Surveillance of Intra-Euro-Area Competitiveness and Imbalances

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EXECUTIVE SUMMARY

Persistent competitiveness divergences and macroeconomic imbalances within the euro area are a cause of concern both for individual Member States and for the functioning of EMU. They increase the economic and financial vulnerability of individual Member States. Large losses in competitiveness combined with persistent accumulation of large current account deficits cannot be sustained forever and can be reversed only at the cost of protracted periods of painful adjustment. Because of trade and financial spillovers across Member States, large macroeconomic imbalances may also hinder the functioning of EMU and weigh on confidence in the euro.

The Eurogroup has discussed the issue of competitiveness divergences repeatedly in recent years and agreed in July 2008 to initiate a regular review of competitiveness developments within the euro area. The present report is part of the European Commission's input to the review carried out by the Eurogroup in 2010. It provides an in-depth assessment of competitiveness and current account developments in euro-area Member States. The report is composed of two parts. The first one presents a horizontal assessment of competitiveness divergences and macroeconomic imbalances, focusing on the impact of the crisis, and discusses possible policy responses. The second part provides an in-depth assessment of the competitiveness situation in each individual Member State.

Competitiveness divergences and current account imbalances increased steadily in pre-crisis years

During the ten years preceding the crisis, the euro area experienced a steady divergence in the competitive position and the current accounts of its Member States. Some Member States saw persistent gains in price/cost competitiveness relative to the rest of the euro area while others registered substantial losses. External divergence also took the form of a steady widening of differences in current account positions. Some Member States built up significant surpluses while others accumulated very large deficits. In those Member States for which data is available, the accumulation of large current account deficits was associated with a sharp deterioration of external liabilities, with net foreign asset positions reaching between 80 % and 100 % of GDP in 2008 depending on the countries considered. The deterioration in external liabilities was aggravated by persistent valuation effects. Finally, a number of Member States showed signs of serious structural weaknesses in their export performance although their current account deficits remained moderate (BE, FR, IT).

The divergence trend observed in the early years of the euro reflects the build-up of a range of domestic imbalances in some Member States. Changes in competitiveness and current accounts are not necessarily bad in a monetary union. For instance, catching-up countries have strong investment requirements that call for inflows of foreign capital and therefore current account deficits. Nevertheless, the divergence in competitiveness and current accounts in the euro area over the past decade was in part fuelled by various domestic economic imbalances, including inappropriate responses of wages to a slowdown in productivity, excessive credit growth in the private sector and housing bubbles. In current account deficit countries, large capital inflows led to an unsustainable accumulation of household and corporate debt, in some countries aggravated by an inappropriate response of fiscal policy. In some Member States, the accumulation of large current account surpluses reflected structural weaknesses in domestic demand.

The crisis has exacerbated the problems posed by intra-euro-area imbalances

Competitiveness divergence within the euro area has persisted throughout the crisis. Most indicators of price and cost competitiveness point to a further divergence in competitiveness within the euro area, both during the crisis and in the early stage of the recovery. Modest signs of convergence have come from labour costs although this seems to reflect mostly cyclical factors. The only clear evidence of competitiveness rebalancing comes from Ireland which registered significant gains in competitiveness in 2008 and 2009.

In contrast, the crisis has prompted a significant reduction in current account differences across Member States. Most Member States which entered the crisis with large current account deficits have experienced significant improvements in their current account positions

over the past two years. Meanwhile, most Member States with large current account surpluses have seen substantial falls in their balances. Large improvements in current account deficits were also registered in Ireland and in some of the new euro-area Member States. This convergence reflects a number of factors. Member States which entered the recession with large current account deficits have experienced both a sharper drop in private-sector demand and a less dramatic fall in exports than the rest of the euro area. The deficit-reducing effect of these forces has been amplified by changes in the composition of domestic demand with, in particular, a substitution of imports with domestic products. Conversely, Member States which entered the recession with large current account surpluses have experienced more resilient private-sector demand and a bigger exposure to the slump in world trade due to their export specialisation and greater trade openness.

The recent convergence in current account positions may be partly temporary and not backed by the necessary changes in relative prices. Key drivers of the convergence, such as the collapse in global demand in surplus countries, the substitution of imports in some deficit countries, are cyclical, and the pre-crisis divergence trend is likely to partly resume once the recovery gains strength. In the absence of progress in recovering competitiveness, the rebalancing in current account deficit countries will be associated with a considerable rise in unemployment. Indeed, for the correction in current account deficits to be sustainable, production needs to be re-directed from weaker domestic demand to the export sector. This process must be underpinned by gains in competitiveness. By the same token, surplus countries need to address underlying structural weaknesses in domestic demand.

Part of the correction of current account differences may be of more structural nature. The crisis has triggered a partial unwinding of some of the underlying domestic imbalances such as asset and real estate booms. However, further correction will be necessary and new imbalances have emerged. Some of the countries with external imbalances or competitiveness problems have registered a cooling-off of the housing market and early signs of improvements in private-sector balance sheets. Further unwinding of these imbalances appears however necessary. Moreover, recent improvements in domestic imbalances have been associated with large rises in unemployment. Part of the rise in slack in labour markets is cyclical and will be absorbed when the economy picks up, but part of it reflects a process of structural downsizing in some sectors. Unemployment therefore risks becoming of a more structural nature. In current account surplus countries, evidence of a structural strengthening of private sector demand remains elusive.

The need for a rebalancing of competitiveness across euro-area Member States remains. Most euro-area Member States have a relatively low adjustment capacity that could be further hampered by the crisis. The correction of competitiveness and external imbalances requires significant changes in relative prices and a reallocation of demand and supply between the non-tradable sector and the export sector. The economy of many euro-area Member States is characterised by a relatively high level of labour and product market rigidities which, in the absence of appropriate reforms, are likely to lengthen periods of adjustment and to make them more costly in terms of unemployment. There is a risk that the crisis could render the necessary adjustment even more challenging:

- In the period of very low inflation brought by the crisis, nominal rigidities are more likely to hamper downward adjustments in relative labour costs and prices. Nominal rigidities are high in most of the Member States facing competitiveness problems.

- Second, unless appropriate policies are put in place, the crisis risks weighing significantly on medium-term prospects for potential output growth. Possible losses in growth potential are generally projected to be stronger in Member States with large competitiveness problems. In these countries, wage bargaining systems face the double challenge of having to adjust to past losses in competitiveness as well as to reduced productivity growth and deteriorated labour markets.

- Third, pre-crisis balance-sheet stress has been severely compounded by the crisis-induced drop in asset prices and changes to risk

attitudes. The ongoing phase of balance sheet correction is likely to persist for some time. Member States which face considerable adjustment needs in terms of both price competitiveness and corporate balance sheets will have to strike a delicate balance between raising corporate cash flow to fix balance sheets and lowering prices to restore competitiveness.

- Finally, the crisis has negatively affected financial intermediation, thereby hampering the necessary reallocation of capital and, consequently, labour across sectors.

Competitiveness divergences call for an ambitious and comprehensive policy response

All euro area Member States are facing formidable policy challenges to address the economic, budgetary and financial implications of the crisis and to pave the way to sustainable growth. Mitigating the impact of the crisis on potential output and employment, boosting productivity growth and strengthening the euro area's external competitiveness position in the global economy are objectives that are shared by all. However, a smooth adjustment of intra-euro area competitiveness divergences and macroeconomic imbalances is key for the recovery and, more generally, for the successful and sustainable functioning of EMU in the long term. It is therefore essential that Member States put in place an ambitious and comprehensive policy response geared at speeding up and improving intra-area adjustment mechanisms.

Tackling competitiveness divergence and current account imbalances will require action in a broad range of Member States, including both those with current account deficits and surpluses. Nevertheless, the policy response will have to differ significantly across Member States, and will have to be carefully designed to address the specific vulnerabilities and needs of the country concerned. At the current juncture, given heightened financial market discipline and the magnitude of deleveraging needed, the situation appears particularly challenging and the need for policy action particularly pressing in Member States showing a combination of high public debt, large current account deficits and large competitiveness losses.

The policy response should be comprehensive. It should cover measures in four key areas: fiscal policies, credit markets, labour markets, and product and service markets. While measures targeted at boosting labour productivity or improving the functioning of the financial sector would be beneficial in all Member States, the mix of policies – including both macro- and microeconomic - should be targeted to the country-specific needs and challenges. In particular, large price and cost adjustments will be needed in Member States which have accumulated large losses in competitiveness and large current account deficits in pre-crisis years. This calls for policy action to foster gains in labour productivity and enhance wage flexibility. In most Member States, wages are formed in a collective bargaining process without formal involvement of governments. Nevertheless, policy-makers can affect wage setting processes via a number of ways, including the provision of information or wage rules, changes to wage-indexation rules and the signalling role played by public sector wages. In addition, reforms of labour markets should also contribute to make wage setting processes more efficient. Finally, also non-price competitiveness factors, such as technology-intensity, quality of services and the dynamics of export destinations, have a role to play in adjustment processes in these countries. In Member States which accumulated large current account surpluses in pre-crisis years, there is a need to identify and tackle the sources of persistent weakness in some parts of private sector demand, including the possible role of a lack of competition in the service sector, of the tax system and credit constraints.

Co-ordinated efforts involving both countries with current account deficits and surpluses would facilitate competitiveness adjustment. While the adjustment effort remains the responsibility of each individual Member State, coordinated efforts to rebalance demand and competitiveness could produce a smoother adjustment path with smaller adjustment costs for the euro area as a whole. Coordination would, however, not mean an identical policy response in all Member States. It could take various forms, including agreement on a

common diagnosis and on the nature of the policy response needed, regular exchanges of information about policy measures with competitiveness implications for the euro area, etc.. The Eurogroup can play a key role in the coordination process by identifying adjustment needs and fostering a common diagnosis.

The policy response should be seen in the context of the design of exit strategies. Some measures taken in the context of the European Economic Recovery Plan, such as the use of temporary subsidies for employment, may hinder competitiveness adjustment processes, e.g. by preventing the necessary reallocation of labour. It is therefore important that these measures do not become entrenched. More generally, the comprehensive and coordinated exit strategies in euro-area Member States need to take into account their impact on relative competitiveness and current account imbalances. In particular, fiscal consolidation requirements must give due weight to the impact of competitiveness adjustment on revenues and debt while the role of fiscal policy in speeding up competitiveness adjustment should be taken into account when designing exit strategies. In line with recent EDP decisions, there is some room for gradualism in surplus countries but swift and determined consolidation is imperative to restore market confidence in deficit countries. On the supply side, measures taken in the context of exit strategies should contribute to rebalancing competitiveness within the euro area and to facilitating necessary labour and capital reallocation.

Looking further ahead, i.e. beyond pressing competitiveness adjustment needs, it is also important to reflect on possible avenues for improving the surveillance of external and domestic imbalances. The crisis has clearly demonstrated the need for closer policy coordination and deeper and broader policy surveillance to facilitate such coordination. The recent experiences validate the analysis made in the Commission's 2008 EMU@10 Report. The report made the case for deeper and broader macroeconomic surveillance in the euro area to address emerging macroeconomic imbalances at an early stage. It is now time to move to action and harness the framework of economic coordination and surveillance in the euro area in order to prevent future imbalances or detect and tackle them early on. In particular, given the critical role played by credit cycles in the emergence of large current account deficits in some parts of the euro area, a key medium-term policy challenge is to prevent the emergence of imbalances on credit and asset markets. It is necessary to devise and put in place mechanisms that would limit the occurrence of credit and asset price excesses but also devise specific instruments to cool-off credit and asset markets if necessary. The issue is critical in EMU where regional/national credit cycles cannot be addressed by monetary policy. Given the importance of credit developments for macro-prudential supervision, these considerations also raise the question of the link between competitiveness surveillance and the risk assessment to be carried out by the European Systemic Risk Board.

INTRODUCTION

The first decade of EMU has witnessed steady competitiveness divergence between euro-area Member States together with the emergence of large differences in current account positions. In some Member States, the counterpart to rising external imbalances has been the build-up of a range of domestic imbalances, including housing bubbles, overstretched balance sheets and surging external liabilities. In other Member States, this counterpart has taken the form of persistent weakness in private sector demand. Persistent competitiveness divergences and macroeconomic imbalances are a cause of concern for the euro area as a whole. They increase the economic and financial vulnerability of individual Member States and pave the way for protracted periods of painful adjustment. Because of large trade and financial spillovers across Member States, large macroeconomic imbalances may also hinder the functioning of EMU and weigh on confidence in the euro.

These problems have been acknowledged for some time now. In its Communication on "EMU@10: successes and challenges after 10 years of Economic and Monetary Union" the Commission proposed a broad policy agenda aimed at improving the functioning of EMU. It stressed in particular the need to broaden economic surveillance in order to detect and address macroeconomic imbalances at an early stage. Enhanced surveillance efforts were seen as particularly warranted in the area of external competitiveness and current accounts where noticeable divergences between Member States had emerged since the launch of the euro.

In order to address these challenges, the Eurogroup agreed in July 2008 to initiate a regular review of competitiveness developments within the euro area. The present report is part of the European Commission's input to the review carried out by the Eurogroup in 2010. It assesses the external performance of euro-area Member States since the launch of the euro, focusing in particular on the impact of the global financial and economic crisis. It also discusses possible policy responses. The competitiveness assessment is broad-based, drawing on the examination of a wide range of indicators comprising price- as well as non-price competitiveness, current accounts, external asset positions, export market shares etc. It also includes a review of the domestic imbalances that underlie changes in competitive positions. The report is composed of three parts:

Part I presents a horizontal perspective with a cross-country review of developments in price and cost competitiveness and external performance. It focuses on recent developments and the impact of the crisis, setting them against the more medium-term trends observed since the launch of the euro. It also analyses changes in the drivers of competitiveness and external performance and in the underlying domestic imbalances. A section is devoted to the implications of the crisis for the competitiveness adjustment channel in the euro area.

Part II, provides an overall assessment of competitiveness developments in the euro area and discusses policy implications. It proposes a set of policy measures at the macro- and microeconomic level to improve competitiveness adjustment within the euro area.

Part III presents country-specific fiches on competitiveness developments in the 16 individual euro-area Member States. The country specific analysis underpins the overall competitiveness assessment and policy analysis presented in the report by an extensive and detailed expertise of the economies and institutions of the countries concerned.

