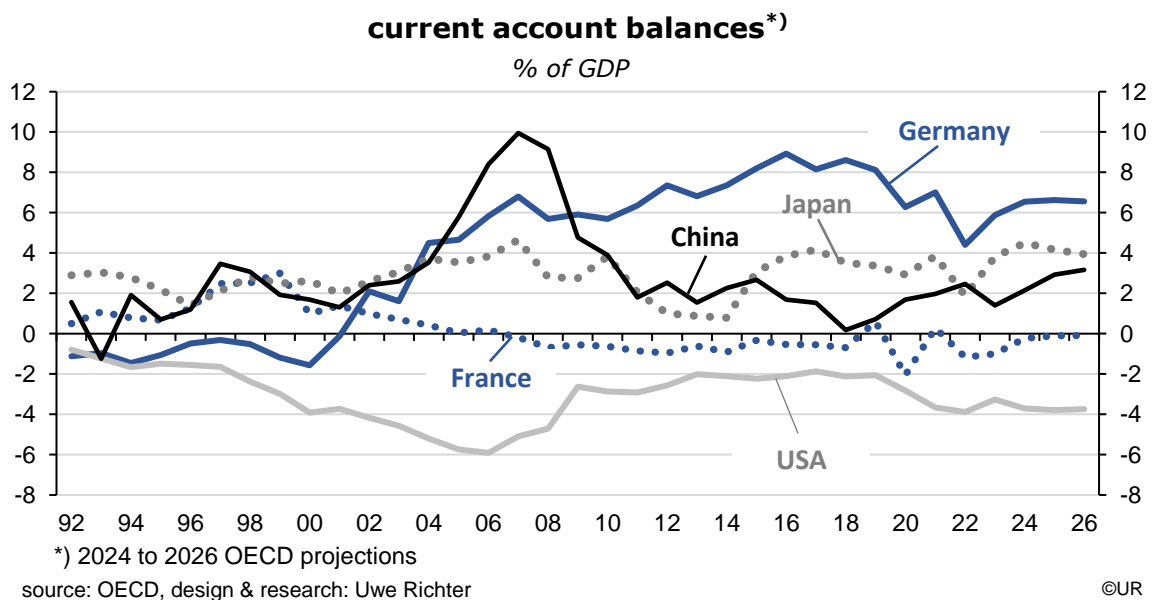


## Europe's competitive position not as poor as some would have it

Mainz, December 13, 2024 | Dieter Wermuth

For quite some time I have been annoyed by the never-ending complaints of politicians and lobbyists that Western European countries were lacking international competitiveness, and that action was needed to change that. The new EU Commission has just made competitiveness one of the four main issues it intends to address in coming years. I had always suspected that the true reason for these complaints was to slow wage growth and to boost corporate profits. How can it be that Germany, since the end of the huge financial effort to bring the eastern part up to speed in the wake of reunification in 1990, ie, since about 2005, has achieved annual surpluses in its balance on current account of about 6% of GDP, far more than other large economies, if it was lacking competitiveness? Other countries would be glad to have such a "problem".



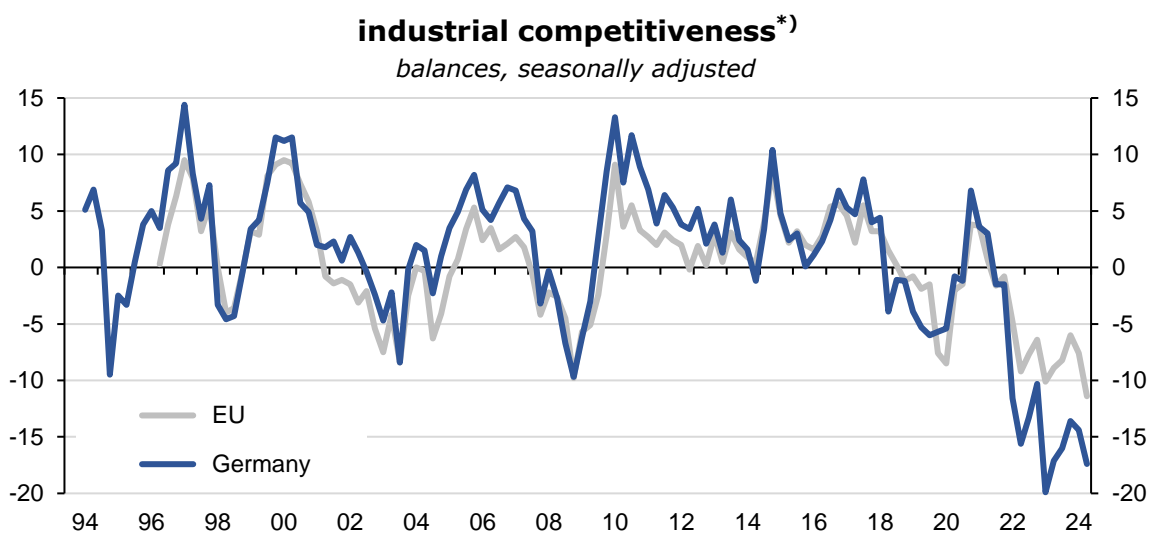
In the meantime I have changed my view somewhat: surpluses are not necessarily a good indicator for the success of an economy in international markets. They can not only be generated by the production of goods and services which can be sold successfully but also, for instance, because the economy is stagnating or in a recession – which means it is unable to import much while at the same time trying to fill the output gap by exporting more aggressively. It could also be that the exchange rate is undervalued, in which case the country will export more and import less. None of these are indicators of a superior competitiveness.

