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Routes out of recession: improving competitiveness in Germany, France and Italy

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The recession in Europe has three main causes: the need to implement structural reform at an accelerated pace combined with the insecurity which this creates; the lack of credit available to the private sector; and the policy of budgetary restraint employed over recent years. Approaches adopted to beat the recession must be similarly multi-faceted. This paper focuses on economically viable structural reforms aimed at improving competitiveness, and identifies a number of priorities for Germany, France and Italy. To what extent implementation is feasible in practice is an issue that will be determined during the political process both in the countries under review and within Europe as a whole.

Germany, France and Italy differ markedly in their current and prospective levels of competitiveness. The measures needed to safeguard and strengthen their future economic power are also very different: (i) Germany can use investment to strengthen domestic demand, maintain its employment potential and modernise its infrastructure. (ii) France can increase the flexibility of its labour market, alter its policies on social welfare and wages, and, over the medium term, reduce government expenditure relative to GDP. (iii) Italy has scope to improve the efficiency of its public administration, so that the country can once again make productive use of its capital assets.

The three faces of the Euro crisis

Since autumn 2012 the liquidity problems faced by some members of the Eurozone have, thanks to the European Central Bank, been overcome. The fact that Europe still remains in recession has three principal causes:

(1) The lack of structural flexibility seen in many national economies inhibits any rapid improvement in competitiveness. Economic restructuring takes time: this makes the road from domestically driven growth (stemming from consumption and residential construction) to greater foreign direct investment and increased export activity more challenging.

(2) The availability of credit within the economy continues to be constrained by legacy assets on bank balance sheets which still need to be cleaned up. The banks also have to address the necessary tightening of regulatory requirements. Lending requirements are being raised to keep the level of new risks as low as possible, and consequently the volume of new lending to the private sector is inadequate.

(3) Demand is too weak. Eurozone countries are aiming to achieve ambitious debt targets through strict austerity policies. But at present neither export markets, nor companies or private households are able to fill the resultant lack of demand. Hence incomes − from wages, interest, and company profits − are falling, thereby weakening demand further. This creates a downward spiral which, to date, has not been checked.

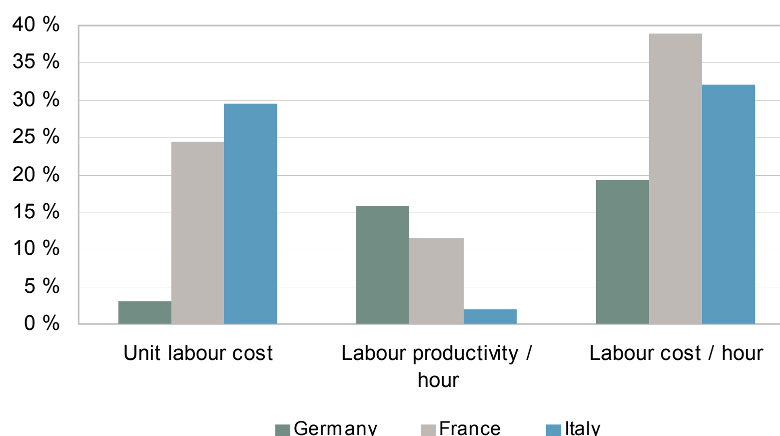
These three causes of the European recession need to be tackled simultaneously, but different measures must be used with differing timescales. This paper focuses on the most important economically viable measures for increasing competitiveness in the three largest economies in mainland Europe.

What is competitiveness?

A country's competitiveness comprises its current productivity level and its scope for increasing this productivity in future.[1]

Figure 1: Unit labour costs, labour productivity and labour costs per hour worked

(Change between 2000 and 2011, expressed as a percentage)



Source: OECD

Note: This paper contains the opinion of the authors and does not necessarily represent the position of the KfW.

In order to achieve a comprehensive evaluation of the various aspects of current and prospective future competitiveness, it is necessary to draw upon a variety of indicators.

The traditional indicators: current account balance and unit labour costs

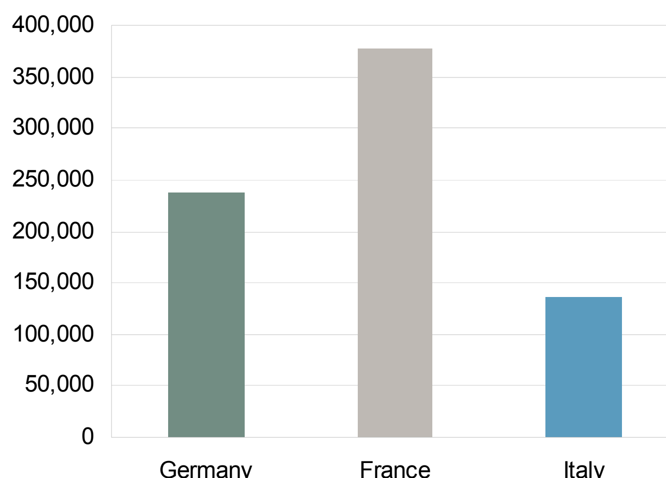
The traditional yardsticks used for comparing competitiveness between different nations are the current account balance and the trend in unit labour costs, this being a measure of the relationship between labour costs and labour productivity.