Part I

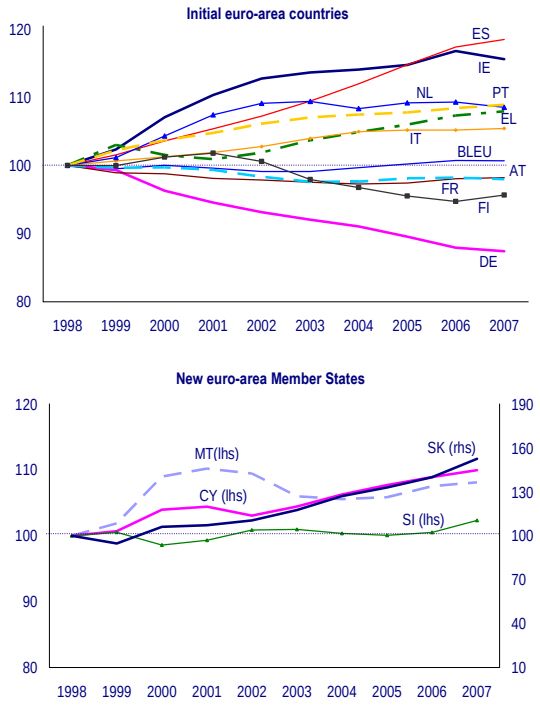
Horizontal analysis - Trends in competitiveness and impact of the crisis

Part I of the report provides a horizontal analysis of the impact of the financial and economic crisis on external imbalances within the euro area. It is structured as follows. Section 1 sets the stage by recalling the developments in competitiveness and current accounts within the euro area since the introduction of the euro. Section 2 surveys the impact of the financial crisis on competitiveness and current accounts in the euro area. Section 3 discusses the main drivers of the recent developments and the extent to which they may be considered as a temporary or persistent legacy of the crisis. Differences in Member States' external performance can in part be related to a range of domestic imbalances that call for policy action. Section 4 therefore reviews progress made with this these underlying domestic imbalances. Finally, Section 5 discusses the implications of the financial crisis for the functioning of the competitiveness adjustment mechanism.

1. COMPETITIVENESS IN THE EURO AREA: PRE-CRISIS TRENDS (1998-2007)

In the decade preceding the global economic crisis, the euro area experienced significant and persistent divergence in its Member States' competitiveness as measured by real effective exchange rates (REER). Some Member States saw significant falls in their REER, while others registered sharp rises (Graph I.1.1). Most of the countries that have introduced the euro in the last few years also experienced periods of sustained appreciation, but most of it preceded euro adoption and was consistent with underlying fundamentals.

Graph I.1.1: **Intra-area real effective exchange rate developments, based on GDP deflator, euro-area countries (1998-2007, 1998=100)**



Source: Commission services.

Although the precise country ordering depends on the specific measure used, the broad pattern of divergence is visible irrespective of price deflator (i.e. GDP deflator, unit labour costs or export prices) or reference group (i.e. intra-euro area or total REER).

However, narrow measures of REER (i.e. restricted to the specific segments of the economy), such as export price-based REER, may in some cases show a different picture than measures covering the entire economy (Graph I.1.2). These differences can in general be related to differences in price behaviour between the tradable and the non-tradable sectors.

An important feature of these REER developments is their persistence over time. While episodes of strong divergence in REER were also observed in periods prior to the launch of the euro, particularly in the 1970s and 1980s, the divergence was generally reversed rapidly by nominal exchange rate re-alignments.

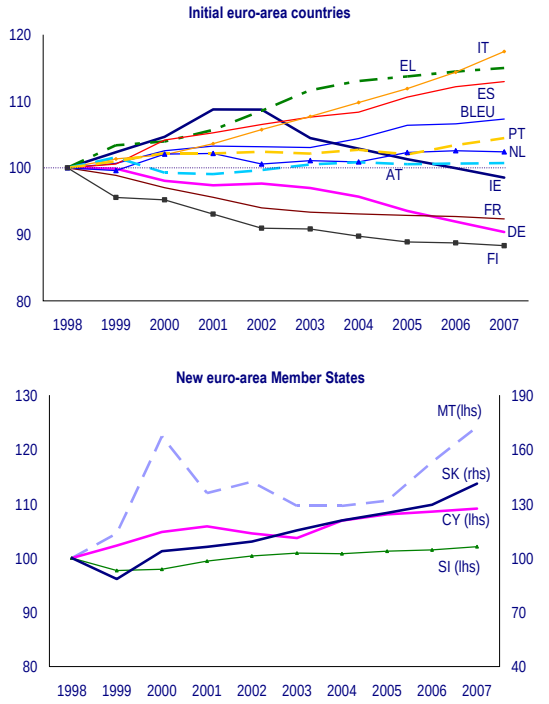
The pre-crisis divergence in price and cost competitiveness across Member States can be ascribed to a range of factors, some of which are linked to the healthy functioning of EMU. To some extent, changes in relative prices reflected a process of cross-border convergence in the price level of tradable goods fostered by the Single Market and the enhanced price-transparency brought by the euro. In a few Member States, the Balassa-Samuleson effect also played a role.([1]) The observed divergence in competitiveness developments was, in part, a natural response to cyclical divergence as Member States in a comparatively strong cyclical position experienced a real appreciation.

Nevertheless, divergence in price competitiveness also has much less benign causes. Cyclical differences are relatively small in the euro area and cannot explain the persistence of the competitiveness divergence over a period of 10 years. Indeed, divergence in price competitiveness was also partly driven by an inappropriate response of wages to country-specific shocks in some Member States (IE, EL, ES, IT, PT). A few of them (ES, IT) experienced difficulties in adjusting to deteriorating productivity performance in the manufacturing sector. Others (IE, EL) suffered from excessive

([1]) The Balassa-Samuelson effect states that, under some conditions, a country that experiences faster gains in the productivity of the tradable sector relative to the non-tradable sector than the rest of the world will also experience higher inflation (i.e. a real appreciation). The effect is frequently used to explain why catching-up economies tend to experience a lower price level than more advanced economies and an appreciating real exchange rate.

wage pressures in the service sector, with public wages acting sometimes as a key driver (PT).

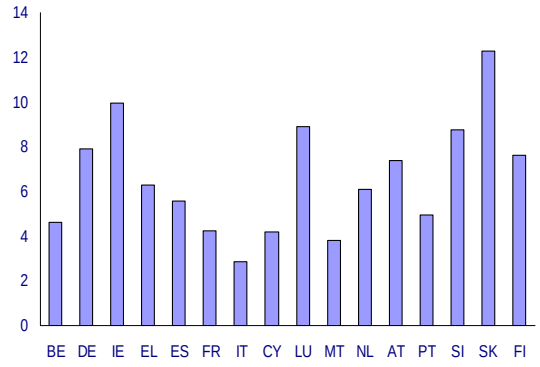
Graph I.1.2: **Intra-area real effective exchange rates developments, based on export prices, euro-area countries (1998-2007, 1998=100)**



Source: Commission services.

Divergence in price and cost competitiveness in the euro area went hand in hand with a divergent export performance. Some Member States benefited from a surge in exports of goods and services, with annual growth averaging 7-8% or more during 1999-2007 (DE, IE, LU, SI, SK) (Graph I.1.3). In contrast, other Member States posted a rather dismal export performance, with average annual growth in the 2-4% range (BE, FR, IT, CY, MT, PT). To some degree, this disparity reflects differences in geographical specialisation, with some Member States being better positioned in fast growing export destinations such as East Asia or Eastern Europe. However, geographical specialisation can explain only a limited part of the export differences and the heterogeneity is mostly attributable to differences in market share developments. Some countries lost considerable market shares and posted sluggish export growth over 1999-2007 (BE, FR, IT, MT, PT) while others were much more successful on both counts (DE, IE, SI, SK).

Graph I.1.3: **Export growth, euro-area countries (annual average growth rate in %, 1998-2007) (1)**



(1) Export of goods and services, volumes, National Accounts.
Source: Commission services.

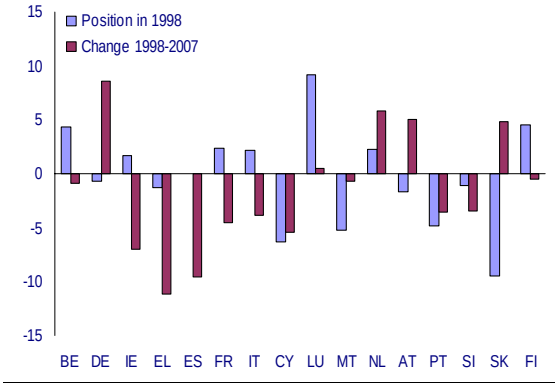
Non-price competition also contributed to the differences in Member States' export performance. Changes in Member States' competitive positions are not always fully captured by measures of price or cost indicators. The differences in export performance of some Member States over the decade preceding the crisis are in fact difficult to explain solely on the basis of measurable price and cost considerations ([2]). Non-price competitiveness is difficult to assess as it depends on a range of factors such as product quality or technological content, after-sale services or distribution services and cannot be captured in a single indicator. However, structural factors such as sectoral or technological specialisation played a role in the observed divergence of Member States' export dynamics.

The diverging trend in competitiveness and export performance were associated with a steady widening of the differences in Member States' current account positions. Since the introduction of the euro, current account differences in the euro area have been on a clear widening trend and the divergence reached an all-time high in 2007. To a large extent, the current account positions reached in 2007 were built after the launch of the euro

([2]) See 'Differences in Member States' export performance' in European Commission (2010), 'The impact of the global crisis on competitiveness and current account divergences in the euro area', Quarterly Report on the Euro Area No.1.

(Graph I.1.4), although some countries entered Stage III of EMU with an already sizeable deficit (especially PT). Most of the fluctuations and country differences in current accounts boil down to developments in the balance of goods and services, which is usually the largest component of the current account.

Graph I.1.4: **Current account position in 1998 and changes between 1998 and 2007, euro-area countries (% of GDP) (1)**



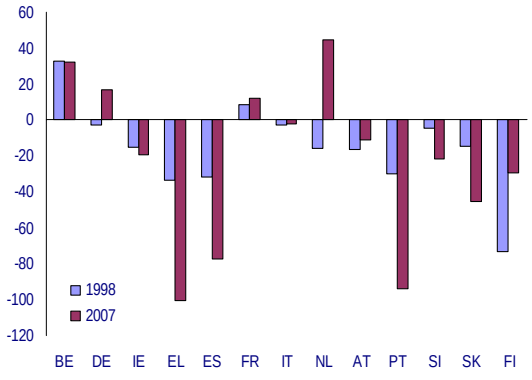
(1) Net lending (+) or net borrowing (-), total economy; for LU balance on current transactions.
Source: Commission services.

Member States which accumulated large current account deficits also saw a sharp deterioration of their external liabilities with net foreign asset positions reaching 80-100% of GDP (see Graph I.1.5). Moreover, the deterioration of their net asset positions was larger than warranted by their cumulated current account deficits. This was due to negative valuation effects. Valuations effects on external assets and liabilities are the capital gains/losses on these asset and liabilities that are due to fluctuations in asset prices and exchange rates. Financial globalisation has led to a sharp increase in gross cross-border holdings of foreign assets and liabilities that paves the way for increasingly large valuation effects. Such valuation effects can play an important role as they affect the level of the trade balance needed to keep the NFA position stable. ([3])

([3]) For an analysis of valuation effects in the euro area see 'The importance of valuation effects for external asset positions in the euro area' in European Commission (2010), 'The impact of the global crisis on competitiveness and current account divergences in the euro area', Quarterly Report on the Euro Area No.1.

Between the launch of the euro and the onset of the crisis, current account deficit countries experienced steady negative valuation effects which added significantly to the deterioration of their net external asset position. These effects were mostly due to the fact that price gains on equity liabilities (i.e. equity held by foreigners) exceeded price gains on external equity assets.

Graph I.1.5: **Net foreign asset position, euro-area countries (in percent of GDP) (1)**



(1) Fore Ireland and Slovenia data for 2001 instead of 1998.
Source: Commission services.

A large part of the cross-country divergence in the current account since the late 1990s is rooted in domestic demand factors. There have been considerable and persistent differences in the strength of domestic demand across Member States since the launch of the euro. Stronger relative demand pressures in a given Member State tend to fuel import demand and depress the current account. Differences in domestic demand pressures across Member States were related to 'traditional' medium-term determinants of the current account such as fiscal policy and demographic factors, as well as to reductions in risk premiums and easier access to international financing, especially in catching-up economies. Differences in export performance – and therefore price competitiveness – also contributed to the divergence of current accounts but, in most Member States, this was of second order compared with domestic demand factors.

Losses in competitiveness and the build-up of large current account deficits in some Member

States can be related to a range of underlying domestic macroeconomic imbalances. As already highlighted, labour markets did not always respond appropriately to country-specific shocks. Productivity performance was also disappointing in some indebted and converging economies. Although these catching-up Member States benefited from large capital inflows, foreign capital was often channelled to the most productive uses. More specifically, in some Member States the inflow of capital facilitated the rise in household and corporate debt. It fuelled excessive credit dynamics and contributed to the emergence of housing bubbles. Moreover, as a counterpart to the increasing debt, net foreign asset position deteriorated significantly, increasing exposure to global financial shocks.

Underlying domestic imbalances were not restricted to large current account deficit countries. Surplus countries such as Germany, the Netherlands and Austria experienced a significant increase in their current account after the beginning of the decade which reflects persistent weakness in private sector demand. ([4]) The weakness can primarily be traced back to the corporate sector although households also played a role in Germany. In the three countries, companies raised gross savings and reduced physical investment to acquire financial assets and reduce debt. Further work is needed to understand the drivers of this persistent balance sheet adjustment but, in some cases, policies may have encouraged the self-financing of corporations and has put retained profits at a tax advantage.([5])

([4]) For a more detailed analysis of current account surpluses in the euro area see ' Anatomy of current account surpluses in the euro area ' in European Commission (2010), 'The impact of the global crisis on competitiveness and current account divergences in the euro area', Quarterly Report on the Euro Area No.1.