From a national welfare point of view it would be best if the economy were able to sell its products at home and abroad at rising prices while importing products at falling or slowly rising prices – provided there is full employment. In such a scenario it would be almost irrelevant whether the balance on current account would show a surplus. Seen from this perspective, deficits would actually be desirable. They could be a sign that foreign savers are attracted by the investment opportunities in the country, triggering net capital inflows. The

US is the role model in this respect: with the help of foreign investors its economy has been growing at a robust pace and does not need to save as much itself. For a long time, trend growth of productivity and employment has been significantly faster than in the European Union.

What other indicators of competitiveness should be looked at if balances on current account are not unambiguous? The Munich-based economic think tank ifo Institut [has published a report](#) last month under the headline “the competitiveness of the German economy in a free fall”. To be on the safe side, the authors had put a question mark behind it.

On a quarterly basis, the EU Commission releases data on the competitive situation of the EU, the euro area and 31 countries (some outside the EU). They are based on identical surveys of firms in the manufacturing sector. The text used is as follows: “In the past 3 months, compared to the previous 3 months, our competitive position has improved / has not changed / has deteriorated.” The survey is split into three segments – home country, EU (outside own country) and foreign markets outside the EU.



\*) manufacturing, competitive position outside EU

source: EU Commission; design & research: Uwe Richter

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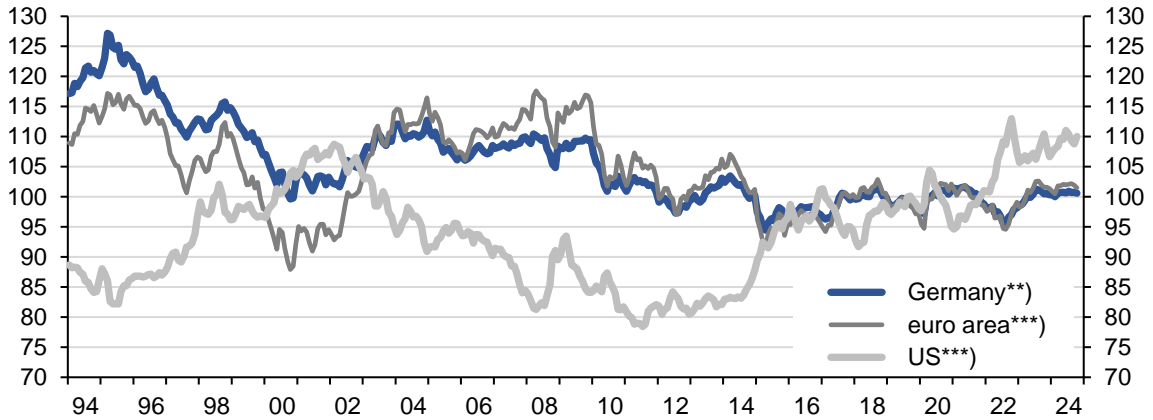
According to these surveys, Europe’s competitiveness has declined significantly over the past years. To be sure, the surveys are about changes, not absolute levels. But still. Germany has been hit the most among the larger countries: never since the beginning of the time series in 1994 has the balance of positive to negative responses been as negative as in the past two years. High energy prices and the overwhelming market power of China have left deep scars. None of the other large EU countries – Italy, the Netherlands, Spain and France – seem to undergo such profound structural changes as Germany. There is at least almost full employment - the number of newly created jobs has continued to increase until a few months ago.

