Columnists

Free Lunch: Getting real about competitiveness

The economy is more complicated than some simple models allow

Martin Sandbu's Free Lunch

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Why is a wage cut supposed to be good for you again?

The longstanding joke about economists is that they see something work in reality then go about figuring out whether it can also work in a model. Some do things the other way round: they see something work in a model, then ask whether it also works in reality. If it doesn't, the best economists revisit their model. Others believe the model is right and the reality is wrong. And then there are those who don't even bother to check if it works in reality at all.

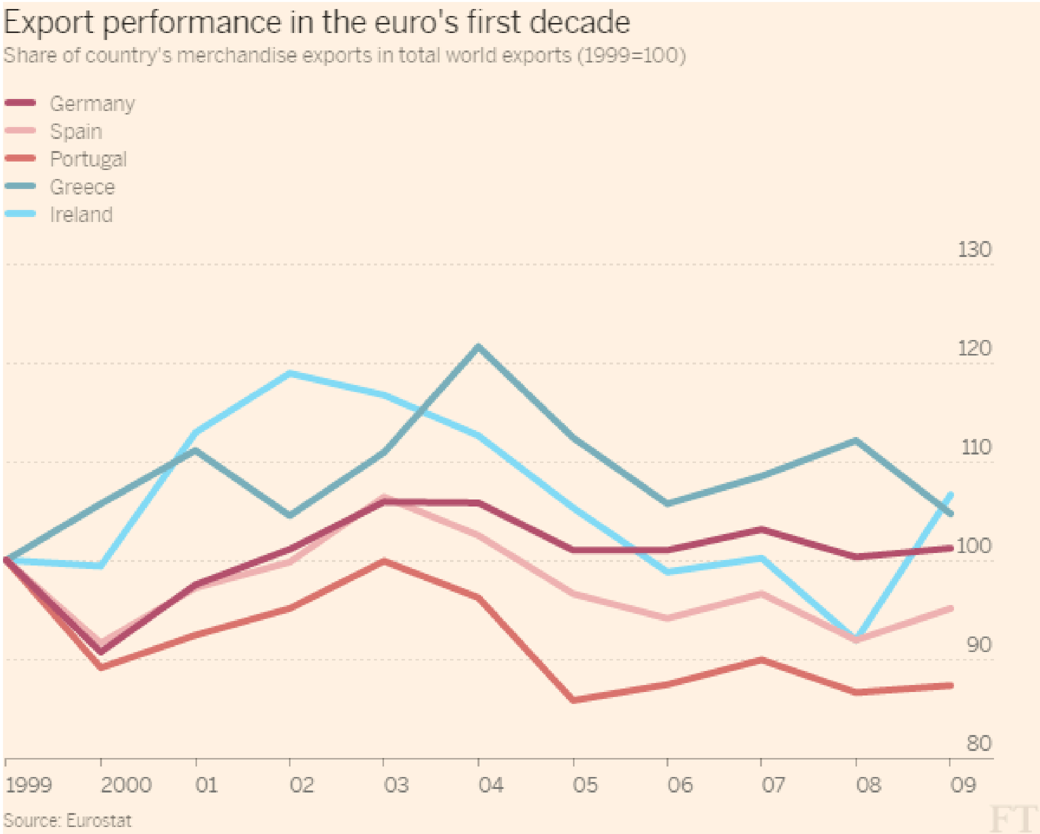
One longstanding model-inspired economic policy chestnut is the notion that a nation's prosperity depend on its international "competitiveness". In the past decade the competitiveness obsession has informed policy debate about the euro in particular. The euro had to fail, it is said, because locking in exchange rates forever makes it harder for economies that lose competitiveness to adjust so that they end up consuming more than they produce and stay at the mercy of fickle foreign capital inflows.

This is the conventional account of what went wrong with Greece and other eurozone peripheral states that racked up large trade deficits before the crisis. If they cannot adjust their exchange rate, their only choice is a painful process of driving down nominal wages, a so-called internal devaluation, to regain competitiveness. This sort of analysis is exemplified, for example, in Joseph Stiglitz's new book-length critique of the euro (http://next.ft.com/content/a84ae368-5a2e-11e6-9f70-badea1b336d4), but paradoxically also by those he criticises, who say that (within the euro) there is no alternative to pushing down wages (http://next.ft.com/content/64eb75a6-57cd-11e5-9846-de406ccb37f2) or more precisely unit labour costs.

There are many problems with this view, both in the model itself and in its fit (or rather lack thereof) with reality.