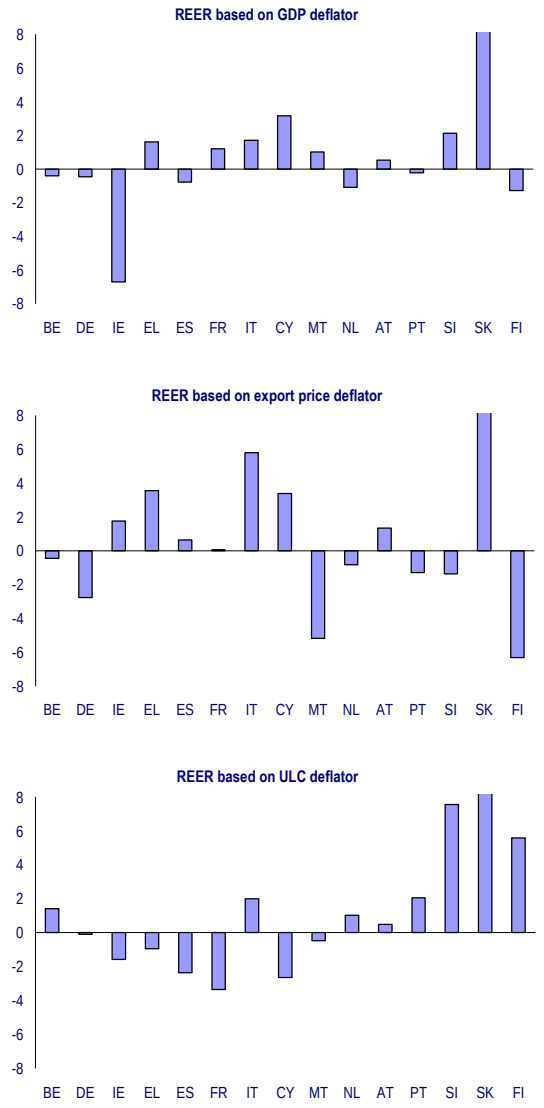
([5]) See Bundesbank (2000), Monthly bulletin, August (p.61).

2. DEVELOPMENTS IN COMPETITIVENESS AND EXTERNAL PERFORMANCE DURING THE CRISIS

Since the outbreak of the financial crisis in 2007 the divergence in price-based measures of competitiveness has continued in the euro area. Except for Ireland, the intra-euro-area REER based on GDP deflators does not show any clear sign of convergence in price competitiveness in 2008 and 2009 (Graph I.2.1).([6]) Most of the Member States registered very small changes in this measure of competitiveness, usually not exceeding 2% over the last two years, although Ireland, with a depreciation of almost 7% stands out. ([7]) The REER deflated with export prices shows more variations among countries but again without any clear rebalancing of pre-crisis competitive positions (Graph I.2.1). There is even some positive correlation between the developments during 1999-2007 and during 2008-2009, implying that the competitiveness divergence based on this measure rose further during the crisis.

Only measures of the REER based on unit labour costs (ULC) show some modest movement towards reducing the previously accumulated divergence. Among current account deficit countries, Spain and, to a lesser extent, Greece recorded a depreciation of the intra-euro-area REER based on ULC over 2008-09, but the magnitude of depreciation was rather limited. In contrast, Portugal resumed real appreciation after a few years of moderation (Graph I.2.1). At the same time, most of the surplus countries (NL, AT, FI) experienced real appreciation, with Germany's REER being broadly stable. Among the rest of the countries, developments were rather heterogeneous. Slovenia and Slovakia recorded large appreciations (though mostly before euro entry in the case of Slovakia) and Italy and Belgium moderate ones. Cyprus, Malta, Ireland and France saw improvements in their cost competitiveness. Overall, these differences in ULC-based REER developments suggest that some moderate competitiveness adjustment took place through unit labour cost via the labour market. The absence of clear signs of convergence with the price-based measures of the REER indicates, however, that the convergence effect of developments in ULC was largely offset by opposite movements in profit margins.

Graph I.2.1: **Intra-area real effective exchange rate developments, euro-area countries (change 2007-09, in %) (1)**



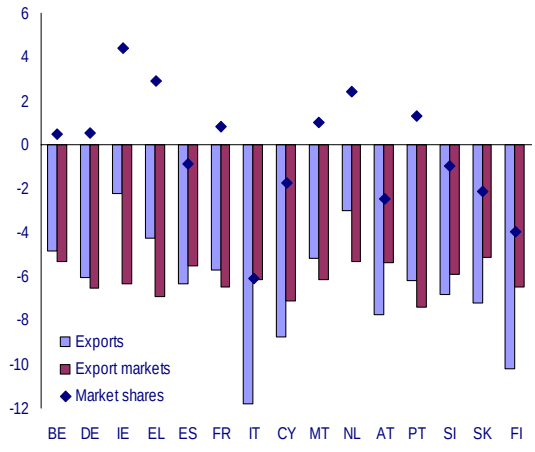
(1) Percent change between annual average in 2007 and in 2009. Data for 2009 based on Commission Autumn Economic Forecast. SK is off scale, the value is 10.3% (GDP deflator), 9.1 % (export price deflator) and 14.3% (ULC deflator). Data for Belgium include Luxembourg.
Source: Commission services.

([6]) Data shown in this report is based on the Commission's AMECO database (storage of early March 2010).

([7]) Slovakia has recorded large real appreciation during since 2007. However, it should be borne in mind that Slovakia introduced the euro only at the beginning of 2009 and most of the real appreciation comes from the nominal appreciation experienced before the introduction of the euro.

Over the 2008-09 period exports fell in all Member States due to the collapse in world trade, but the size of the fall differed significantly between countries. On the one hand, Italy's export volumes of goods and services contracted by almost 12% and Finland's by more than 10% on average per year during those two years. On the other hand, exports of Ireland, the Netherlands and Greece fell by a more moderate average of 2-4%. At the same time, growth rates in country-specific foreign demand (i.e. the foreign demand addressed to each individual Member State and which depends on the geographical structure of its exports) did not differ so much across Member States, implying that the differences in exports were mainly due to large differences in market share developments (Graph I.2.2).

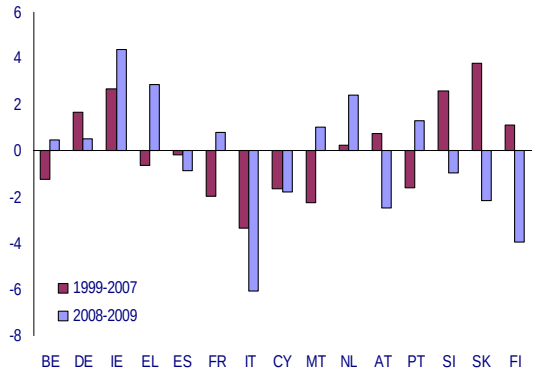
Graph I.2.2: **Exports, export markets and market shares, euro-area countries (change 2007-2009, in %) (1)**



(1) Exports: exports of goods and services, National Accounts (average annual growth). Export markets: export weighted imports of goods and services at constant prices for 35 industrial markets (average annual growth). Market shares: ratio of exports to export markets (% change).
Source: Commission services.

The differences in market share developments cannot easily be related to recent price competitiveness developments. This suggests that factors other than price competitiveness must have shaped export developments over the recent period (these factors will be discussed in the next section). Although the export performances over 2008-09 differed considerably among Member States, there is some indication that countries with large current account deficits (EL, ES, PT) and countries without large deficits but a weak export performance prior to the crisis (BE, IE, FR, IT) fared somewhat better than the large surplus countries (DE, LU, NL, AT, FI) and the new euro-area Member States (CY, MT, SI, SK), especially when compared with past trends (Graph I.2.3). While current account deficit countries were on average loosing market shares before the crisis, they have generally posted some gains since 2007. The opposite holds broadly for the surplus countries and the new Member States. Developments in the other countries were rather heterogeneous with France and Belgium showing a reversal of pre-crisis trends.

Graph I.2.3: **Market share changes, euro-area countries (annual average growth rate in %) (1)**



Source: Commission services.

The crisis has triggered a significant narrowing of current account differences within the euro area. The reversal of the previous divergence trend in current accounts can be traced back to both surplus and deficit countries (Graph I.2.4). Most countries with large current account surpluses (DE, NL, FI) saw significant falls in their external balances over 2008-09 with smaller changes in Luxembourg and Austria. ([8]) With the exception of Portugal, countries with large deficits experienced large improvements in their current account positions. Improvements, sometimes large (MT, SI), were also registered in the deficits of the new Member States. Finally, in the rest of the countries (BE, IE, FR, IT) current accounts deteriorated somewhat, except Ireland, which registered an improvement.

([8]) This data is based on the March 2010 storage of the AMECO database. More recent data suggest that the current account deficit in Greece may have improved only marginally during the crisis.

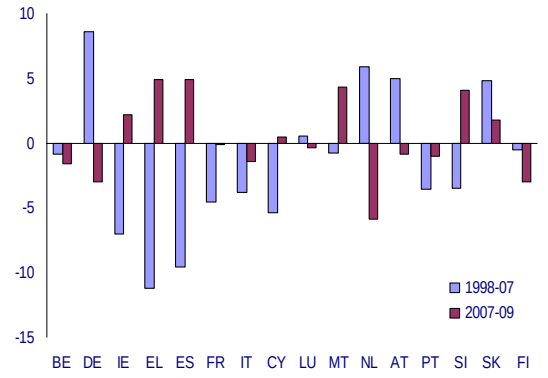
Table I.2.1: **Current account composition (in % of GDP) (1)**

	Balance of goods & services		Net primary income		Net current transfers		Current transactions		Capital transactions		Net borrowing	
	(1)		(2)		(3)		(1)+(2)+(3)=(4)		(5)		(4)+(5)=(6)	
	2009	Ch. 2007-09	2009	Ch. 2007-09	2009	Ch. 2007-09	2009	Ch. 2007-09	2009	Ch. 2007-09	2009	Ch. 2007-09
BE	2.8	-1.1	0.7	-0.3	-1.4	-0.3	2.0	-1.7	-0.2	0.2	1.9	-1.5
DE	4.6	-2.5	1.8	-0.2	-1.4	-0.2	5.0	-2.9	0.0	0.0	5.0	-3.0
IE	15.8	5.6	-17.6	-3.2	-1.3	-0.1	-3.1	2.2	0.0	0.0	-3.1	2.2
EL	-4.8	6.2	-3.7	-0.8	-0.2	0.5	-8.8	5.9	1.3	-1.0	-7.5	5.0
ES	-2.1	4.7	-1.9	0.4	-1.2	-0.3	-5.1	4.9	0.4	-0.1	-4.7	4.8
FR	-1.2	0.7	0.7	-0.4	-1.7	-0.3	-2.3	0.0	0.0	-0.1	-2.3	-0.1
IT	-0.4	-0.2	-1.7	-1.1	-1.0	-0.1	-3.2	-1.4	0.0	-0.1	-3.1	-1.5
CY	-6.4	-0.1	-5.7	0.1	0.4	0.1	-11.6	0.1	0.2	0.1	-11.5	0.3
LU	31.1	-2.3	-20.6	0.2	-1.2	1.8	9.4	-0.3	N/A	N/A	N/A	N/A
MT	2.6	4.5	-6.2	-2.7	1.1	2.6	-2.5	4.5	0.8	-0.1	-1.7	4.3
NL	7.2	-1.5	-2.8	-4.2	-1.7	-0.2	2.7	-5.9	-0.5	-0.1	2.3	-6.0
AT	4.2	-1.7	-1.1	1.0	-0.7	-0.2	2.5	-0.9	0.0	0.0	2.5	-0.9
PT	-7.6	-0.1	-4.1	-0.4	1.1	-0.4	-10.6	-0.8	1.2	-0.2	-9.4	-1.0
SI	1.5	3.2	-1.5	0.6	-0.6	0.2	-0.5	4.0	0.0	0.1	-0.5	4.2
SK	-0.2	0.8	-1.2	1.4	-1.7	-0.3	-3.1	2.0	0.7	0.3	-2.4	2.3
FI	2.8	-2.4	-0.1	-0.1	-1.2	-0.2	1.5	-2.8	-0.5	-0.2	1.0	-3.0

(1) Net lending/borrowing composition, which consists of the current account and capital transactions.
Source: Commission services.

As a result of these changes, there is a clear negative correlation between the current account position recorded in 2007 and developments in 2008-09 (Graph I.2.5).

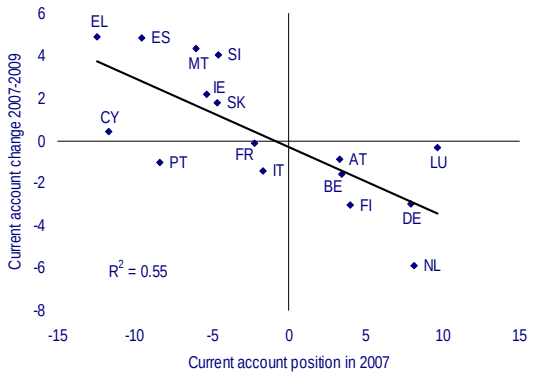
Graph I.2.4: **Changes in current accounts, euro-area countries (% of GDP) (1)**



(1) Net lending (+) or net borrowing (-), total economy; for LU balance on current transactions.
Source: Commission services.

The trade balance was the main driver of the changes in the current account in 2008-09 (see Table I.2.1). However, other components of the current account also played a role in some Member States. Especially, in the Netherlands the large deterioration of the primary income balance was the main component of the drop in the current account since 2007. The deterioration stems mainly from a fall in dividends payments on foreign investment, caused by the global crisis.

Graph I.2.5: **Change in the current account between 2007 and 2009 and its position in 2007, euro-area countries (% of GDP) (1)**

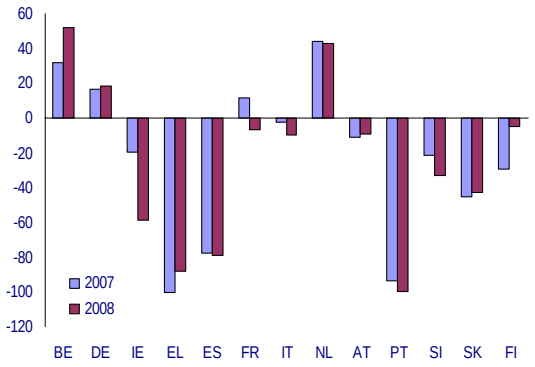


(1) Net lending (+) or net borrowing (-), total economy; for LU balance on current transactions.
Source: Commission services.

An important metric against which to assess the sustainability of current account deficits is the overall net foreign asset position. Despite the reduction in the level of current account deficits, large deficit countries have so far continued to experience a deterioration of their Net Foreign Asset position (NFA) (Graph I.2.6). In 2008, with the exception of Greece, Member States with large net external liabilities registered a further deterioration of their NFA position as a share of GDP. NFA position in deficit countries is expected to deteriorate further in the years to come as current account deficits continue to be accumulated, although on a smaller scale than before the crisis. The forecast sharp slowdown in

GDP in deficit countries will be an aggravating factor, which will more than offset the effects of smaller current account deficits on the ratio of NFA to GDP.

Graph I.2.6: **Net foreign asset positions, euro-area countries (% of GDP)**



Source: Commission services.

