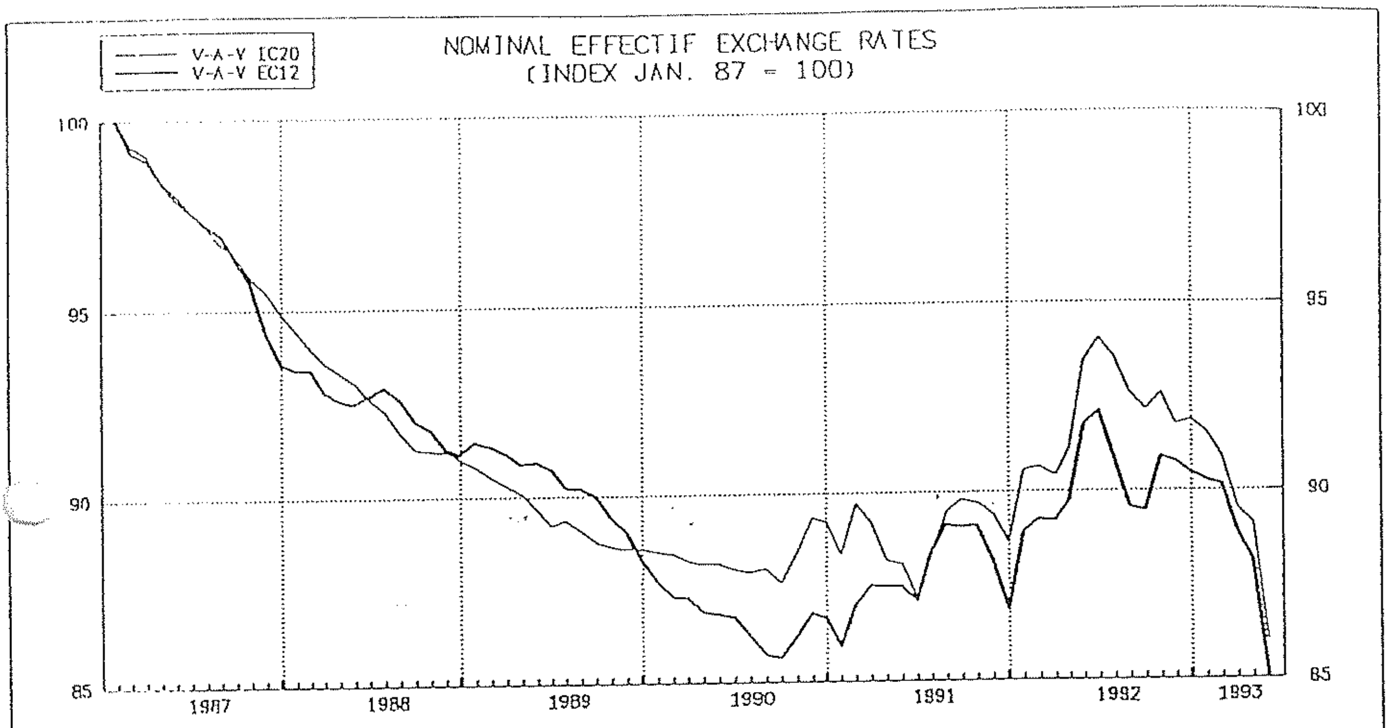
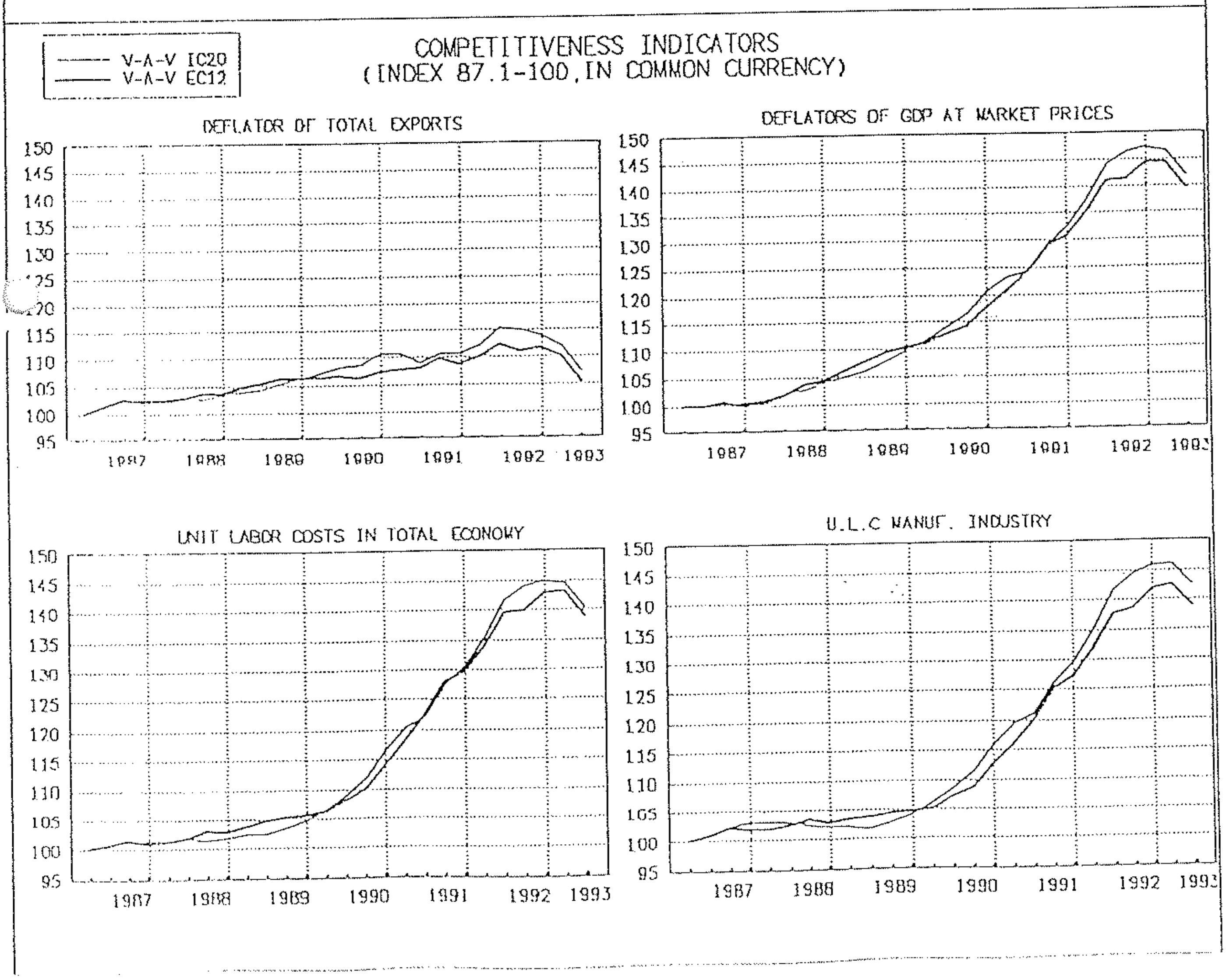
GRAPH 11

EFFECTIVE EXCHANGE RATES