Germany's current account surplus (7 % of GDP in 2012) contrasts with deficits in both France (2 % of GDP) and Italy (1 % of GDP). The German surplus is driven by a high goods export ratio (41.5 % of GDP in 2012). This ratio, together with the stable world market share of German exports, demonstrates that German products are competitive internationally. However, at the same time this high current account surplus also means that domestic demand is weak; a great deal of capital flows abroad, and is therefore no longer available for investment in productive capital at home. This neglect of capital investment will weaken Germany's competitiveness in future. By way of contrast, the current account deficits seen in France and Italy are primarily expressions of the weak state of the economy at the present time, and do not constitute grounds for serious concern.

Due to rises in labour costs far exceeding the increases achieved in labour productivity, France and Italy have both fallen behind in international competitiveness. This was not a major problem as long as domestic demand provided growth. But rising unemployment and the uncertainty that companies face in planning for the future is now exposing these weaknesses.

In contrast, over recent years Germany has become more competitive internationally, as labour productivity has climbed substantially whilst unit labour costs have remained virtually unchanged. Between 2000 and 2011 labour productivity (i. e. the efficiency of labour deployed) rose by 16 % in Germany, 12 % in France and just 2 % in Italy (see Figure 1). Over the same period, hourly labour costs rose by 19 % in Germany, 32 % in Italy and 39 % in France. This yields an increase in unit labour costs of 30 % in Italy, 24 % in France and only 6 % in Germany.

Figure 2: Foreign direct investment 2004−2012 (in EUR millions)



Source: Ameco

Quality of institutions

The World Bank's "Doing Business" report includes a comparison of 185 different countries in terms of the hurdles which an entrepreneur must overcome to set up and run a business. A business can be established quite quickly in all three countries, and the time it takes is roughly the same (9 days in Germany, 7 in France and 6 in Italy). However, if this new company needs connecting to the electrical grid, Germany has the shortest waiting time, at an average of 17 days. In France it actually takes 79 days, and in Italy as long as 155 days. If an entrepreneur needs to file a suit over contract compliance, he must allow even more time. The legal process will take an average of a little over a year (394 days) in Germany and about the same in France (390 days). In Italy it will take almost three years (1,210 days). The judicial reforms which are planned are therefore an important step forward.

High-quality institutions and authorities which operate efficiently bring down the cost of setting up and running a company, thereby increasing a location's attractiveness. The World Economic Forum compares 144 countries in terms of their quality as business locations.[2] In the area of institutional quality Germany holds 16th place, ahead of France (32) and Italy (97). This places the Italians behind countries such as Ethiopia and China.

Germany achieves this ranking despite a comparatively low government expenditure ratio (45 % of GDP in 2011, as against 50 % of GDP in Italy and 56 % of GDP in France). Consequently, of these three nations Germany is working most efficiently.[3]

Attractiveness for foreign direct investors

A foreign direct investment is a long-term decision. It is usually the result of a careful examination of the institutional and structural environment in place at the location which is to be established or expanded. As such, it represents a vote of confidence in a national economy. Over the last eight years, France emerges best in a comparison with Italy and Germany (Figure 2). Investment sources do not differ greatly between the three countries: the majority comes from the EU-27 (between 60 and 72 %), followed by the USA (7.5−12 %), Switzerland (6−7.5 %) and Japan (1.7−3.3 %).

According to surveys of foreign investors, there are four reasons why France takes pole position: its high quality of life; its geographic location; the quality of its infrastructure; and the support offered for research and development (R&D), including R&D tax relief. There is scope for reform here in both Germany and Italy.

The labour market

Comparing labour market data highlights other potential areas for reform. First of all, it is noticeable that the participation rate in France and Italy lags behind that of Germany (Table 1). On the other hand, the part-time employment rate in Germany is significantly higher, with the part-time rate higher for women than for men, and increasing with the number of children.[4] This suggests that at least a proportion of part-time work is due to a lack of child care provision and is therefore not undertaken by choice. There is therefore a potential for growth from higher employment lying dormant in all three countries. A glance at the statistics for actual hours worked per year shows that Italy and France need to increase the number of people employed, whereas Germany needs to increase the hours worked by the working population. Working lifetime, measured by effective retirement age, is similar in all three countries.