In current account surplus countries, the crisis has triggered some negative valuation effects on external asset and liability positions reducing NFA positions by about 5 percentage points of GDP in 2008 (last available data). These valuation effects can in part be related to adjustments in the pricing of risk on bonds as well as losses due to the sub-prime crisis. Further negative valuation effects in 2009 are not unlikely. Valuation effects have also triggered very large changes in NFA positions in some Member States that are acting as financial intermediation centres and/or serve as an investment base for multinational companies (e.g. BE, IE). These countries have accumulated large gross positions which may lead to large swings in NFA positions at times of crisis. In 2008, negative valuation effects reduced the NFA position of Ireland by about 30 percentage points of GDP (which represents 6 times the current account deficit of that year).([9]) Finally, the crisis appears so far (again on the basis of 2008 data) to have partly reversed the pre-crisis trend of negative valuation effects in large current account deficit countries. This is quite clear for Greece where positive valuation effects improved the ratio of NFA to GDP by more than 20 percentage points in 2008. These valuation effects, that are mostly related to fluctuations in equity prices, were also positive although much smaller in Spain and Portugal.([10])

Looking at the financial side of the balance of payment, the analysis of capital flows indicates that the financial crisis has accentuated a trend towards short-term financing of current account deficits within the euro area. Available, although patchy, data suggest that large current account deficits within the euro area are primarily financed by funds from other euro-area Member States (see Box I.2.1). If anything, the financial crisis seems to have accentuated this pattern despite the fact that it has brought a sharp drop in cross-border flows within as well as outside the euro area. Nevertheless the crisis also seems to have accelerated a trend towards a shortening of the maturity structure of capital inflows with a rise in central bank funding and short-term bank funding. This raises sustainability issues concerning the post-crisis financing of current account deficits in the euro area.

Overall, this short review of recent developments in Member States external performance suggest that the economic and financial crisis has led to a reduction in the current account differences in the euro area, but has led to only modest convergence in price/cost competitiveness. In spite of smaller current account divergences, negative NFA positions have continued to build up in deficit countries. Also the trend towards short-term financing of the deficit has further strengthened during the crisis. The impact of the crisis on Member States' export performance has been quite heterogeneous, particularly in terms of export market shares, but these differences cannot be related to competitiveness developments. To some extent, Member States which posted robust export growth prior to the crisis have been hit more severely by the slump in world trade than those which showed a weaker performance in the past.

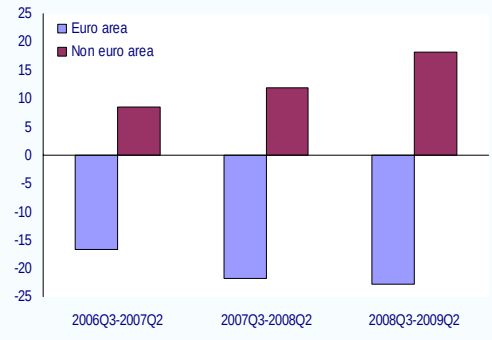
([9]) The negative valuations effects in Ireland mostly come from the country's net foreign asset position in securities other than sharesdue to Ireland's large net (positive) holdings of securities other than shares abroad, the global fall in the price of these securities since then beginning of the cris has translated into large negative valuation effects in this country.

([10]) In EL, ES and PT, domestic equity prices rose faster than in the rest of the world during the years preceding the crisis. As a result, foreign equity holdings in these countries benefited from bigger equity price gains than these countries' equity holdings abroad, generating negative valuation effects on the net foreign asset position. As the same factor has played in reverse since the beginning of the crisis, past valuation losses have been partly reversed.

Box I.2.1: The external financing of current account deficits during the financial crisis

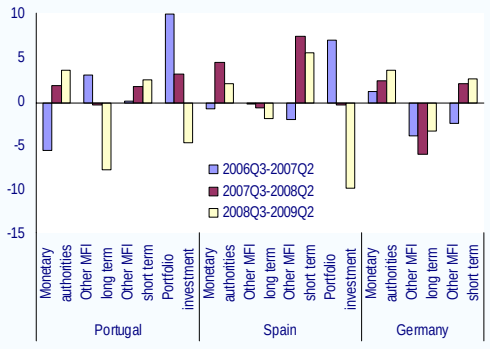
The financing of current account deficits seems to have remained mainly intra euro area during the financial crisis. A geographical coverage of cross-border financial flows is not systematically available for euro-area Member States, neither in the financial account statistics nor in the balance of payments statistics. However, two different statistical sources indicate that the cross-border flows of current account deficit countries are mainly of an intra euro-area nature. Firstly, IMF data on financial stocks, available in terms of portfolio investment for a larger number of countries, show that prior to 2008 between 70% and 80% of portfolio investment in Spain, Portugal, Greece and over 50% in Ireland came from euro-area countries. ([1]) Secondly, the Bundesbank's balance of payments data on financial flows show that Germany has been a net supplier of funds to the euro area and a net receiver of flows from outside the euro area in recent years. ([2]) From 2008Q3 to 2009Q2, German net outflows to the euro area increased slightly, while non euro-area net inflows to Germany increased substantially. All things considered, it is likely that euro-area current account deficit countries have been important beneficiaries of German capital outflows before and during the financial crisis.

Net financial flows – Germany
(as % of GDP) (1)



(1) Positive number indicates net inflows, and a negative one indicates net outflows.
Source: Deutsche Bundesbank.

Net other investment flows in the banking sector
(as % of GDP) (1)



(1) For PT and ES, short and long-term other investments for other MFIs include deposits, loans and other. For DE, they only include loans. Positive number indicates net inflows, and a negative one indicates net outflows.
Source: Bank of Portugal, Bank of Spain and Deutsche Bundesbank.

The crisis has marked a generalised plunge in cross-border flows. After a period of growing financial integration characterised by buoyant cross-border flows with the rest of the world, a reduction in the intensity of cross-border flows became visible already in the second half of 2007 in Spain, Portugal and Ireland. In Ireland, the total of external assets and liabilities flows plunged from 337% of GDP in 2007 to 173% of GDP in 2008. The reduction in the total of external assets and liabilities flows for both Spain and Portugal was of the order of 20 pp of GDP between 2007 and 2008, from about 37% of GDP in 2007. Consistent with these developments, German total financial inflows and outflows dropped from 45% of GDP in 2007 to 12% of GDP in 2008.

Monetary authorities have enhanced net borrowing from abroad in order to deal with liquidity shortages and other Monetary and Financial Institutions (MFIs) have accelerated short-term

([1]) Data on cross-border portfolio holdings are available from the IMF Coordinated Portfolio Investment Survey (CPIS). While the CPIS offers a geographical decomposition of investment in assets across 218 destinations, it suffers from the caveats that some countries might be under reporting and that the data are available only with a two year time lag: accordingly, the latest data available are from 2007.

([2]) A more detailed geographical decomposition of net foreign investment flows from Germany to euro-area individual Member States gives a distorted picture, given that bilateral flows from one country to another often transit via third countries.

(Continued on the next page)

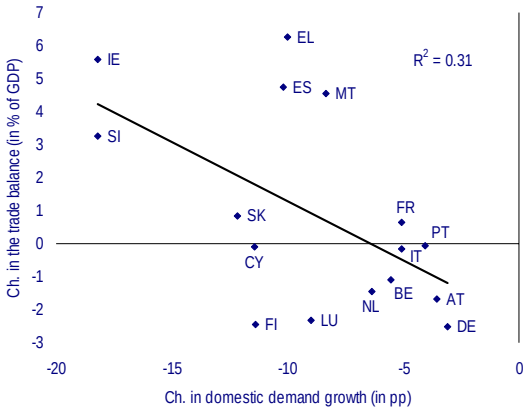
Box (continued)

borrowing from the rest of the world. In the four surveyed countries, monetary authorities have had to intensify borrowing from abroad in order to overcome liquidity shortages in the domestic money market. At the same time, other credit institutions have raised their short-term borrowing from abroad at the expense of long-term funding. Also other MFIs' net inflows of portfolio investment have fallen dramatically since the onset of the crisis. This indicates credit institutions' difficulties in raising funds through securities issuance outside the domestic market as well as an increase in the collateral requirement which credit institutions have to supply in order to get finance on the money market.

3. EXPLAINING RECENT DEVELOPMENTS: A LOOK AT THE UNDERLYING DRIVERS

Developments in current account positions since the beginning of the financial crisis can be traced back to a range of factors related to domestic demand and export performance.

Graph I.3.1: **Changes in domestic demand and in the trade balance, euro-area countries (change between 2007-09)**

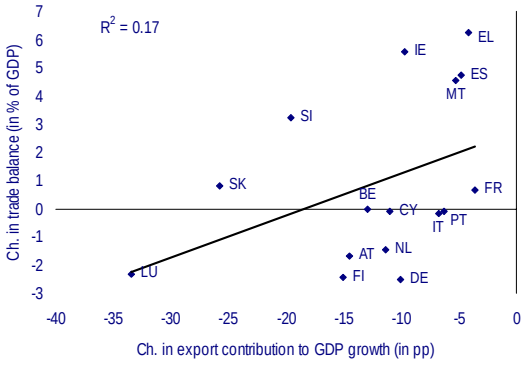


Source: Commission services.

There is a relatively close cross-country correlation between changes in the trade balance and changes in domestic demand between 2007 and 2009 (Graph I.3.1). Member States which saw an improvement in the trade balance also experienced a stronger contraction of domestic demand than the rest of the euro area and vice versa. The negative relation suggests that a large part of the recent changes in current accounts has been driven by changes in domestic demand via the import channel.

To a lesser degree, recent developments in Member States' trade balances reflect also differences in the exposure to the slump in world trade (Graph I.3.2). Changes in the trade balances are positively correlated with the changes in the contribution of exports to GDP growth during the crisis. The latter can be interpreted as a measure of the size of the trade shock experienced during the crisis. A higher contribution indicates lower exposure to the slump in world trade (either because of a lower drop in exports or because of lower trade openness). This suggests that, to some extent, Member States with a lower exposure to the trade slump in 2008-09 also saw a bigger drop in their current account positions. The correlation is however considerably smaller than for domestic demand, indicating that country differences in exposure to the trade slump have played a less important role that country differences in domestic demand.

Graph I.3.2: **Changes in exports and in the trade balance, euro-area countries (change between 2007-09)**



Source: Commission services.

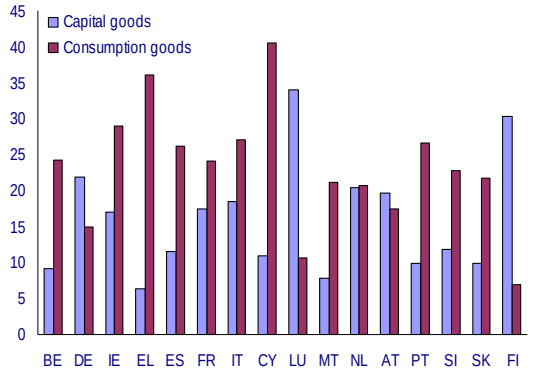
Summing up, this evidence suggests the following explanation for the recent reduction in current account differences within the euro area. After a decade of steady divergence, the global financial turmoil has brought some convergence in current account positions via its differentiated impact on demand and trade in surplus and deficit countries. Most Member States which entered the recession with large current account deficits have seen a combination of very weak domestic demand and a lower exposure to the slump in world trade than in the rest of the euro area. This has allowed significant improvements in the trade balance via both lower imports and more resilient exports. Conversely, Member States which entered the recession with large current account surpluses have experienced more resilient demand and a bigger exposure to the slump in world trade, which have worked towards reducing the surpluses.

Overall, the crisis has clearly exposed the vulnerabilities in countries with large current account imbalances, both deficits and surpluses. Of course, the precise nature of the vulnerabilities varies between countries.

Turning first to the causes of the observed country differences in domestic demand during the crisis, the strong negative demand shock triggered by the crisis in large current account deficit countries can be traced back to the private sector. The current-account balance of an economy reflects the saving and investment decisions of the domestic institutional sectors: households, corporations and the government. Data on saving and investment balances show that Member States with large current account deficits have experienced a sharp rise in the Net Lending or Borrowing (NLB) of the private sector only partly offset by a deterioration in government deficits (Table I.3.1). ([11]) The pattern, which has been less pronounced in Portugal than in Greece or Spain, is largely confined to high deficit countries. Only Ireland and Slovenia show similar developments in private NLB in the rest of the euro area. In contrast, in countries with large current account surpluses, changes in private-sector savings and investment have been far more limited. In those countries, drops in current account surpluses have been mostly driven by increasing public deficits.

Moving on with the causes of the observed country differences in trade exposure during the crisis, these can be related to both differences in trade openness and in the product composition of exports. Most Member States posting large current account deficits tend to be less exposed to trade shocks than the rest of the euro area due to their lower trade openness. In addition, the crisis has exposed the importance of non-price factors for export developments. In particular, the composition of the export basket has been an important determinant of the exposure to the world trade turbulences during the crisis. ([12]) The crisis has hit trade flows much more severely for some products than others. Trade in services, except for transport, has in general fared better than trade in goods. Among goods, investment goods have seen much steeper drops in trade. In contrast, trade in traditional "non-cyclical" sectors such as food and beverages or pharmaceuticals, has been more resilient. Surplus countries in the euro area show a high relative specialisation in capital and investment goods (Graph I.3.3) and have faced sharper contractions in exports during the recession. All the other Member States tend to be more specialised in consumption goods, which has mitigated the impact of the trade slump on exports. The geographical distribution of exports does not seem to have been a major factor of country differences in trade exposure. Overall, the drivers of the differentiated export developments in the euro area during the crisis have been to a large extent cyclical and may well turn around with the recovery.

Graph I.3.3: **Share of capital and consumption goods in total exports of goods, euro-area countries (2007, in %)**



Source: Commission services.

In some deficit countries, an additional source of improvement in the trade balance has been an exceptionally strong drop in imports reflecting change in the composition of domestic demand. The change has been particularly visible in some Member Sates (notably EL, ES, CY, SI but also FI). A comparison of changes in imports and domestic demand shows that the elasticity of imports with respect to demand has increased substantially during the crisis in these countries, implying a substitution of local demand away from imports towards domestic products.

The substitution effect can be related to composition effects and the investment cycle. With falling wealth and lower incomes, households are likely to shift consumption to products of lower price segments. To the extent that domestic and foreign goods belong to the low and high price segment respectively, the shift will reduce the

([11]) The NLB of a sector is calculated as the difference between its savings and its investment and therefore measures the sector's contribution to the overall current account.

([12]) See European Commission (2010) 'The impact of the global crisis on competitiveness and current account divergences in the euro area', Quarterly Report on the Euro Area No.1.