IN PORTUGAL





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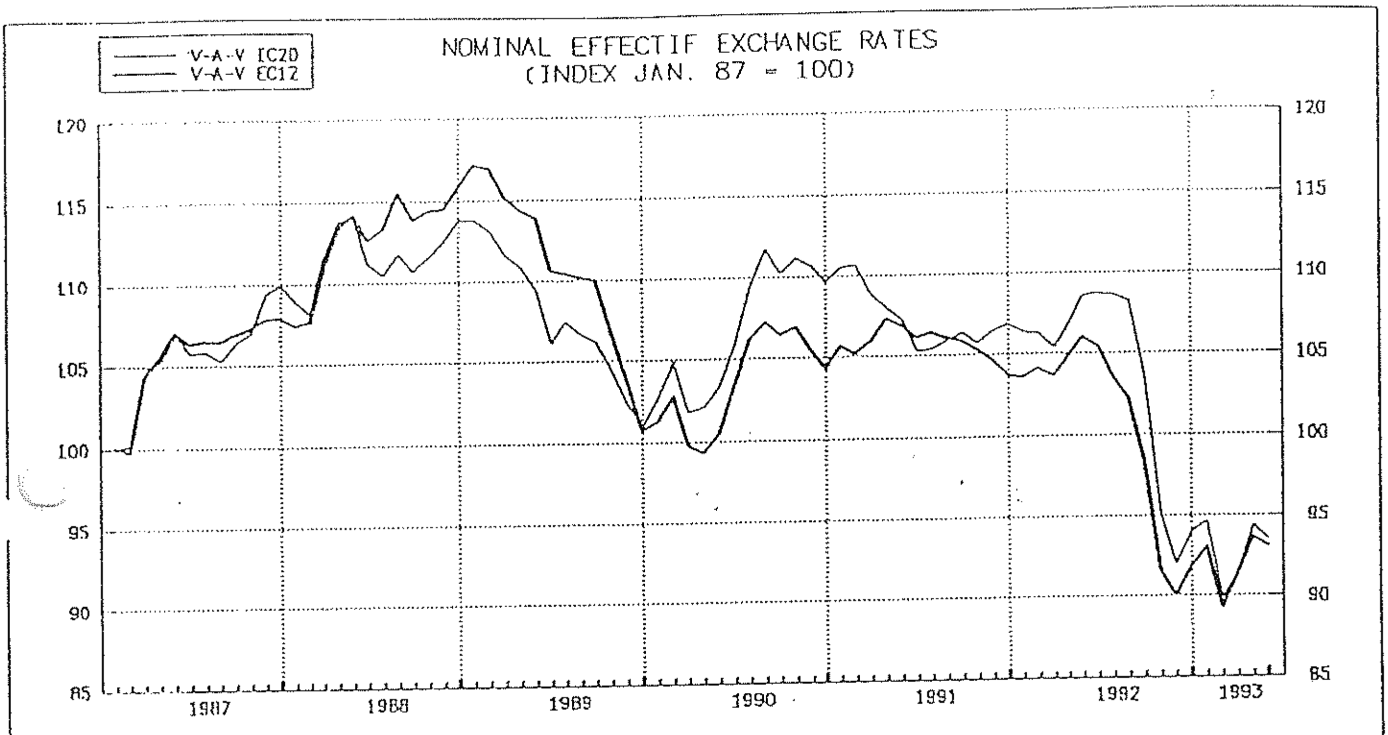
