European Parliament

AT A GLANCE

Competitiveness Indicators in the Euro Area

This note provides an overview of competitiveness indicators in Euro Area Member States and their recent developments, mainly in relation to the Macroeconomic Imbalance Procedure (MIP).

Competitiveness of a country is a concept at the centre of the economic debate and policy recommendations, even if it has no unequivocal definition. Given its relative and complex nature, several different indicators have been proposed in the literature to measure it.

According to the MIP Regulation, the scoreboard used for the detection of macroeconomic imbalances should encompass *"[...]indicators which are useful in the early identification of external imbalances, including those that can arise from [...] changes in price and cost developments and non-price competitiveness, taking into account the different components of productivity*" (Article 4.3).

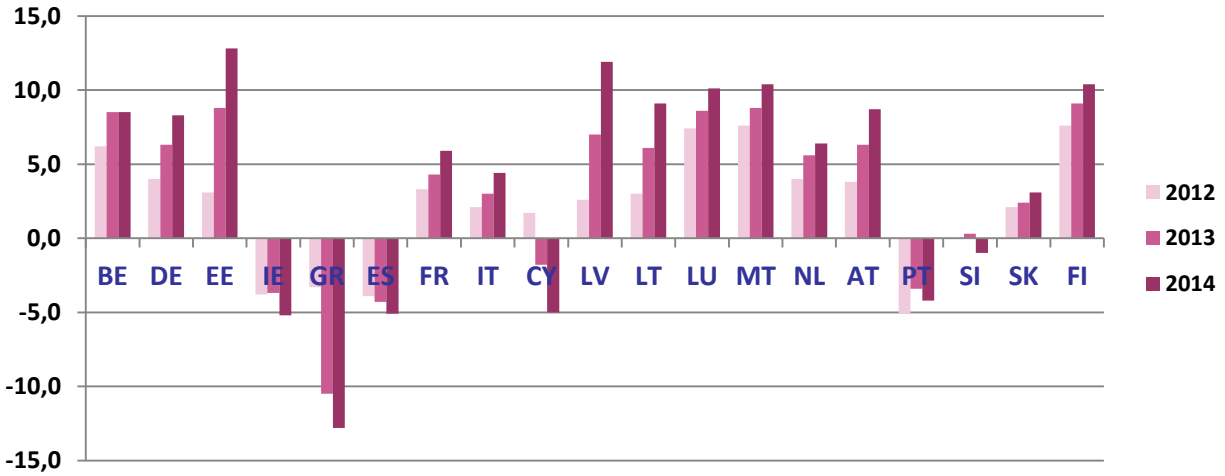
The indicators used in the MIP scoreboard to measure price and cost competitiveness (ability of firms to sell at low prices in international markets) are the **Real Effective Exchange Rate (REER)** and the nominal **Unit Labour Cost (ULC)**. In addition, the **Export Market Share (EMS)** accounts also for any factors of export developments other than cost and price. The rationales and methodologies of these indicators are detailed in a Commission's paper on the scoreboard.

The **REER** provides information on the changes in the prices of domestically produced goods, relative to those produced by relevant trading partners. It is the average of bilateral nominal exchange rates (weighted according to country's exports) deflated by an index of consumer prices. The MIP scoreboard reports the 3-year percentage change of the REER (with a threshold of ±5% for EA countries). As the nominal exchange rate is the same for all EA Member States, the REER is mainly affected by the geographical composition of exports and the inflation rate of the economies. High values of the REER signal a loss of competitiveness, whereas very low ones may point to problems related to domestic demand.

The **ULC** measures the average cost of labour per unit of output, and is computed as the ratio of nominal compensation per employee to real GDP per person employed. As such, it links the labour cost to productivity: a rise of ULC is then seen as the result of an increase in labour cost that is not compensated by a corresponding increase in labour productivity. A large and sustained growth of ULC may signal the deterioration of the cost advantage (or competitiveness position) of the economy, with possible negative impact on its trade account and its export market share. In the context of the MIP, the ULC indicator is defined as the percentage change over 3 years (with a threshold of +9% for EA countries).

Finally, the **Export Market Share** is defined in the context of the MIP as the percentage change of exports shares over total world export in the latest 5 years (with a threshold of -6%). Negative values indicate a loss in competitiveness.