Table I.3.1: **Net lending and borrowing by sector, euro-area Member States (change 2007-09, percentage points of GDP)**

	Net lending borrowing					Gross savings					Gross capital				
	Private			Gov	Total	Private			Gov	Total	Private			Gov	Total
	Hh	Corp	Total			Hh	Corp	Total			Hh	Corp	Total		
BE	1.4	1.0	2.4	-5.7	-3.3	1.7	-0.6	1.1	-5.2	-4.1	0.2	-1.2	-1.1	-1.3	-2.4
DE	0.0	-0.4	-0.4	-3.5	-4.0	0.5	-2.4	-1.9	-3.0	-4.9	0.6	-1.8	-1.2	-0.1	-1.3
IE	12.4	0.4	12.7	-12.7	0.0	5.4	-3.2	2.2	-12.6	-10.5	-6.9	-3.6	-10.4	0.0	-10.4
EL	-4.1	16.2	12.1	-8.8	3.3	-8.3	14.9	6.6	-6.4	0.2	-4.5	-1.3	-5.8	0.0	-5.7
ES	9.8	8.4	18.2	-13.1	5.1	6.0	4.6	10.6	-12.6	-2.0	-3.6	-3.6	-7.2	1.1	-6.1
FR	1.9	3.6	5.4	-5.5	-0.1	0.9	1.5	2.5	-5.2	-2.7	-0.9	-2.0	-2.9	0.1	-2.7
IT	1.5	1.6	3.1	-3.8	-0.6	0.9	-0.2	0.8	-3.9	-3.1	-0.6	-2.1	-2.7	-0.3	-3.0
CY	N/A	N/A	N/A	-6.8	N/A	N/A	N/A	N/A	-6.9	N/A	N/A	N/A	N/A	N/A	-3.2
LU	N/A	N/A	N/A	-5.9	N/A	N/A	N/A	N/A	-5.0	N/A	N/A	N/A	N/A	N/A	-2.5
MT	N/A	N/A	N/A	-2.3	N/A	N/A	N/A	N/A	-2.6	N/A	N/A	N/A	N/A	N/A	-10.2
NL	2.6	-3.1	-0.5	-4.9	-5.5	3.0	-5.3	-2.3	-4.2	-6.5	0.8	-2.3	-1.5	0.1	-1.4
AT	1.9	0.0	1.9	-3.7	-1.8	2.0	-0.9	1.1	-3.6	-2.6	0.2	-1.0	-0.8	-0.7	-1.6
PT	3.3	1.9	5.3	-5.2	0.0	2.0	-1.2	0.8	-5.2	-4.4	-1.0	-3.4	-4.4	1.3	-3.1
SI	1.9	8.6	10.4	-6.5	4.0	1.5	-0.5	1.1	-5.8	-4.7	-0.3	-8.5	-8.7	0.5	-8.2
SK	4.4	-0.3	4.1	-4.7	-0.6	4.8	-3.6	1.2	-3.9	-2.7	0.3	-1.7	-1.4	-5.8	-7.2
FI	3.2	1.4	4.6	-8.1	-3.5	2.4	-4.0	-1.6	-7.6	-9.2	-0.7	-5.4	-6.1	0.4	-5.7

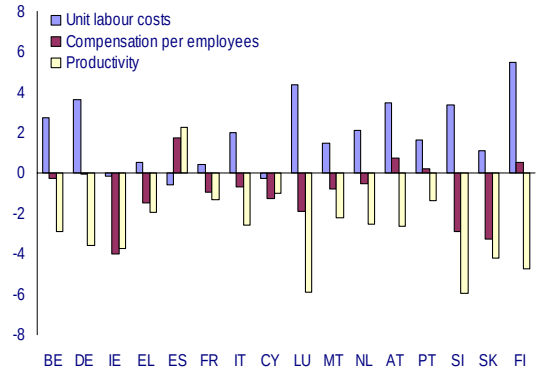
Source: Commission services.

consumption of foreign goods over-proportionally. ([13]) A further factor possibly explaining the strong fall in imports could be related to the kind of products imported. When a country meets a large part of its needs in investment goods via imports – as seems to be the case in Greece – its total import demand is very sensitive to the investment cycle, which has been extremely sharp in the current crisis. Overall, the substitution effect is driven by the crisis and should be largely temporary. The associated improvements in the trade balance should wane progressively as the investment and consumption recoveries set in.

Turning to the drivers of competitiveness, changes in unit labour costs have shown some signs of convergence across Member States mainly due to developments in labour productivity. Unit labour cost (ULC) growth has accelerated significantly since the beginning of the crisis in most Member States but more so in large-surplus countries than in other Member States (Graph I.3.4).

This differentiated behaviour of ULC has been the cause of the moderate convergence of REER based on ULC, reported in Section 2. The convergence has been mainly due to developments in productivity (measured as output per worker), which decelerated more sharply in surplus than in large-deficit countries. Spain has even experienced a pick up in productivity growth compared with its long-term trend. Developments in other Member States are rather heterogeneous with productivity strongly hit by the crisis in some recent euro-area entrants (SI, SK) but also in Ireland. In contrast, developments in compensation of employees have been rather dispersed among surplus and deficit countries. In other countries, growth in compensation has fallen below past trend with particularly sharp drops in Ireland, Slovakia and Slovenia.

Graph I.3.4: **Changes in ULC and its components relative to pre-crisis trends, euro-area countries (percentage points) (1)**



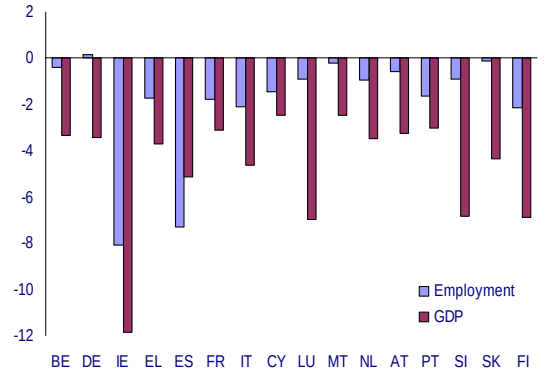
(1) Difference between annual average growth rate in 2008-2009 and in 1999-2007. Employment in persons.
Source: Commission services.

The employment response to the fall in output triggered by the crisis differed significantly across Member (Graph I.3.5). The fall in employment relative to pre-crisis trends has been comparatively smaller in surplus countries and some new euro-area Member States, while larger elsewhere. To

([13]) For example, there is anecdotal evidence that, since the beginning of the crisis, Spanish customers have partly shifted their consumption from luxury imported cars to domestically produced cheaper models.

some extent, the opposite pattern is visible when looking at the average number of hours worked per person (Graph I.3.6). In countries where average hours per worker fell significantly in 2008-09 (DE, LU, AT but also BE) employment growth remained relatively close to trend, a sign of stronger labour hoarding.

Graph I.3.5: **Shocks to GDP and employment during the crisis, euro-area countries (percentage points) (1)**

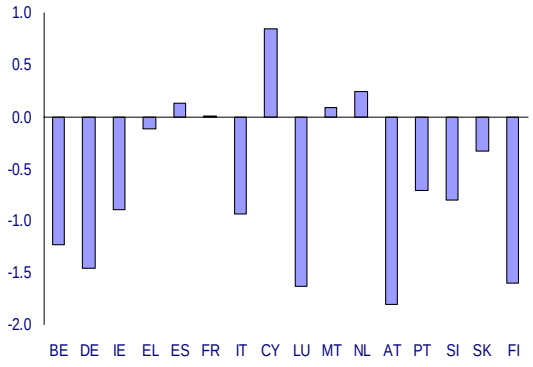


(1) Difference between annual average growth rate in 2008-2009 and during 1999-2007. Employment in persons.
Source: Commission services.

Differences in employment and productivity partly reflect the sectoral distribution of the shocks inflicted by the crisis. Countries that have experienced comparatively large shocks to the construction sector have also recorded significant labour shedding (particularly ES and IE), as employment in this sector is to relatively larger extent based on temporary and flexible contracts and the labour force is relatively low-skilled. Productivity in construction is also relatively low, so the reduction of employment in this sector has also worked towards increasing the productivity in the whole economy. In contrast, the employment response to the crisis has tended to be weaker and labour hoarding larger in countries where the manufacturing sector has been the epicentre of the crisis (e.g. DE, SI, SK).

Differences in employment and productivity can also be related to the structure of the labour market. Labour market data suggest that the crisis has affected mainly the workers with relatively unstable work status, such as temporary workers, low-skilled and self-employed. ([14]) The weight of these groups in total workforce has influenced the magnitude of labour hoarding/shedding across Member States. Spain is a noticeable example in this regard, where fixed-term contracts represent close to ⅓ of total employment. Self-employed have also experienced relatively larger losses in employment. This can be explained by the dependency of the self-employed on bank capital, which has become scarcer in the crisis and by the use of self-employment contracts as a form of flexible employment in some companies. Self-employment is much more prevalent in Southern euro-area countries than in Northern countries such as those with current account surpluses. ([15])

Graph I.3.6: **Growth in hours worked per person employed, euro-area countries (average annual change in %, 2008-09)**



Source: Commission services.

Differences in employment response are also accounted for by differences in employment policy. Governments have taken a range of measures to address the weakening labour market, which have had an impact on employment and labour costs. Government-sponsored schemes to supplement wages of workers working at reduced hours have encouraged labour hoarding in several countries. These measures have been most pronounced in countries as Austria, Germany, Luxembourg, Italy or France, but broadly absent in Spain, Greece or Portugal. Governments' action in

([14]) For a thorough review and discussion see European Commission (2008), 'Labour market and wage developments in 2008', European Economy No. 8/2009.

([15]) The share of the self-employed in the euro area is 9.5%, while the (un-weighted) average in Greece, Spain, Portugal, Cyprus and Italy is 15% and the (un-weighted) average in Germany, Austria, Luxembourg and France is 5.8%.

the labour market has also aimed at alleviating non-wages costs in overall labour costs. These measures have usually taken the form of reduction in social security contributions (BE, FR, DE), especially for low earners (FI, MT). These rebates were usually conditional on job creation and helped to support employment.

Overall, the recorded convergence in labour cost growth within the euro area may prove to be largely temporary. The convergence in ULC growth mostly reflects different Member State responses to the crisis in terms of productivity and employment policies rather than wage adjustment to pre-crisis competitiveness divergence. The productivity responses are largely cyclical and are likely to be progressively reversed when the recovery sets in and emergency labour market measures are unwound. Accordingly, most of the observed convergence in ULC during 2008 and 2009 is forecast to reverse up to 2011.

Looking forward, the analysis presented in this section suggests that the reduction in current account differences observed since the beginning of the crisis is likely to be partly reversed as the recovery takes hold. While current account deficits and surpluses have narrowed significantly in 2008 and 2009, this adjustment has not been followed by significant price adjustments. The moderate adjustment of ULC seems to be mostly cyclical and is likely to be at least partly reversed with the recovery. The reduction of large current account deficits in 2008 and 2009 has been driven by strong falls in imports than rather by gains in export market shares. The fall in imports can be traced back to falling domestic demand and changed elasticities of imports relative to income. It is likely that the elasticities will return to pre-crisis levels once the severe shock of the crisis abates. Imports could then increase again and, in the absence of competitiveness gains, larger current account deficits could re-emerge. In the current account surplus countries, there is evidence that the contraction in exports was particularly strong due to the collapse in world trade. With the recovery in other parts of the world taking hold, exports are likely to bounce back. This would widen current account surpluses again. However, it is worth stressing that the dividing line between permanent and temporary/cyclical effects is particularly difficult to draw in the current situation.

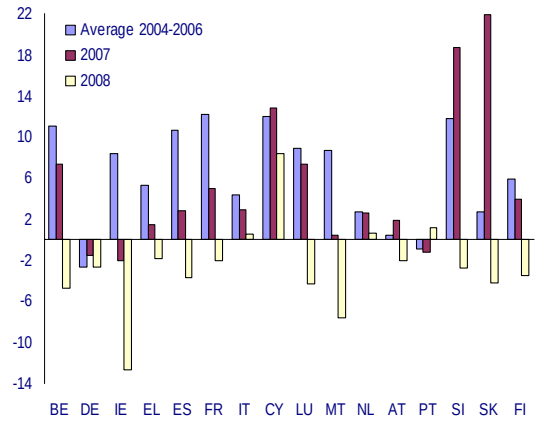
4. UNDERLYING DOMESTIC MACROECONOMIC IMBALANCES

Changes in competitiveness and current accounts are not bad per se in a monetary union. Given that the nominal exchange rate can no longer play the role of an adjustment tool, response to shocks takes place via competitiveness changes. A key issue for economic policy is to distinguishing between 'harmful' and 'benign' changes in competitiveness, with the former requiring some form of policy intervention while adjustment to the latter can be left to market forces. Economic theory suggests that the distinction largely depends on the extent to which changes in external performance are driven by market dysfunction or policy mistakes. It is therefore crucial from a policy perspective to assess the extent to which developments in competitiveness and external performance within the euro area can be related to policy mistakes, market failures or any form of domestic macroeconomic imbalance at Member State level. ([16])

Looking at the developments before the crisis, competitiveness divergence was driven by both 'harmful' and 'benign' factors. Factors such as Balassa-Samuelson effects, price convergence or cyclical differences in unit labour costs could be considered to be largely neutral for external performance. In the same vein, current account dispersion within the euro area was partly a sign of increased financial market integration, with the euro acting as a catalyst. At the same time, differences in cost competitiveness could in part be ascribed to inappropriate responses of wages to productivity shocks. Furthermore, losses in competitiveness and the accumulation of large current account deficits could, in a number of Member States, be related to a range of domestic macroeconomic imbalances that warrant close surveillance. These include sluggish productivity performance, the accumulation of high private sector debt and the emergence of housing bubbles. In surplus countries, the improvement in external balances in pre-crisis years can in part be ascribed to persistent weakness in private sector demand, with balance sheet adjustment in the corporate sector playing an important role. ([17])

The present section discusses the extent to which recent developments in competitiveness and current accounts since the onset of the crisis are underpinned by changes in underlying domestic imbalances. It looks successively at recent developments in housing markets, private sector credit and balance sheets.

Graph I.4.1: **Real house prices, euro-area countries (annual growth in %) (1)**



(1) House prices deflated by the HICP.
Source: ECB, Commission services.

The progressive cooling off of housing markets in the euro area is helping to reduce current-account imbalances. Housing markets have played a pivotal role in the divergence of external positions across euro-area Member States over the past decade. They have amplified the effects of differences in real interest rates and in the speed of financial deepening on domestic demand across Member States. In some Member States, the rapid expansion of the construction sector has also contributed to divert resources away from the export sector. These trends have been all the more worrying as house price developments have been in some cases clearly unsustainable. The ongoing

([16]) For a discussion see European Commission (2009), 'Competitiveness developments within the euro area', Quarterly Report on the Euro Area, No 1.