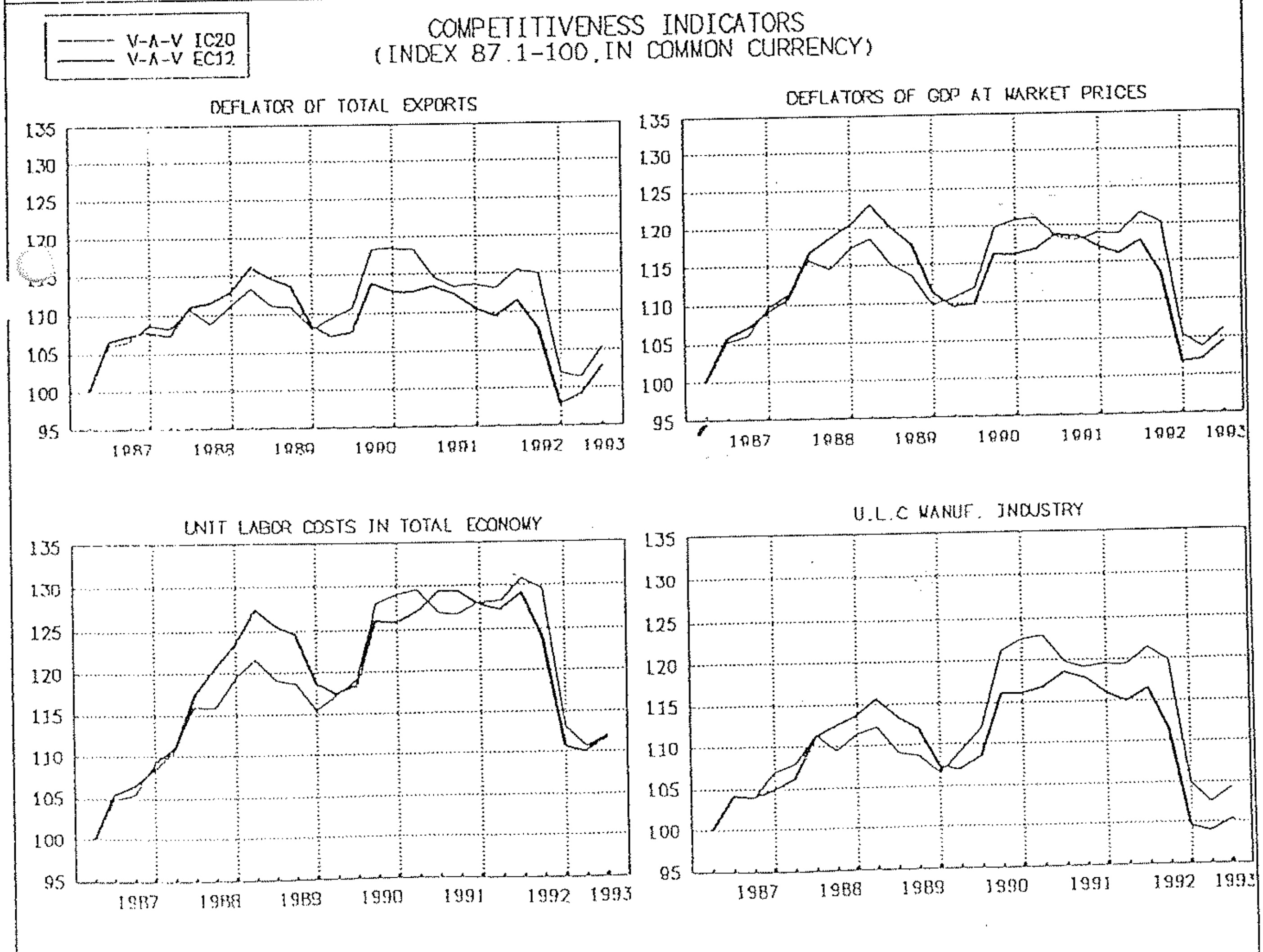
GRAPH 12

EFFECTIVE EXCHANGE RATES IN UNITED-KINGDOM





