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EUROPEAN ECONOMIC PERSPECTIVES

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Europe's Shifting Competitive Landscape

In the run-up to the (European Monetary Union), it was argued that countries with high-inflation pasts would find it very difficult to prosper in a monetary union with low-inflation countries such as Germany. With devaluation ruled out, countries failing to control labour costs would face a deterioration in cost competitiveness and a painful period of economic adjustment.

For much of the last five years, these fears have been misplaced. Germany has been the weakest growing member of the euro area, and former high-inflation economies have tended to outperform. There are a number of reasons for this. First, as a result of the competitiveness lost following reunification in the early 1990s, Germany entered the monetary union with an overvalued exchange rate. This helped mask the deterioration in competitiveness in other euro-area countries during the early years of EMU.

Second, short-term interest-rate convergence meant that countries with high-inflation pasts received a substantial growth bonus when they entered EMU. Moreover, as these countries still tend to have higher inflation than the euro-area norm, they continue to benefit from lower real interest rates than in low-inflation countries such as Germany.

Recent data suggest that the balance of power within the euro area is beginning to change. Germany has now recouped all of the competitiveness lost against the rest of the euro area in the first half of the 1990s. If this is true, then other euro-area countries must be losing cost competitiveness.

Display 1 shows the change in relative whole-economy unit labour costs since the fourth quarter of 1998 for the major euro-area countries. It shows that Germany's intra-euro-area competitive position has improved markedly and that there has been a modest improvement in France. In most of the other euro-area countries, there has been a deterioration in cost competitiveness.

The biggest deteriorations in competitiveness have taken place in the Netherlands and Portugal. The result has been that both countries have moved from the top to the bottom of the euro-area growth league. Both the Netherlands and Portugal experienced severe recessions in 2003 and look set to be among the weakest-growing euro-area economies this year.

Spain and Italy have so far experienced more modest rises in their real exchange rates. However, both countries continue to shed competitiveness. Eurostat data for the first half of 2004 show whole-economy wage costs up 1.5% year over year in Germany, 2.5% in the euro area as a whole, 3.3% in Italy and 4.8% in Spain.[1]

This loss of competitiveness may be starting to have an impact in Spain. In the second quarter of 2004, external demand knocked 1.3 percentage points off Spanish economic growth. Moreover, growth itself moved sideways at 2.6% year over year. With euro-area growth rising to 1.9%, the growth differential between Spain and the euro area has narrowed sharply **(Display 2)**.

Italian economic growth has averaged just 1.4% per annum over the last five years, almost as low as in Germany (1.2%). This poor performance has, in part, been due to a significant drop in export market share **(Display 3)**. While this mainly reflects Italy's reliance on sectors that are vulnerable to low-cost competition from Asia, a deterioration in intra-euro-area cost competitiveness can only add to Italy's woes.

Conclusions

Economic growth within the euro area has varied widely in recent years. Germany has generally been the weakest-growing economy, with former high-inflation countries tending to outperform. However, many of these countries have now experienced a loss of cost competitiveness, especially against Germany. Prior to monetary union, this loss of competitiveness

[1] Spanish labour cost growth is for the first quarter only.

would have been resolved by currency realignment. Within EMU, it is likely to require a painful period of economic adjustment. This is already happening in the Netherlands and Portugal, and Spain may soon endure a similar fate. For Italy, an erosion of cost competitiveness is likely to compound a difficult outlook. Finally, in Germany an improvement in intra-euro-area competitiveness points to a brighter outlook, especially for the corporate sector.