([17]) See e.g. European Commission (2006), The EU Economy 2006 Review: Adjustment dynamics in the euro area – Experiences and challenges;
European Commission (2008), EMU@10 – Successes and challenges after 10 years of Economic and Monetary Union, European Economy No. 2/2008, European Commission, DG Economic and Financial Affairs.

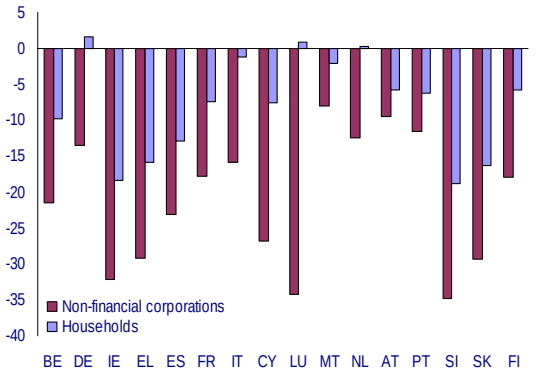
cooling off of housing markets is affecting all euro-area Member States except Germany and Portugal, where house prices have remained fairly flat of negative (Graph I.4.1). It tends, however, to be more pronounced in countries with competitiveness problems and where house price booms were greatest before the onset of the crisis (BE, EL, ES, IE, FR, MT, SI).

The rebalancing of the construction sector is visible in terms of prices but also quantities. In most euro-area countries that underwent or still undergo a catching-up process, as well as Ireland, (although to a lesser degree), the crisis has entailed a dramatic downshift in construction activity relative to pre-crisis trends. In contrast, the downshift has been more muted in current account-surplus countries, with the exception of Finland. Overall, the reduction of housing imbalances is helping to reduce external imbalances within the euro area. At this juncture, it remains difficult to say, however, to what extent the reduction is durable or will be reversed with the recovery.

In a number of Member States, households have embarked on a balance sheet adjustment process combining an increase in savings and a reduction in residential investment. This is particularly the case of some current account deficit countries (ES and IE and to a lesser degree PT and SK). ([18]) The adjustment is translating into a large increase in households' net lending/borrowing (NLB) which is reducing current account deficits. The extent to which the ongoing adjustment is durable or just a temporary by-product of the crisis is difficult to assess. The crisis has probably led to a lasting change in risk attitudes, particularly in the banking sector, suggesting that at least part of the adjustment will persist. In contrast, although households have raised NLB everywhere across the euro area but in Germany, the increase has generally remained limited in Member States that do not feature high current-account deficits (with the exception of FI). The balance sheet adjustment process therefore goes in the direction of reducing the imbalances which underlie competitiveness problems in the euro area.

In contrast, signs of balance sheet adjustment in the corporate sector remain so far limited except in Spain, Greece and, to some degree, in France and possibly in Slovenia. A fairly reliable indication of balance sheet repair in the corporate sector is generally provided by a simultaneous decline in corporate investment and a rise in corporate savings. While in a world of perfect capital markets, adjustment to debt overshooting and excessive leverage can be obtained by the issuance of new equity, in reality the issuance of new equity is often constrained by many factors such as fixed costs of equity issuance, temporarily high risk aversion, the cost of external funding, issues related to corporate control, etc. These capital market imperfections force corporations to rely, at least partly, on internal funding to adjust their balance sheet structure. To achieve this, firms simultaneously cut investment and raise savings. Since the onset of the crisis, such concurrent movements in investment and savings have been registered essentially in Spain, Greece and to a lesser degree in France. Slovenia is borderline, with the largest drop in capital formation in the euro area and only a marginal fall in savings. In other Member States, investment has generally dropped due to various cyclical factors (a lack of demand, increased uncertainty, restricted access to external funds) but savings have also decreased significantly due to deteriorating profitability.

Graph I.4.2: **Credit growth, euro-area countries (change in y-o-y growth Jan. 2008-Jan. 2010)**



Source: ECB, Commission services.

Recent credit data provide further evidence of balance sheet adjustment. Credit to households and corporations fell dramatically over the 2008-09 period in most Member States with large current account deficits, in some of the new euro-area

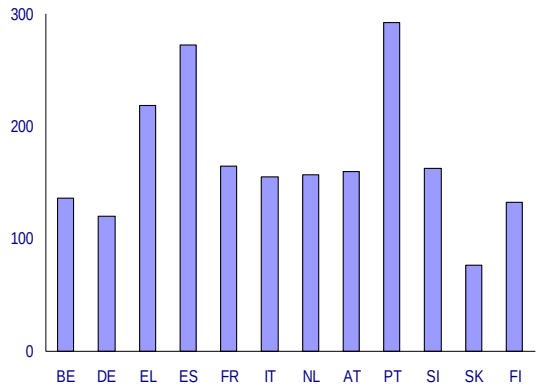
([18]) No data available for EL, CY, LU and MT.

Member States (CY, SI and SK) and of the countries where deficits are not very large but export performance was weak prior to the crisis (mostly BE and IE) (Graph I.4.2). In contrast, the drop in credit has been less strong in Member States with large current-account surpluses.

It is difficult to say how far balance sheet adjustment in the household sector still has to go in highly indebted Member States. But in any event, further balance sheet adjustment is likely in the corporate sectors of a range of Member States, particularly in large-deficit countries. Adjustments to asset price falls, debt overshooting, high leverage and lower growth prospects can trigger protracted phases of balance sheet adjustment characterised by substantial reductions in the net borrowing of the corporate sector. Recent research suggests that euro-area corporations entered the recession with debt overhang of about 15%. ([19]) In addition, the crisis has triggered sharp falls in asset prices which have led to a strong increase in leverage ratios across euro-area Member States. In addition the crisis is also projected to reduce euro-area growth potential. This would raise the debt burden relative to expected earnings and might force companies to reduce debt further. Due to these factors combined with changes in risk attitudes and risk premia, the financial turmoil is likely to be followed by a drawn-out period of corporate balance sheet repair in the euro area.

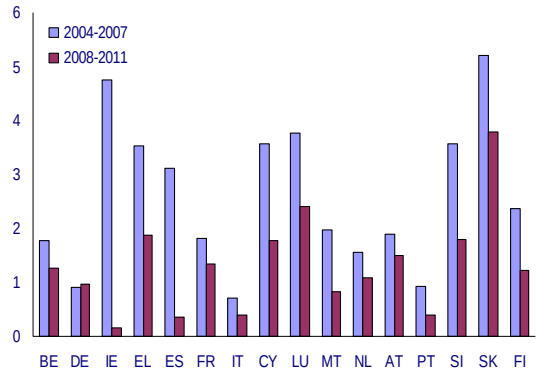
Needs in terms of corporate balance sheet adjustment appear particularly large in Member States with large external deficits. Leverage is indeed high in their corporate sector (Graph I.4.3), potential growth is expected to decelerate more strongly than in the rest of the euro area (with the exception of PT, see Graph I.4.4). Moreover, these countries also faced persistent pressures on profitability in the years preceding the crisis (Graph I.4.5). Some of these factors are also at play in other country groups and could entail some balance sheet adjustments to respond to past pressures on profits (CY, IT) or a sharp slowdown in growth prospects (IE and most new Member States).

Graph I.4.3: **Corporate leverage, euro-area countries (2008, in %) (1)**



(1) Ratio of debt to value added in the non-financial corporate sector. Debt is the sum of securities other than shares and loans. Data for IT are for 2007.
Source: Commission services.

Graph I.4.4: **Potential growth, euro-area countries (average annual growth in %)**



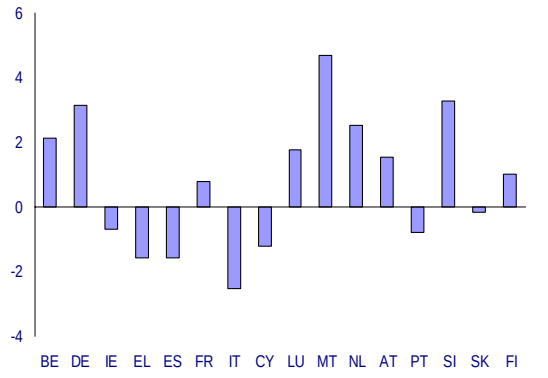
Source: Commission services.

While some progress has been made (and more is to come) in terms of underlying domestic imbalances in current account deficit countries, imbalances related to domestic demand seem to persist in surplus countries. During the crisis, domestic demand remained relatively resilient in surplus countries due to significant fiscal expansion and comparatively stable private sector net lending. As a result, imports have been falling much less than exports and current account surpluses have contracted. This constituted a sizeable positive growth contribution to the rest of the world. At this juncture, it is however difficult to discern any substantial structural strengthening

([19]) Sorensen C.K., D. Marques Ibanez and C. Rossi (2009), 'Modelling loans to non-financial corporations in the euro area', *ECB working paper*, No. 989 (January).

of private-sector demand in these Member States. The changes in risk attitudes and in bank lending triggered by the crisis could prolong the period of corporate balance sheet correction which contributed to the accumulation of surpluses in some of them in the pre-crisis years.

Graph I.4.5: **Changes in corporate profitability, euro-area countries (2004-07, in percentage points) (1)**

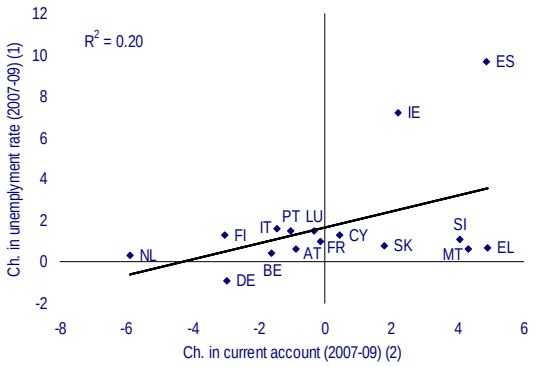


(1) Change in the ratio of gross operating surplus to gross value added in the non-financial corporate sector. 2004-06 for EL and LU.
Source: Commission services.

Whereas some underlying macroeconomic imbalances have been reduced, new imbalances have started to build-up. Some of the countries with external imbalances or competitiveness problems have registered a cooling off of the housing market, early signs of improvements in household balance sheets and very preliminary evidence of an adjustment in corporate debt. These improvements in underlying domestic imbalances have, however, been associated with large rises in unemployment. This is particularly the case for Spain and Ireland (Graph I.4.6).

Part of the rise in slack is cyclical and will be absorbed when the economy picks up. However, part of it is of a more persistent or structural nature. Further evidence of the persistence of the rise in unemployment comes from the steep rise in the estimated NAIRU in Spain and Ireland. The crisis has triggered a process of structural downsizing in some industrial sectors, notably construction (EL, ES and IE). The required reallocation of the labour force to expanding sectors, mostly the export sector, will take time – involving workers' retraining but also new capital investment – and therefore risks being associated with a lasting rise in unemployment.

Graph I.4.6: **Changes in current account and unemployment, euro-area countries**



(1) In pp of labour force. (2) Change in Net lending (+) or net borrowing (-), total economy (in pp of GDP); balance of current transactions for LU.
Source: Commission services.

Further evidence of persistent underlying imbalances comes from a lack of price and competitiveness adjustment. The rebalancing of current accounts among euro-area Member States, has so far been associated with some rebalancing of house prices but, as documented in Section I.2 little changes in other underlying relative prices. To be sustainable, a correction in current accounts must be supported by changes in competitiveness and relative prices in order to redirect demand and supply between the export sector and the rest of the economy. ([20]) This has so far not been the case. The lack of competitiveness adjustment does not seem to be due to the slow response of prices and wages to changes in the cyclical conditions as the competitiveness divergence is projected to persist in the medium term. ([21])

([20]) See discussion on adjustment in Section I.5 for more details.
([21]) Commission (2009), European Economic Forecast. Autumn 2009, European Economy 10/2009.

5. COMPETITIVENESS ADJUSTMENT WITHIN THE EURO AREA

The analysis presented in the previous sections of this report shows that notwithstanding some convergence in current accounts in the past two years, prices and wages have – with the exception of Ireland – adjusted very little to date. Significant imbalances continue to exist in EMU and will put considerable pressure on Member States adjustment capacity in the years to come. This section starts with presenting the size of the competitiveness adjustment needs based on Commission estimates of equilibrium REER. It then assesses the implications of the financial crisis for the functioning of the competitiveness adjustment mechanism and discusses structural features of the Member States' economies that could contribute to facilitate adjustment. It also discusses the benefits of coordinating competitiveness adjustment across Member States.

5.1. ASSESSING THE MAGNITUDE OF THE REQUIRED ADJUSTMENT

Estimates of equilibrium REER can provide a useful benchmark of the required competitiveness adjustments within the euro area. Not surprisingly, the countries with the largest observed current account imbalances exhibit the most pronounced REER misalignments (see Box I.5.1).([22])

The 2009 estimates of equilibrium REER point to persistent competitiveness misalignments but the magnitude of the misalignments is, in most cases, smaller than in the case of the estimates based on 2008 data. The 2009 estimates should however be interpreted with prudence. Assessing equilibrium exchange rates is particularly challenging in times of severe financial and economic crises especially because it is difficult to distinguish temporary from permanent changes in current accounts in times of severe market turbulences (see Box I.5.1 for details). Methodological difficulties related to the exceptional circumstances of the crisis suggest that it is safer to use 2008 estimates of REER misalignments when trying to assess price and wage adjustment needs within the euro area.

Overall, estimates point to the need for a substantial rebalancing of relative prices across Member States. Available evidence suggests that the competitiveness adjustment channel is operational in the euro area. ([23]) However, in the absence of additional reform effort, there is a risk that competitiveness rebalancing will be a drawn-out process. Adjustment of the euro-area economy could be hampered by the significant labour and product market rigidity which characterise the economies of most Member States. Rigidities tend to lengthen the period of adjustment and make them more costly in terms of unemployment. Measures of product and labour market regulations indicate that rigidity tends to be particularly high in the Member States which currently show high competitiveness adjustment needs (Table I.5.1).

The cost of rigidity could be further magnified by asymmetries in the functioning of the competitiveness adjustment channel. Available evidence shows that relative prices within the euro area do respond to relative cyclical positions in such a way as to moderate cyclical differences but the process is asymmetric: in relative terms, wages and prices rise more strongly when the output gap is positive, than fall when the output gap is negative. The asymmetry appears to be large in some of the countries which currently show high downward adjustment needs (see Graph I.5.1). ([24])

([22]) Estimates of equilibrium REER are generally calculated as the level of the REER which is consistent with some specific medium-term macroeconomic or statistical requirement. Various approaches have been proposed in the economic literature. They all have their pros and cons and are surrounded by significant uncertainty. Combining the information provided by different methodologies as is done in this report (which proposes two approaches) can help reduce this uncertainty. Nevertheless, any assessment based on estimates of equilibrium REER should be made with considerable prudence.