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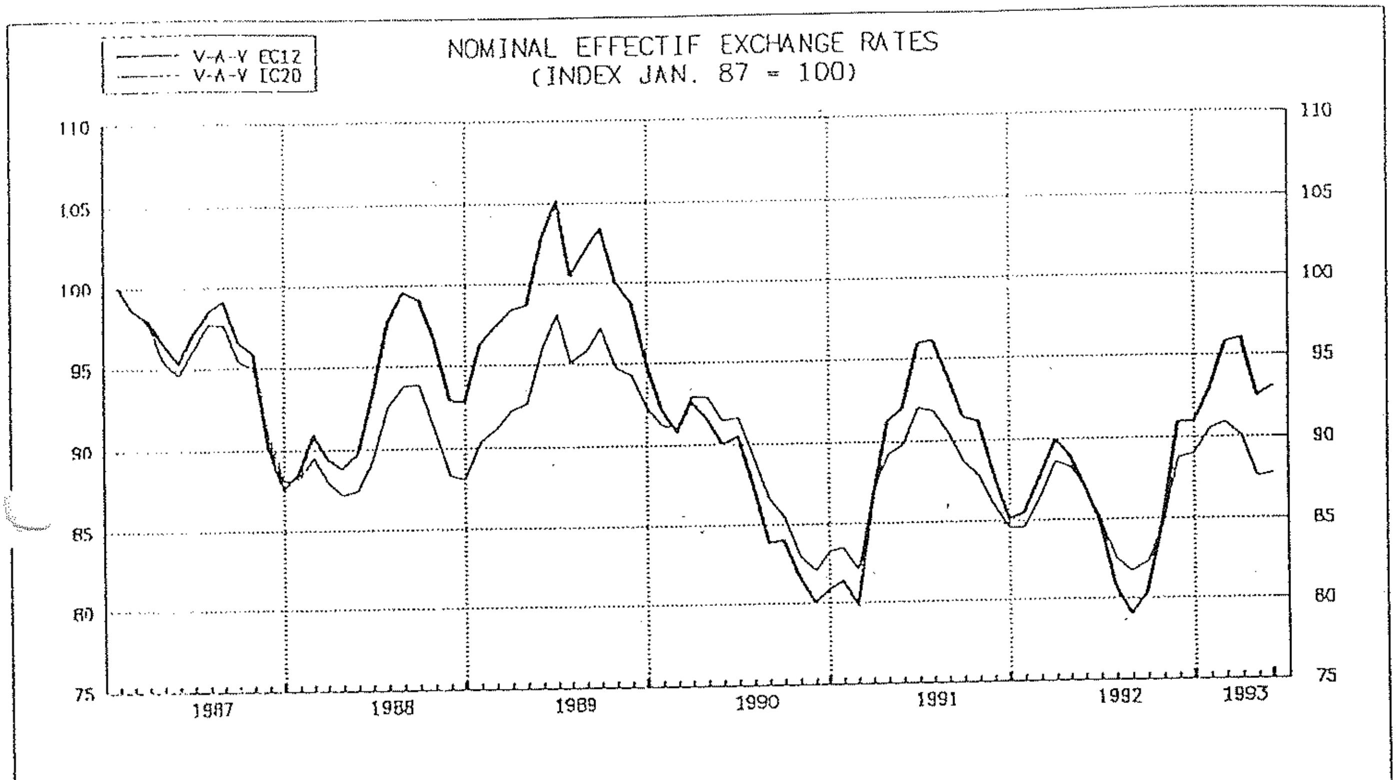
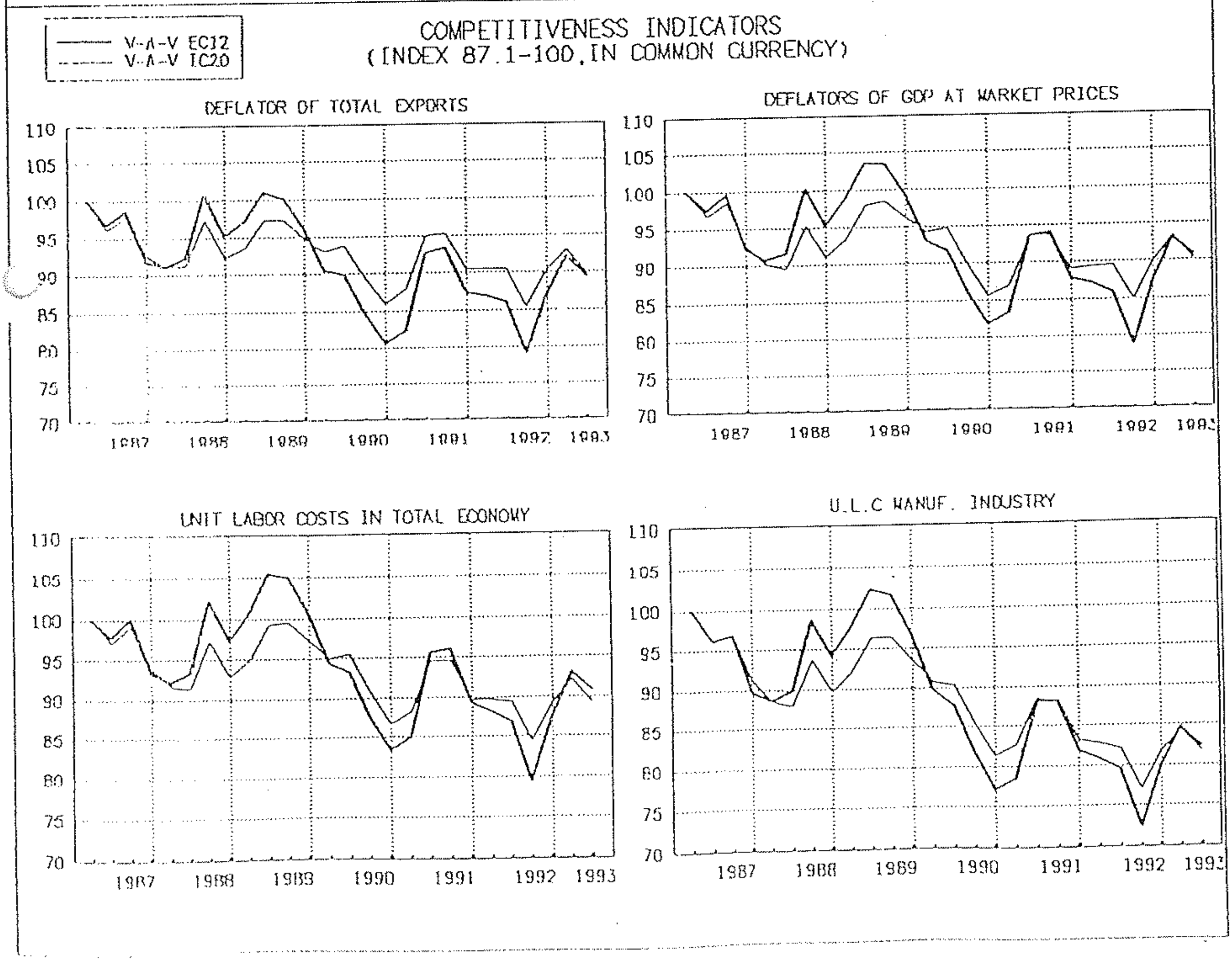
GRAPH 13

EFFECTIVE EXCHANGE RATES IN U. S. A.





II/D/3/YB - 1993/05/18

GRAPH 14

EFFECTIVE EXCHANGE RATES IN JAPAN