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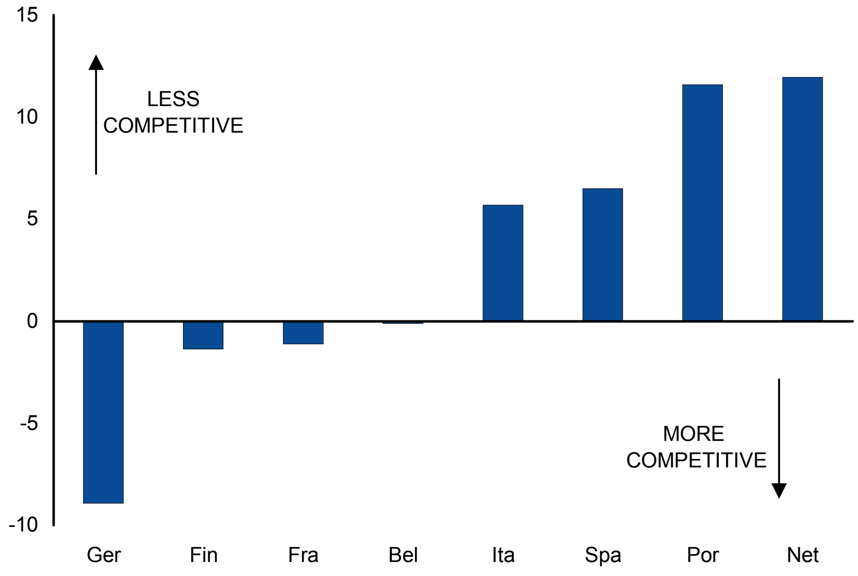
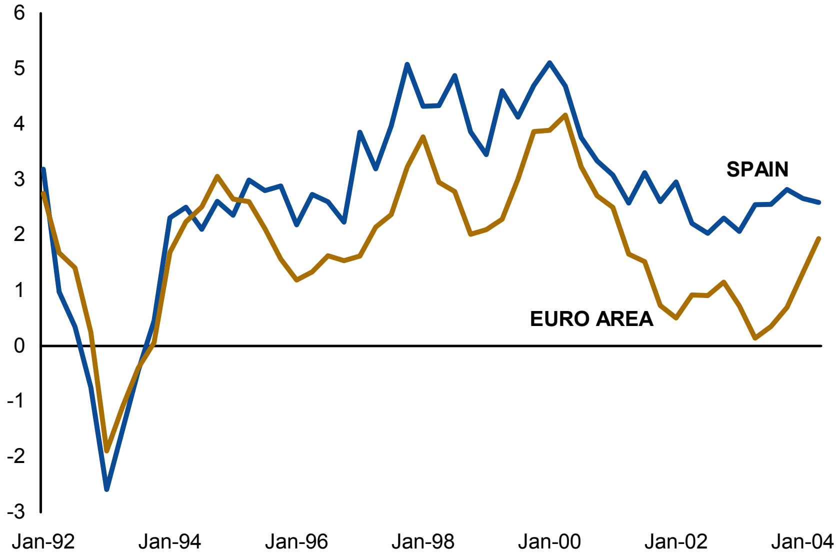
Display 1: Changes In Intra-Euro-Area Competitive Positions
Change in Relative Unit Labour Costs Since 4Q 1998, Percent



Source: European Commission and Alliance Fixed Income, September 17, 2004

There has been a marked change in intra-euro-area competitive positions since the start of EMU in 1999. While German competitiveness has improved markedly, countries such as the Netherlands, Portugal, Spain and Italy have seen a significant deterioration. Latest data suggest that this deterioration is continuing in Spain and Italy.

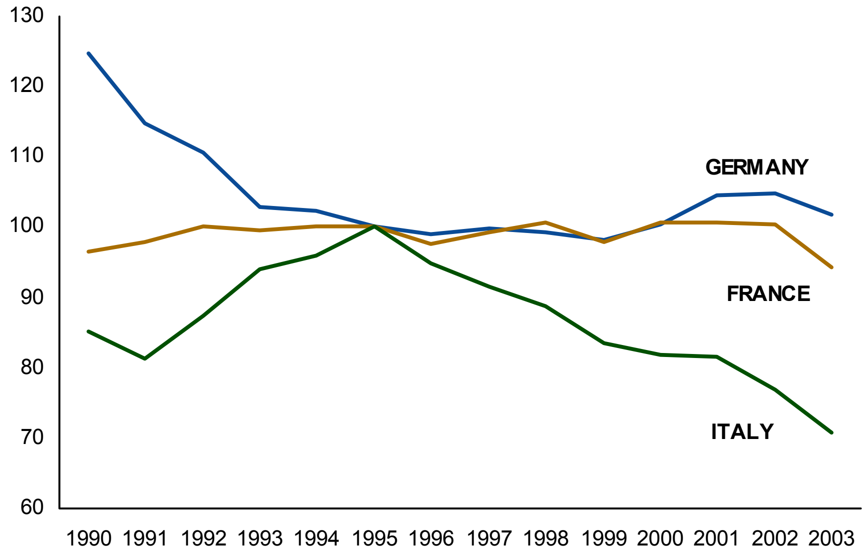
Display 2: Real GDP Growth
% Change Year Over Year



Source: Haver Analytics and Alliance Fixed Income, September 17, 2004

Spanish real GDP growth has run well ahead of the euro-area average in recent years. However, recent data point to a narrowing of the growth gap, suggesting that Spain's deteriorating competitive position may be beginning to weigh on growth.

Display 3: Export Performance For Total Goods and Services
1995 = 100



Note: Export performance equals export volume growth compared with export market growth (calculated as a weighted average of import growth in each individual country's major export markets).
Source: OECD and Alliance Fixed Income, September 17, 2004

Italy's total export performance has deteriorated sharply since the mid-1980s. This, in part, reflects the economy's reliance on traditional export sectors which are most vulnerable to low-cost competition from the developing world.