First, as Paul Krugman taught us (https://www.foreignaffairs.com/articles/1994-03-01/competitiveness-dangerous-obsession) all more than 20 years ago, it makes little sense to apply the concept of competitiveness to countries, which can't go out of business, unlike companies, which can. National prosperity depends not on competitiveness but on productivity.

Second, the word competitiveness focuses our attention on tradeable sectors, as in "export competitiveness". Non-tradeable goods and services, after all, do not compete internationally. There is a widespread belief the peripheral eurozone countries priced their exports out of global markets and that this is what made their external deficits widen. In fact (https://www.ecb.europa.eu/home/pdf/research/compnet/policy_brief_2_export_performance_and_composition_of_ulc_growth.pdf) the exports of these countries held up just as well as those of Germany during the euro's early boom years, and for good reason: costs did not particularly run away in tradeable sectors. The large cost increases were in non-tradeable sectors, and the deficits were racked up by import booms, not export erosion.



Third, competitiveness is often treated as measured by how low "unit labour costs" are — the total compensation paid to workers for a given quantity of production. But it is misleading to apply unit labour costs to whole economies rather than individual sectors. It is meaningful to examine the labour compensation involved in producing one car, for example, but what is the labour compensation involved in producing one unit of gross domestic product? It boils down to labour's share of economic output. The theoretical abuse of applying the unit labour cost concept at the whole-economy level camouflages the capital-labour distributive conflict (http://www.levyinstitute.org/publications/unit-labor-costs-in-the-eurozone) in the language of efficiency.

Be that as it may, those misconceptions might be unimportant if it were empirically true that pushing down labour costs boosts employment and thereby prosperity in crisis-hit economies. In such circumstances, a policy focus on regaining competitiveness — through wage cuts when exchange rates are fixed or unified — could be optimal. But as Jordi Galí and Tommaso Monacelli show in a new paper, a realistic model of the economy suggests that wage flexibility can be counterproductive (http://www.nber.org/papers/w22489), above all inside a currency union.

Galí and Monacelli show that when wages and prices do not respond to economic changes simultaneously and instantaneously, more flexible wage-setting boosts employment largely when monetary stimulus reacts to falling wages by increasing aggregate demand. Even when this happens, the gain in wellbeing is damped by the cost of more unpredictable and volatile wages. But most importantly, when monetary policy does not respond to wage falls, greater wage flexibility can lead to less economic prosperity.

Fourth, then, competitiveness in the form of downwardly more flexible wages is not a substitute for competitiveness in the form of a falling exchange rate (which already does not always live up to (http://next.ft.com/content/89d328ba-0541-11e6-9b51-0fb5e65703ce) its positive billing). On the contrary, they are complements: wage flexibility can act as a stabiliser in an economy that sets monetary policy without regard to the exchange rate; but in a currency union more flexible wages can make things worse. But the model also shows that to the extent *product* prices are made more flexible too, the negative impact of wage flexibility can be mitigated or even turned positive.

The policy implications of this analysis are considerable. They undermine the core of the eurozone policy programmes shared by the European Commission, the European Central Bank and the International Monetary Fund, to the extent these focus on labour market liberalisation designed to make wages more flexible.

If any structural reforms ought to be prioritised, it is *product* market reforms that would make goods and services cheaper — as the IMF's own research department has been arguing for years (http://next.ft.com/content/41352a16-011f-11e6-ac98-3c15a1aa2e62). It also means that aggregate demand stimulus is crucial to ensure that any increase in wage flexibility has a positive rather than a negative effect. In the eurozone, that means greater leeway for fiscal deficit spending in a recession, debt restructuring to make such deficit spending more possible and more effective (http://voxeu.org/article/fiscal-multipliers-and-fiscal-positions-new-evidence), and banking policy, again including restructuring, that restores credit flow to damaged economies.

All, in fact, policies the eurozone's political leaders are free to enact today.

Other readables

- The Freakonomist does it again (http://www.nber.org/papers/w22487). Steven Levitt asks people to toss a coin for advice about whether to make big life changes. Those whose coin toss comes down for change are both more likely to make the change in question, and are happier as a result.
- For those who haven't kept up with the productivity debate, John Cassidy usefully rounds up all the main points (http://www.newyorker.com/news/john-cassidy/the-great-productivity-puzzle) in a short article.

Numbers news

- Japan's industrial production does better than expected (http://next.ft.com/content/da1daf2c-5924-38ba-8a96-d04559269222), but the economy as a whole is standing still (http://next.ft.com/content/4059800e-c08b-37da-a118-5c7402eb16dc).

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