([23]) See e.g. European Commission (2006), The EU Economy 2006 Review: Adjustment dynamics in the euro area – Experiences and challenges;
European Commission (2008), EMU@10 – Successes and challenges after 10 years of Economic and Monetary Union, European Economy No. 2/2008, European Commission, DG Economic and Financial Affairs.

([24]) Arpaia, A. and K. Pichelmann (2007), 'Nominal and real wage flexibility in EMU', European Economy, Economic Paper No. 281 (June), European Commission, DG Economic and Financial Affairs.

Box I.5.1: Assessing competitiveness adjustment needs on the basis of equilibrium exchange rate estimates

This box presents estimates of the competitiveness adjustment needs in individual euro-area Member States. The adjustment needs are calculated as the change in the REER required to close the gap between estimates of the equilibrium current account and the underlying value of the current account. The required exchange rate adjustment is obtained by means of country-specific elasticities of the current account with respect to the real exchange rate. The underlying value of the current account is the actual value of the current account corrected for an estimated impact of the cycle (the output gap) and of past changes in real effective exchange rates. Two approaches are used to assess the equilibrium current account:

- **The current account norms (CAN).** This approach estimates the current account that would prevail over the medium to long-term on the basis of a set of fundamentals variables including, inter-alia the determinants of the saving-investment balance of the economy.* The relation between current account balances and fundamentals is estimated on a large panel of industrial and emerging economies. The prediction from this estimation based on average values of the fundamental variables for the last 7 years is the current account norm.
- **The net foreign asset stabilisation (NFAS).** The benchmark current account is, in this case, the one that guarantees the stabilisation of the NFA/ GDP ratio at a given level. In the present analysis, the requirement is that the NFA/ GDP ratio is stabilised at the most recent available value (referring to 2007).

Current accounts, current account norms according to the CAN and NFAS approach and estimated over-/undervaluation in REER

	Actual current account (% GDP, 2008)	Underlying current account (% GDP,2008)	Current account norm (% GDP, 2008)	Current account that stabilises the NFA position (% GDP, 2008)	2008 Estimated over-/ undervaluation (%)		2009 Estimated over-/ undervaluation (%)	
					CAN	NFAS	CAN	NFAS
BE	0.2	-1.6	0.5	1.0	1.5	1.8	2.0	2.2
DE	6.6	7.3	-1.2	0.4	-11.3	-9.1	-5.1	-3.1
IE	-5.1	-8.8	-0.5	-0.2	5.9	6.1	5.6	6.2
EL	-13.8	-13.7	-6.6	-5.3	16.8	20.0	7.2	13.7
ES	-9.5	-10.4	-3.5	-2.7	14.6	16.2	6.4	12.2
FR	-3.3	-3.8	-1.0	0.0	6.0	8.3	4.8	7.1
IT	-3.0	-3.4	-1.9	0.0	3.1	7.2	3.6	7.7
NL	4.2	5.3	1.7	1.1	-2.9	-3.4	1.6	0.9
AT	3.6	4.4	-1.4	-0.4	-6.0	-4.9	-1.1	0.1
PT	-12.1	-12.9	-5.3	-2.1	13.5	19.3	10.6	18.5
SI	-6.1	-4.7	-1.7	-1.4	2.6	2.8	2.2	3.0
SK	-6.8	-11.0	-3.5	-3.2	5.3	5.5	8.0	8.3
FI	2.6	2.7	-0.3	-1.3	-3.9	-5.3	1.7	1.0

Source: Commission services.

The current financial crisis significantly complicates the estimation of misalignments. First, the estimates of competitiveness adjustment needs are based on preliminary data for 2009 that could be revised substantially. This is true for the value of current-account balances but also for estimates of the output gap used to calculate the underlying current account. Second, the correction for output gaps and lagged REER effects permits to estimate underlying current account figures that better reflect structural positions. However, during periods of financial turbulence and very sharp contraction in activity, current accounts are likely to be driven to a greater extent by temporary factors which cannot properly be corrected with the estimation approach. While the approaches are able to account for the business cycle, the severe crisis is

(Continued on the next page)

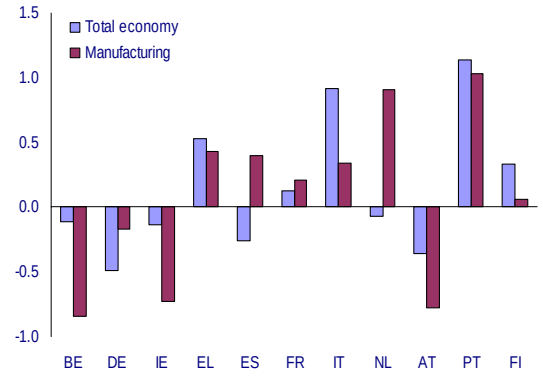
Box (continued)

associated with many very significant temporary phenomena that cannot be catered for. For example, higher import elasticities to GDP during the crisis have led to marked improvements in current accounts in Greece and Spain because imports fell more strongly than the cycle would suggest. The estimation approach takes this as a permanent improvement while it is conceivable that the elasticity has changed only temporarily due to the crisis. Similarly, surplus countries' exports have been severely hit but the sharp reduction in exports might be a temporary effect linked to the sectoral nature of the collapse of world trade. This effect would not be catered for in the estimation approach. The uncertainties surrounding estimates of equilibrium exchange rates in times of sever crisis are, to some extent, reflected in large differences in the estimates provided by the two approaches in some countries.

Overall, estimation results should therefore not be interpreted mechanistically. The table in this box therefore presents the estimated over-/undervaluation for 2009 and 2008 alongside the underlying estimates of the current account norm and the current account level that stabilizes the NFA, both for 2008. The 2008 values appear to better suited for the analysis since the 2009 estimates are significantly affected by the exceptional crisis situation.

(*) See for instance Chinn, M.D. and E.S. Prasad, (2003), 'Medium-term determinants of current accounts in industrial and developing countries: an empirical exploration', *Journal of International Economics*, Vol. 59, pp. 47-76, and Lee, J., G.M. Milesi-Ferretti, J. Ostry, A. Prati, and L. Ricci (2008), 'Exchange rate assessments: CGER methodologies', *IMF Occasional Paper* No. 261.

Graph I.5.1: **Asymmetries in the response of competitiveness to the business cycle, euro-area countries (1)**



(1) The asymmetries are calculated as the difference in the cyclical response of ULC in times of positive and negative output gaps. The cyclical response is measured by the elasticity of ULC (relative to the rest of the other euro area) to the output gap (relative to the rest of the euro area). Estimations are done for the period 1970-2005.
Source: Arpaia and Pichelmann (2007).

5.2. POSSIBLE IMPACT OF THE CRISIS ON MEMBER STATES' ADJUSTMENT CAPACITY

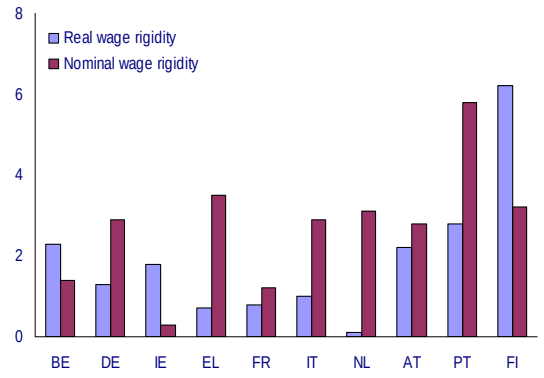
In the absence of policy responses, there is an additional risk that the global economic and financial crisis could further hamper competitiveness adjustment due to: i) the interaction between nominal rigidities and the period of low inflation brought by the crisis; ii) the impact of the crisis on corporate balance sheets; and iii) the possible negative impact of the crisis on potential output.

In the current context of low inflation, nominal wage rigidities emerge as a distinct source of concern. A distinction can be made between nominal and real downward rigidities which correspond, broadly speaking, to workers' reluctance to accept, respectively, nominal and real wage cuts. In theory, both types of rigidities have the potential to slow adjustment processes and raise the associated costs in terms of unemployment. In the current environment of low inflation, however, concerns about nominal rigidities have come to the fore. Indeed, both economic theory and empirical evidence suggest that nominal rigidities become more binding the lower the level of inflation.

Evidence from firm-level data shows that nominal rigidities are, to various degrees, prevalent in most euro-area Member States. But nominal rigidities seem to be particularly prevalent in those Member States that experienced large losses in competitiveness prior to the financial crisis

(Graph I.5.2). ([25]) Evidence based on micro data should be interpreted with prudence as its macroeconomic implications are not fully established yet. For instance, company surveys show that firms can at least partly circumscribe nominal wage rigidities by cuts in non-wage labour costs (e.g. bonuses, rates of promotions, new recruitment at lower wages, etc.). ([26]) It is also possible that nominal wage rigidities may become less widespread after a protracted period of low inflation as actors on the labour market become more used to nominal wage cuts and less prone to nominal illusions. Overall, however, micro data point to an increased risk of protracted price adjustment in a context of low inflation. This risk calls for reforms aimed at reducing nominal rigidities. The recent experience in Ireland and Greece also shows that determined policy action in terms of public wages can facilitate overall competitiveness adjustment when changes in public wages influence private-sector wage negotiations.

Graph I.5.2: **Micro evidence on nominal and real wage rigidities, euro-area countries**



Source: Dickens, Goette, Groshen, Holden, Messina, Schweitzer, Tutunen, Ward-Warmedinger (2008) "Downward real and nominal rigidity: micro evidence from the international wage flexibility project", updated data from Journal of Economic Perspectives, 21(2), pp.195-214, 2007.

As discussed in the previous section, pre-crisis balance-sheet stress has been severely compounded by the crisis-induced drop in asset prices and changes to risk attitudes. The ongoing phase of balance sheet correction is likely to persist for some time, at least in the corporate sector. Member States which face considerable adjustment needs in terms of both price competitiveness and corporate balance sheets will have to strike a delicate balance between raising corporate cash flow to fix balance sheets and lowering prices to restore competitiveness. In other words, corporate balance sheet correction may slow the speed of the adjustment process by reducing firms' capacity to pass through lower wage costs into output prices.

Finally, the functioning of the competitiveness channel could also be impaired by the negative impact of the crisis on potential growth. Many economists argue that, unless appropriate policies are put in place, the crisis will entail a significant and lasting fall in the level of potential output and could, possibly, shift potential growth below its pre-crisis trend during a protracted period. ([27])

This negative effect reflects a temporary increase in the NAIRU but also a downshift in productivity. A rise in the NAIRU reduces the unemployment gap and could therefore contain downside pressures on wages resulting from the ongoing rise in unemployment. Furthermore, to the extent that changes in trend productivity tend to be reflected in wages with a lag, negative shocks to productivity can lead to a temporary increase in unit labour costs. ([28]) The combination of these two mechanisms could lead to relative labour cost pressures in Member States where either i) the crisis-induced slowdown in productivity is comparatively stronger or ii) the response of wages to changes in productivity is slower.

As highlighted in Section I.4., Commission estimates point to a risk of larger losses in potential growth in Member States with large

([25]) See for instance: ECB (2009), 'New survey evidence on wage setting in Europe', ECB Monthly Bulletin, February 2009. Dickens et al(2007), 'How wages change: micro evidence from the International Wage Flexibility Project', Journal of Economic Perspective, No. 21(2), pp. 195-214.

([26]) ECB (2009), op. cit.

([27]) See for instance:
European Commission (2009), 'The impact of the economic and financial crisis on potential growth', Quarterly Report on the Euro Area, Vol. 8 No.2.
European Commission (2009),' Impact of the current economic and financial crisis on potential output', European Economy, Occasional Papers No. 49 (June), European Commission, DG Economic and Financial Affairs.

([28]) The existence of such lags in European countries (but not in the US) is well documented. See the seminal contribution of Blanchard, O. J. and L. Katz (1999), 'Wage dynamics. Reconciling theory and evidence', *American Economic Review*, No. 89, May 1999, pp. 69-74.

competitiveness adjustment needs. In these countries, wage bargaining systems face the double challenge of having to adjust to past losses in competitiveness as well as to weaker productivity growth. Clearly, policies to boost potential growth would be highly beneficial.

5.3. STRUCTURAL FACTORS WHICH COULD FACILITATE ADJUSTMENT PROCESSES

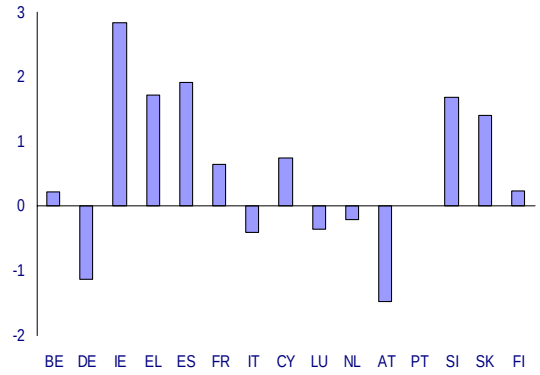
The fact that the crisis may weigh on Member States' adjustment capacity calls for an ambitious policy response. The previous discussion in this section has already suggested three areas where policy action would facilitate adjustment: i) structural reforms that reduce nominal and real rigidities; ii) structural reforms that counter the impact of the crisis on potential output; iii) measures that facilitate balance sheet adjustment, particularly in the corporate sector.

The remainder of this section looks at two additional areas where reform could help to facilitate adjustment processes: internal adjustment and non-price competitiveness. It also discusses the possible benefits of a coordinated policy response in the euro area.

Adjustment to external imbalances will not only require rebalancing of relative export prices but also changes in domestic relative prices. Empirical evidence shows that sustainable changes in the current account must be supported by changes in the internal exchange rate (i.e. the price of non-tradable goods and services relative to the prices of exports), as much as the external exchange rate (i.e. the price of exports relative to the prices of foreign competitors). ([29]) For euro-area Member States, the importance of this internal adjustment process has, if anything, increased with the introduction of the euro as the suppression of nominal exchange rate realignments has eliminated a key channel of adjustment of the external exchange rate.

The underlying mechanics of the internal adjustment has been particularly visible in some parts of the euro area in recent years. Before the crisis, Member States with large current account deficits were suffering from excessive domestic demand pressures with price pressures particularly marked in the non-tradable sector (notably housing) where supply tends to respond less or more slowly to price signals than in the tradable sector. This led to a shift of demand towards the tradable sector. These economies also experienced an opposite shift of supply from the tradable to the non-tradable sector as the comparatively high prices of non-tradable attracted capital and labour. Both shifts contributed to raise the current-account deficit. Graph I.5.3 provides evidence of these sectoral changes: employment growth in the non-tradable sector has significantly exceeded employment growth in the tradable sector in most countries which have built-up large current-account deficits (and conversely in surplus countries).

