Depressing wages

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Vassilis Monastiriotis 2011-7-18

I was looking again yesterday at last week's press-conference by Poul Thomsen, the International Monetary Fund's mission chief for Greece. Despite the bleak projections about growth (-3.7%) and inflation (+2.9%), Thomsen tried to convey a positive message, by suggesting that the competitiveness of the Greek economy shows signs of recovery, as the cuts in public sector wages and the rise in unemployment have contributed to a 7% drop in average wages in industry (private sector excluding agriculture and services) and an overall drop in unit labour costs (an index of productivity-discounted production costs) by 8%. Thomsen emphasised the need for further reforms and a continuing commitment to containing labour costs as the sine-qua-non condition for a Greek recovery.

Now, let's be clear. Greece faces a sizeable current account deficit and has experienced a real appreciation both inside the eurozone (according to Eurostat data by 6.5% between 1999 and 2009) and in relation to its main trading partners (by 15-20%, owing both to inflation and to the 'strong' euro – see Ioakeimoglou, Institute of Labour, Study No34 and the Eurostat data on nominal effective exchange rates).

But are wages to blame for this? The first reaction of the typical macroeconomist would be to say 'yes': wages in Greece have grown faster than in other eurozone countries over the last 15 years, reflecting – among others – significant labour market rigidities. And, while labour productivity also increased faster than average, unit labour costs moved from 65% to 84% of the eurozone average. In real terms however (adjusting for their purchasing power), wages remain about 25% lower than the eurozone average: Greece still maintains a cost advantage over its eurozone partners.

How are we then to explain Greece's weak competitiveness? The second, more reflective, reaction of a perhaps less typical macroeconomist would be to say that this is due to high final prices, because profit margins (and price mark-ups) in Greece are among the highest in the eurozone, reflecting – among others – significant product market distortions and rigidities. Higher prices lead to less competitive exports and more imports from abroad – hence also the substantial trade deficit.

But there is more to competitiveness than prices; and there is more to trade deficits than relative costs. Price competitiveness is to a large extent determined by changes in the nominal exchange rate. Although Greece has a fixed nominal exchange rate inside the eurozone, some 45% of the country's trade is outside the EU. Greece has thus suffered significantly from the nominal appreciation of the euro since 2002. Eurostat data on intra- and extra-EU trade testify to this: between 2000 and 2008 the Greek trade deficit (as a percentage of GDP) increased by 11.4%; this was more-than-fully accounted for by the increase in the country's extra-EU trade deficit (by 65% – from 6% of GDP to 9.5% of GDP), as the intra-EU trade deficit actually declined in the same period (by 14% – from 11.3% to 9.5%). So, on the basis of trade performance indicators, Greece has in fact gained competitiveness vis-à-vis its EU partners. Its deteriorating trade deficit concerns mainly its performance against non-EU countries, where the appreciation of the euro – and, by implication, the wage-depression policies pursued in the eurozone 'north' – has played a central role.

But, even besides this, a country's overall competitiveness depends not on prices/costs but, ultimately, on *the quality of the domestically produced goods relative to their cost* and on *the ability of domestically produced goods to reach foreign markets*. It seems to me that this is where Greece's main problems are. And this explains why other countries, from Germany to Portugal, manage to export a higher share of their GDP (35% for Germany, compared to 20% for Portugal and 8% for Greece), despite their higher prices and higher labour costs. Similarly, trade deficits depend not only on export performance but also on the propensity to import, i.e., the extra cents that go to imports for every one-euro increase in domestic incomes. This in turn depends on two things: domestic preferences (the willingness of domestic consumers to purchase foreign products) and domestic supply (the capacity of the domestic

economy to satisfy domestic demand). And I have the impression that on both of these fronts Greece scores rather poorly. In simple terms, Greece produces very few products to satisfy domestic demand (its domestic production of tangible goods is a third of its domestic consumption of tangible goods) and Greeks seem to have a stronger 'taste' for foreign products than for goods produced domestically.

So, if the problem with the Greek external balance is not only prices but also export capacity and demand for imports, can depressing wages help in the direction of improving the country's external balance? Well, to some extent yes. Lower wages will increase further the price-competitiveness of domestically produced goods and raise exports (note that although in the last couple of years Greek exports have been on the rise, especially as a share of GDP, in money terms they are still lower than those of 2007 or 2008 – despite the decline in unit labour costs that Poul Thomsen celebrated in his press conference). Moreover, they will weaken the appetite of the Greeks to purchase products from abroad and allow domestic producers to start new endeavours and engage in the production of new goods.

But in a country with low domestic savings and low rates of reinvestment of profits, depressing wages also implies depressing domestic demand – and thus fewer opportunities for producers to enter new markets (of previously imported goods) – and perhaps also depressing product quality. This will certainly not help – at least not in the long-run. Instead, what would make more sense would be to raise the technology content – and the quality – of Greek products, to strengthen entrepreneurship, reduce entry costs, improve access to foreign distribution networks and modernise the capital base of the economy. This would then raise further labour productivity (due to technology and scale effects) and by implication also the relative price-and-quality competitiveness of the Greek economy.

It is not difficult to see that to do this, one needs more money: a new growth stimulus and new capacity-enhancing investments under a new development model. In theory, this has been in the policy agenda at least since the October 2009 elections – if not since I was born – but there is very little to show in terms of policy actions in pursuit of this. Instead, what is being continuously pursued is the old good (or, not-so-good) recipe of depressing wages and labour costs. **As if Greek wages were not already depressing enough…**