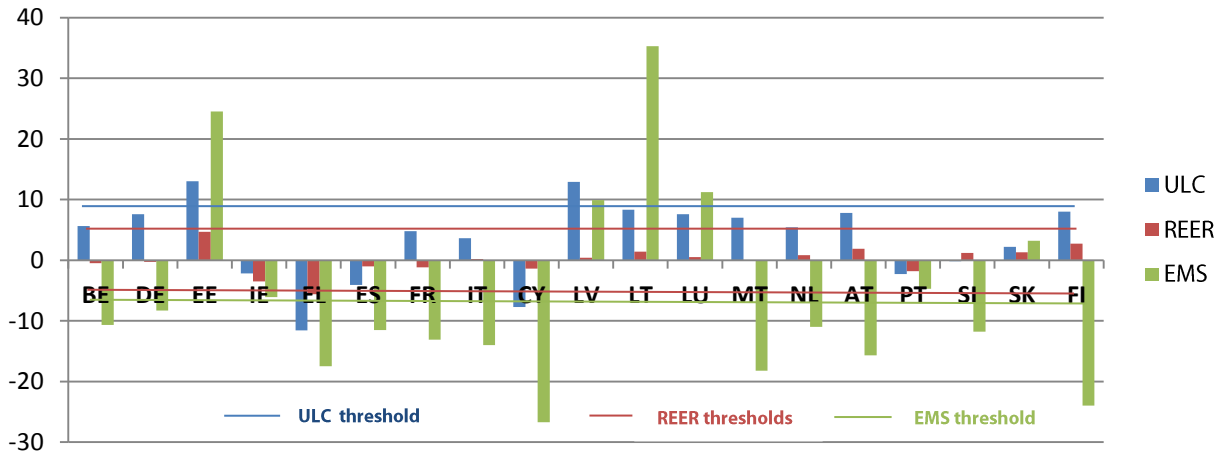
Graph 1: Unit Labour Cost in EA Member States, 2012-2014 (Index 2010=0)



Source: Eurostat, data retrieved on 1 February 2016

Graph 1 shows the developments of the ULC in Euro Area Member States: it can be noted that the indicator remained negative and/or continued to decrease in countries that were under financial assistance during the period 2012-2014 (Ireland, Greece, Spain, Cyprus and Portugal), with Slovenia being the only non-programme country where ULC decreased by 1 pp in 2014. In all other Member States this indicator showed positive and increasing trends (with the exception of Belgium, where it stabilized in 2014).

Graph 2: ULC, REER and EMS indicators according to the MIP scoreboard (values for 2014)

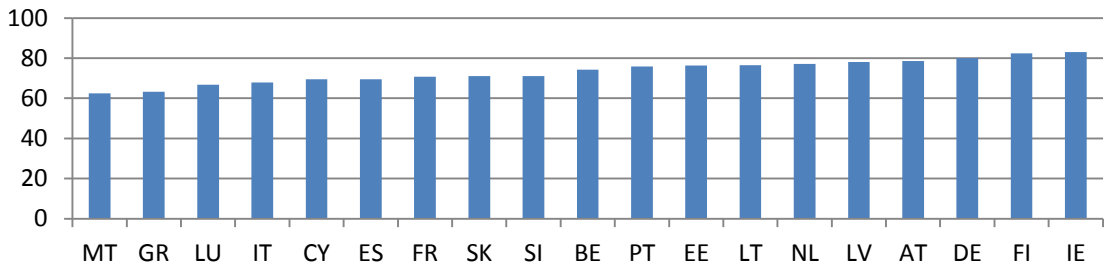


Source: AMR 2016

Graph 2 presents the three MIP indicators for competitiveness in the EA Member States. It shows that countries that experience increases in their exports are not those with decreasing ULC and/or REER.

Although competitiveness in the MIP is referred to at the macro-economic level, policy recommendations on competitiveness generally address the business environment in which individual firms operate. In fact, structural reforms are often called on to foster competitiveness by, *inter alia*, easing the entry of new firms in the market, or ensuring the correct functioning of the economy through efficient regulatory and judicial systems. In this context, the Doing Business Report of the World Bank comprises eleven dimensions measuring the easiness of establishing and running a business. In Graph 3, EA Member States are ranked according to the aggregate indicator for competitiveness, expressed on a scale from 1 to 100, the 100 representing the set of all the best practices across the entire sample of the countries in the Report.

Graph 3: Facility of Doing Business Aggregate Indicator: EA Member State in 2014*



Source: World Bank Doing Business Report 2015. *Data show a constant pattern over the past three years (2012-2014)

The graph seems to indicate that countries with high values of the indicator "facility of doing business" are not necessarily those with increasing export market shares or decreasing ULC and REER. The use of different competitiveness indicators in formulating policy recommendations should therefore take into account their respective specificities and limitations[1].

[1] The suitability of the ULC indicator is disputed by some economists, see for example: "A critique of Nominal and Real macro Unit Labour Costs as an indicator of competitiveness" by Merijn Knibb, June 2015.