Young people need to be better integrated into the work force. In France and Italy this is particularly hampered by the weak economic situation and by strict regulations governing unfair dismissal.

Investing in the future: infrastructure, innovation and education

To ensure long-term competitiveness, three factors are of particular significance: the quality of infrastructure, education and the ability of private enterprise to innovate.

Infrastructure: In 2008, investment per head of population in transport infrastructure [5] amounted to EUR 229 in Germany, EUR 299 in France and EUR 357 in Italy. In this area of investment, Germany has limped behind the others for some years (Figure 3). This may well become a problem for Germany's attractiveness as a business location and for German productivity.[6] In contrast, the level of investment in Italy has made scarcely any contribution to higher labour productivity. Because of this − and also because significant investment has already been carried out in the past − an infrastructure investment programme is likely to have little success in Italy.

Education: Two aspects of workforce education are particularly relevant: firstly, training in fundamental capabilities such as reading, arithmetic, and a basic knowledge of science, which are required in most functions in a technologically advanced economy; secondly, a larger pool of highly qualified workers (university educated), who play a crucial role in determining a country's capacity for innovation.

The OECD's PISA tests measure competence in reading, mathematics and science among fifteen-year olds, who represent the workforce of the future. Here too it is evident that all three countries have scope for improvement against the leading countries (Finland and South Korea). German schools have roughly a year's lead over those in France and Italy, most notably in the areas of mathematics and science[7] (see Table 1).

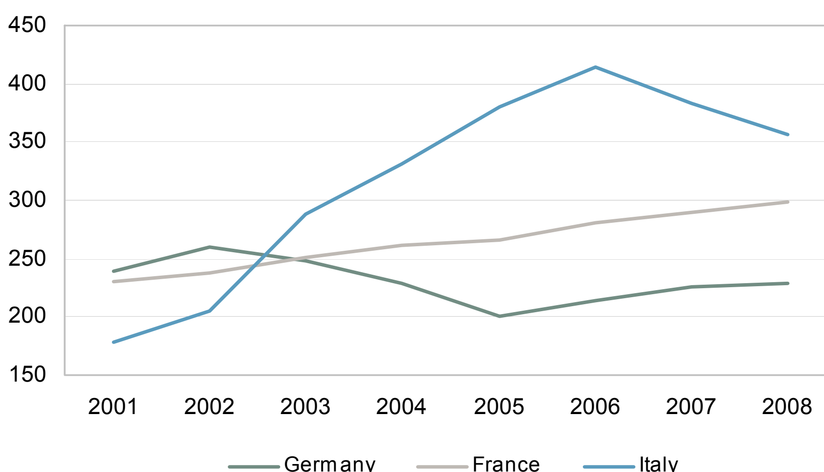
The percentage of university graduates among the working age population (25−64) is another area where Italy still has marked room for improvement. In 2010 this proportion was just 14.8 %, compared with 26.9 % in Germany and 29 % in France. At the same time the ratio in all three countries is below the OECD average of 30.3 %.[8]

Table: Labour market and long-term competitiveness statistics

	Germany	Italy	France
Labour market			
Unemployment rate (December 2012)	5.3	11.3	10.5
Participation rate (2010) as a percentage of the working population	71.2	56.9	64.0
Hours worked in a normal week (2010)	40.0	39.7	39.3
Actual hours worked in year (2010)	1,419	1,778	1,554
Effective retirement age (2004−09)	61.8	61.1	59.1
PISA test results 2009 (points scored)			
Reading	497	486	496
Mathematics	513	487	497
Science	520	489	498
Innovation			
Expenditure on research and development as a percentage of GDP (2011)	2.84	1.25	2.25
Triadic patent applications per million inhabitants (2010)	68.63	11.99	39.19

Source: OECD, Eurostat

Figure 3: Infrastructure investment per head of population in EUR



Source: OECD, Eurostat

A good education becomes especially important when the number of available workers falls due to demographic change. In Germany and Italy, where birth rates are 1.36 and 1.40 children per woman respectively, this is a more serious problem than in France, which has a rate of 2.01 children per woman.

Innovation: Seeking out talent, searching for ideas and engaging in research and development (R&D) are all important prerequisites for innovation. Those German SMEs which adopt ideas from abroad and take on staff with experience in other countries almost double their productivity.[9]

Germany's expenditure on R&D amounts to 2.84 % of GDP. This is 25 % more than in France and 44 % more than in Italy, and thereby allows Germany greater scope for innovation. But expenditure on research and development is not keeping pace with the front runners (Israel, Finland and South Korea) in any of these three countries.

These differing levels of research activity are reflected in patent application numbers: in 2010, Germany applied for 75 % more patents per head of population than France, and over five times as many as Italy (see Table 1).