So much about the soft data on Europe’s competitive situation. How about hard data? One [indicator for the price competitiveness](#) is the so-called real exchange rate, the aggregated exchange rates, weighted with the shares of the various partner countries in foreign trade, and adjusted for differentials in inflation, unit labor costs or productivity. This is not a daily

market exchange rate and is only published, with a time lag, on a monthly basis by the Bank for International Settlements in Basel. If the real exchange rate rises, the country loses its competitive advantage in terms of prices and cost – and vice versa.

**real effective exchange rates<sup>\*)</sup>**

2020=100



\*) CPI-based – \*\*) against a group of 62 trading partners – \*\*\*) against a group of 43 trading partners  
 note: an increase denotes a decrease in the price competitiveness of the domestic economy

source: BIS; design & research: Uwe Richter

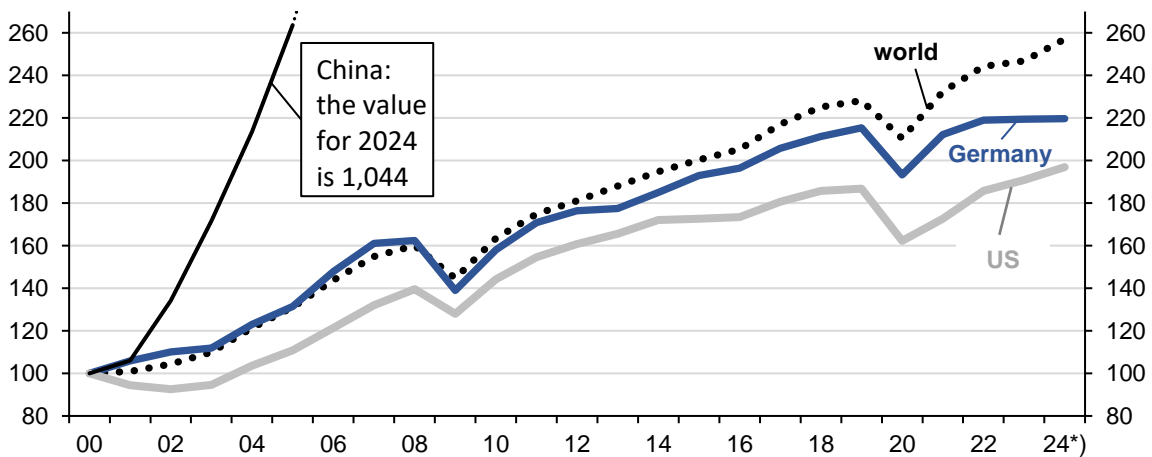
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On this basis, the competitive position of euro area firms has almost not changed over the past ten years; in the two decades before it had improved a lot. Contrary to perceptions in most media and prejudices in general, the trade-weighted and inflation-adjusted US dollar has increased considerably since 2014. As regards international competitiveness, it is the US which has a problem, not the euro area or Germany.

It is also worth to analyze changes in the share of countries in world trade. As you will have guessed, the big winner over the past quarter century is China. The data in the following graph are from the OECD.

**exports of goods and services**

volume in US\$, 2000=100



\*) based on OECD projections

source: OECD; own calculations, design & research: Uwe Richter

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The rest of the world can only stand on the sidelines and watch in amazement. In some important product lines China has reached monopoly power, such as batteries for electric vehicles or solar panels. Europe is presently just as dependent on these products as it was, not long ago, on Russian gas.

Overall, the losses of market shares are less than those of the US. And to be sure: in the long run China uses water for cooking, as anybody else. Trees do not grow to reach the sky. China is also dependent on customers abroad. The “old” industrial economies will not fall into poverty because East Asia is growing so fast. Even China cannot escape the effects of the law of diminishing returns – it’s already visible in recent trends in trade. Going by historic role models such as Great Britain and Japan, economic growth rates and standards of living will level off and converge over time. But for now, it is important to cooperate with China and to avoid trade wars. Trade barriers are bad for all parties involved.

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