The end result

The potential growth rates estimated by the EU Commission measure how quickly a country can grow in the long run at a constant level of capacity utilisation. Potential growth over the next few years is estimated at 1.5 % for Germany, 1.0 % for France and roughly -0.1 % for Italy. The lower this growth rate the weaker its competitiveness is likely to be, and the more urgent is the need to introduce structural reforms to promote growth.

Conclusion: what should be done?

Looking at all these indicators together, it is clear that the areas requiring most urgent action differ between the three countries. Whereas France and Italy need to take measures straight away to raise their current competitiveness, Germany can focus more closely on ensuring its future competitiveness.

The most urgent task for France is to make its labour market more flexible, in order to raise the employment rate and contain growth in unit labour costs. Among other measures, liberalising the services sector could be helpful in this regard. Reducing the government expenditure ratio over the medium term can also contribute here, without the quality of France's institutions suffering as a result. Over the long term France has greater scope for raising its competitiveness, thanks to its higher population growth rate. This should be used to increase expenditure on research and development and to promote tertiary education.

Italy also needs to increase its labour market flexibility. Other tasks include deregulation as well as measures to improve efficiency within the public administration system, and the legal system in particular. In order to achieve long-term competitiveness, it is especially important to improve the education system, primarily in the teaching of basic skills, followed by support for tertiary education. A significant increase in research and development expenditure would strengthen Italy's innovative capabilities, which is equally desirable in view of the expected demographic trend. Targeting expenditure in these areas is also likely to increase Italy's labour productivity.

In Germany there is a particular need to safeguard future competitiveness. This is especially important due to the demographic trend, which is even poorer than in the other countries. An important point to address here is the low level of infrastructure investment in general, not only in transport infrastructure, where there is a substantial backlog of necessary investment. Furthermore, Germany still falls short of the EU research and development expenditure target of 3 % of GDP. In the areas of basic skills and university graduates, Germany is could work on joining the OECD's top flight. Germany can learn from its French neighbours with regard to becoming a more attractive location both for foreign direct investment and for raising a family. This includes not least expanding child care provision and reducing the ratio of involuntary part-time work in favour of more full-time employment. In principle, in order to bring down the current account surplus it makes sense to strengthen domestic demand, preferably via increased investment.

Slightly higher real wage increases in Germany would also help equalise the macroeconomic imbalances which exist within the Eurozone. But the major share of wage adjustment is likely to take place in France and Italy, as wage determination processes become more flexible and unit labour costs fall until they are once again aligned with labour productivity. In the short term, however, this process of adjustment is very painful and constrains growth.

Since the adaptation measures needed in France and Italy have a negative impact on employment income, private consumption will not be a driver of growth for the foreseeable future. Additionally, high interest rates and weak banks restrict investment. In Italy this has already led to recession, and in France no growth is expected this year.

As the government expenditure ratio is already high, providing any additional expenditure is difficult, and therefore productivity increases should be supported instead through a more efficient distribution of funds. In view of the relaxation seen in capital markets, it is possible to reduce the government expenditure ratio at a moderate pace in the current economic environment, thus avoiding additional pressure on domestic demand. The lower the inflation rate falls, the more cautious Europe needs to be with any further cutbacks.

Structural reform needs to be tackled without delay, in order to give private enterprise the certainty to plan for the future. Since France has no acute imbalances to be eliminated and Italy's national budget shows a primary surplus, the process of implementation can be stretched out over a period of time. ■

1 Cf. Krugman, Paul (1994), “Competitiveness – A Dangerous Obsession”, Foreign Affairs, Vol. 73, No. 2 (March / April 1994).

2 In the annual Global Competitiveness Report.

3 It should be borne in mind here that national expenditure ratios are only truly comparable between identical social welfare systems. Differences between nationally guaranteed social security benefits have a direct influence on expenditure ratios, but are unrelated to the quality of the institutions.

4 Cf Eurostat (2013), “Almost a third of women and 5 % of men having a young child worked part-time in 2011” Press release 37/2013, 7th March 2013, URL: http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/3-07032013-AP/EN/3-07032013-AP-EN.PDF

5 This includes investment in road, rail, inland waterways, ports and airports.

6 Cf. Zeuner, Dr Jörg (2013), Investing for the future, Focus on Economics No. 21, KfW Economic Research.

7 PISA test results are calibrated so that the average for OECD countries is 500 points (with a standard deviation of 100 points). Hence a value greater than 500 represents an above average performance, and a value under 500 is below average. A 30−35 point gap is equivalent to a school year.

8 However, it should be borne in mind here that the definition of tertiary education varies from country to country, and that it has not been standardised by the OECD.

9 Cf. Brutscher, Dr Philipp and Dr Michael Schwartz (2013), Learning to succeed: how SMEs benefit from the international exchange of ideas, Focus on Economics No. 20, KfW Economic Research.