Graph I.5.3: **Employment growth in the non-tradable sector relative to the tradable sector, euro-area countries (2001-07 in %) (1)**



(1) Average annual growth of employment in the non-tradable sector relative to the tradable sector in relation to the euro area. Non-tradable sector is approximated by construction and market services while tradable sector comprises agriculture and industry.
Source: Commission services.

These changes in the relative prices of the tradable and non-tradable sectors will now have to be reversed as the crisis has prompted a brutal unwinding of upward demand pressures in current-account deficit countries. The collapse in demand has been associated with a decrease of the current-account deficits but also the emergence of substantial excess capacity, particularly in the non-tradable sector. Regaining competitiveness is necessary to achieve a sustainable improvement in

([29]) Ruscher, E. and G.B. Wolff, (2009)' External rebalancing is not just an exporters' story: real exchange rates, the non-tradable sector and the euro', European Economy, Economic Papers No. 375 (March), European Commission, DG Economic and Financial Affairs.

the current account that is associated with full use of labour and capital resources.

Moving the economy to a more sustainable path will require unwinding all past excesses and therefore not only improving the price competitiveness of the export sector but also reducing the relative prices of non-tradable. The price rebalancing will be associated with re-channelling of capital and labour resources from the non-tradable to the tradable sector. Overall, the change in the price of non-tradable will be needed to avoid a protracted period of underutilisation of capital and labour resources. This means that price/wage flexibility in the non-tradable sector (mostly services) will partly determine the speed of the competitiveness adjustment.

An important dimension of a country's adjustment capacity therefore relates to its capacity to reallocate capital and labour resources across sectors. The magnitude of the change in the internal exchange rate necessary to put the economies with large current-account deficits back on a sustainable path will depend on how responsive supply and demand are to changes in relative prices. In particular, the required adjustment of the internal exchange rate will be larger the more rigid supply is. If resources, particularly labour, are characterised by little mobility across sectors, the burden of adjustment will fall more on consumption and will require larger price changes (with a risk of more slack in the economy during the phase of adjustment). Overall, boosting adjustment capacity will not only require policy measures targeted at the export sector but also reforms in the non-tradable sector.

The need to reallocate capital and labour across sectors involved in adjustment processes points at the importance of a well-functioning financial sector. The crisis has negatively affected financial intermediation, thereby hampering the necessary reallocation of capital and, consequently, labour across sectors. Ongoing efforts to restore the full-functioning of the financial sector are therefore crucial for competitiveness adjustment processes within the euro area.

Another area where reform could facilitate competitiveness adjustment is non-price competitiveness. The adjustment capacity will also depend on Member States' degree of non-price competition. Measures aimed at fuelling innovation and raising product quality would clearly alleviate the necessary price adjustment in countries which have lost significant price competitiveness. Many of these measures, however, are characterised by long lags which limit their usefulness in the current adjustment process. ([30])

A maybe more promising avenue to enhance non-price competitiveness relates to the so-called "extensive margin" or product variety. Empirical trade studies have pinpointed the important role played by increased product variety in the trade creation among advanced economies. For instance, Hummels and Klenow (2005), conclude that new product varieties account for about 60% of trade creation in larger economies. ([31]) The extensive margin has also been highlighted as an important channel in the case of the positive impact of the euro on trade. ([32]) The introduction of the euro seems to have reduced fixed costs related to external trade, allowing companies which were previously not exporting to offer their product on the intra-euro-area market and those already exporting to extend the range of products sold abroad. This effect seems to have played out relatively rapidly without involving the traditional price channel where export market shares are gained by undercutting competitors' prices. ([33]) Further work is probably needed before the extensive margin can be turned into an operational policy lever. There might, however, be a case for

([30]) There is evidence that increases in product quality have contributed substantially to the strong export growth registered in Central and Eastern European countries over the past decade. This may, however, be largely explained by a technological catching-up process. Whether similar rapid gains in product quality can be achieved in countries which are already well integrated in the global economy is questionable. See: Fabrizio, S., D. Igan and A. Mody, 'The dynamics of product quality and international competitiveness', *IMF working Paper*, No. WP/07/97.

([31]) Hummels, D. and P. J. Klenow, 2005, 'The variety and quality of a nation's exports', American Economic Review, Vol. 95, No. 3, pp. 704-723.

([32]) See for instance, Baldwin et al (2008), 'Study on the impact of the euro on trade and foreign direct investment', European Economy, Economic Papers No. 321 (May), European Commission, DG Economic and Financial Affairs.

([33]) Several studies estimating the time pattern of the effect of the euro on trade report a euro-induced increase in trade already in 1999. See for instance Flam, H. and H. Nordström (2006), 'Euro effects on the intensive and extensive margins of trade', CESIfo Working Paper No. 1881, December.

looking into measures that could facilitate the access to foreign markets by small and medium sized companies. As these companies' products already exist, policies relying on the extensive margin could prop up exports more rapidly than policies aimed at raising product quality.

Finally, it is worth stressing the potential benefits of policy coordination across Member States in adjustment processes. Scope for coordination arises from the existence of financial, competitiveness and trade spillovers. The financial crisis has amply demonstrated the potential strength of financial spillovers either via cross-border bank links or via cross-border contagion effects, particularly on sovereign bond markets. Scope for coordination also arises from the fact that competitiveness imbalances within the euro area feature in both current account surpluses and deficits. A coordinated process would therefore help reduce the amount of domestic demand and price adjustment to be done in any given Member State. In addition, an asymmetric adjustment (involving some Member States with competitiveness adjustment needs but not all of them) is likely to affect the current account and the competitive position of the Member States which show no adjustment needs. Coordinated efforts to rebalance demand and competitiveness could produce a smoother adjustment path with smaller adjustment costs for the euro area as a whole. However, the adjustment effort remains the responsibility of each individual Member State. Any country with an adjustment need must primarily adjust its own imbalances. Gains from changes in inflation and domestic demand in the trade partners depend on bilateral trade weights and are only of second order.

Table I.5.1: Selected structural indicators, euro area countries

Definition and source	Labour markets					Product markets			Knowledge and innovation				
	Active labour market policies	Making work-pay	Labour taxation	EPL	Long term Labour supply	Business environment	Business Dynamics - Start-up conditions	Product Market Regulation	R&D and Innovation		Education		R&D efficiency
	(1) * ↑	(2) * ↓	(3) * ↓	(4)*** ↓	(5)* ↑	(6)*** ↓	(7)** ↓	(8)*** ↓	(9)* ↑	(10)* ↑	(11)* ↓	(12)* ↑	(13)** ↑
AT	0.5	68.0	44.1	2.4	61.0	1.1	7.0	1.3	2.6	11.0	10.9	5.4	0.9
BE	1.1	83.0	49.6	1.7	62.0	1.3	2.0	1.4	1.9	14.0	12.3	6.0	0.8
CY	0.1	61.0	11.9	n.a.	64.0	N/A	7.0	N/A	0.5	4.2	12.6	7.0	0.5
DE	0.5	74.0	47.4	2.7	62.0	1.3	7.0	1.3	2.5	11.4	12.7	4.4	0.8
ES	0.6	82.0	35.6	2.9	62.0	1.2	30.0	1.1	1.3	11.2	31.0	4.3	0.7
FI	0.7	75.0	38.2	2.2	62.0	1.3	14.0	1.2	3.5	18.8	7.9	6.1	0.9
FR	0.7	77.0	44.4	2.5	59.0	1.2	4.0	1.5	2.1	20.5	12.7	5.6	0.9
EL	0.1	59.0	36.7	2.4	61.0	N/A	30.0	N/A	0.6	8.5	14.7	4.0	0.7
IE	0.5	78.0	15.0	1.6	64.0	N/A	2.0	N/A	1.3	18.7	11.5	4.9	0.7
IT	0.4	72.0	42.0	1.8	60.0	0.8	4.0	1.4	1.1	8.2	19.3	4.7	0.8
LU	0.4	88.0	31.4	2.6	59.0	1.7	14.0	1.6	1.6	n.a.	15.1	3.4	0.9
MT	0.0	62.0	18.6	n.a.	59.0	N/A	7.0	N/A	0.6	7.1	37.3	6.8	0.8
NL	0.7	81.0	40.2	2.6	64.0	0.7	1.0	1.0	1.7	8.9	12.0	5.5	0.7
PT	0.4	82.0	32.6	4.2	63.0	0.9	1.0	1.4	1.2	18.1	36.3	5.3	0.5
SI	0.1	81.0	40.9	2.7	60.0	N/A	3.0	N/A	1.5	9.8	4.3	5.7	0.5
SK	0.1	43.0	35.6	2.5	59.0	N/A	14.0	N/A	0.5	11.9	7.2	3.8	0.4
Euro area	0.5	75.4	42.1	2.5	61.0	1.1	9.0	1.3	1.8	12.9	16.6	4.9	0.8

'?' means that higher indicator levels correspond to better performance; '?' means that higher indicator levels correspond to worse performance.
(1) ALMP expenditure as % of GDP 2007; (2) the indicator of "unemployment trap" (low wage-earner, single) 2007 is one of the main structural indicators that reflects the level of disincentives to work imbedded in the tax and benefits systems. (3) Tax wedge on low wage earners 2007 (single earner); (4) OECD regular Employment Protection Legislation 2006 (data SI for 2003); (5) Average exit age from the labour force 2007 (IE, MT, SI data for 2006, LU data for 2005) indicator is highly correlated with the employment rate of older workers and reflects the impact of pension system (including the early retirement schemes) on the decisions to stay longer in the labour market; (6) PMR administrative regulation, 2008; (7) Starting a Business - Reported time (minimum in days), 2007; (8) OECD overall PMR, 2008; (9) Gross domestic expenditure on R&D (GERD) in %GDP, 2007; (10) Science and technology graduates per thousand of inhabitants, 2007; (11) Early school-leavers; (12) Spending on Human Resources in % of GDP, 2006 (EL and MT data for 2005); (13) Efficiency scores (2005): patents per million of inhabitants.

Part II

Overall Assessment and Policy Implications

1. OVERALL COMPETITIVENESS ASSESSEMENT

While the financial crisis has triggered an abrupt (and partly temporary) unwinding of some of the external imbalances that have hampered the functioning of EMU, significant imbalances remain in place. The present report shows that the observed correction process is far from being completed as both external imbalances and underlying domestic imbalances have only partly been resolved. Most notably, in most Member States concerned, recent corrections in external imbalances have been bearing more on quantities than on prices, and changes in relative prices and competitiveness adjustment have so far been limited. There is a significant risk that external imbalances increase again once the euro-area recovery gathers momentum.

On the basis of the horizontal analysis presented in Part 1 of the report and the detailed country analysis presented in Part 3, the following overall competitiveness assessment can be made for euro-area Member States.

Member States which have accumulated large current account deficits since the late 1990s and entered the crisis with largely overvalued real exchange rates (ES, PT and in particular EL) still face substantial competitiveness adjustment needs. Greece is a case apart in the light of the extent of the imbalances, its structural weaknesses and persistent losses in competitiveness. In some of these countries, the crisis has brought a reduction in current account deficits mostly via its effect on private sector balance sheets. However, part of the observed current account correction could prove temporary and revert when the economy recovers. Furthermore, signs of improvements in price/cost competitiveness are, at best, moderate, and effective real exchange rates are still substantially overvalued. Net foreign liabilities also remain large in the three countries. These countries entered the crisis with overstretched balance sheets in the private sector and, particularly in Spain, oversized housing markets. There have been improvements in these underlying domestic imbalances but further significant progress is needed and the burst of the real estate bubble is likely to have a lasting economic impact particularly on employment. Potential output could also be more affected by the crisis in this group than in the rest of the euro area. This would aggravate the burden of external liabilities and, together with a high degree of labour and product market rigidities, could hamper competitiveness adjustment. Overall, these countries can be said to suffer from large external imbalances with Greece standing out due to a combination of large current account deficit, weak competitiveness and very high public debt.

Member States which entered the crisis with sizeable current account surpluses (DE, NL, LU, AT) have seen a significant cut in their external balances over 2008-09. This reflects the combined effect of relatively resilient domestic demand in the face of the crisis and a strong exposure to the slump in world trade. Much of the rebalancing of the current accounts seems, however, to be of a cyclical nature and could be reversed when the recovery gathers momentum.

Member States that have recently joined the euro (CY, MT, SI, SK) face varying degrees of competitiveness problems. Due to limited statistical information, the competitiveness assessment of these countries should be considered with caution. Special mention should be made of Cyprus which has experienced large current account imbalances

A number of Member States do not register large current account deficits but showed worrying structural weaknesses in the export sector already before the crisis (BE, FR, IT, FI). Both Belgium and France suffer from unfavourable geographical and sectoral export composition, which threatens their export performance in the long run. Italy continues to underperform due to persistent challenges in product and labour markets. The financial crisis has exposed severe structural weaknesses in the export sector of Finland, which are reflected in a lasting reduction of its current account surplus.

Special mention should also be made of Ireland where the impact of the crisis has been particularly strong. In terms of the existing imbalances, the country shares a number of features with the countries in the large current-account deficit group. However, the assessment of the competitiveness situation is more favourable for Ireland than for other deficit countries due to its

proven adjustment capacity and its lower current account deficit. In fact, Ireland has already been able to regain substantially competitiveness due to strong wage moderation – in particular in the public sector – and flexible labour markets.

2. POLICY IMPLICATIONS

This report has shown that external imbalances and underlying domestic imbalances remain a source of concern in the euro area. In order to improve the functioning of EMU, to reduce the significant economic hardship imposed by the crisis on parts of the population and to ensure a sustainable recovery, these imbalances need to be addressed. The present section discusses a set of policy measures geared at speeding up and improving intra-area adjustment mechanisms. In particular, steps should be taken in four key areas: macroeconomic policies, credit markets, labour markets, and product markets. Reflecting differences in Member States' adjustment needs, these policy measures are country specific.([34])

Reducing imbalances requires a co-ordinated effort involving both countries with current-account deficits and surpluses. Coordination across Member States would facilitate competitiveness adjustment because of the existence of price competitiveness, trade and financial cross-border spillovers. The need for coordination also derives from the fact that the smooth adjustment of the euro area is a responsibility for all of its members. The adjustment effort remains the responsibility of each individual Member State. But coordinated efforts to rebalance demand and prices would produce a smoother adjustment path and smaller adjustment costs. Coordination could take various forms, including agreement on a common diagnosis and on the nature of the policy response needed, regular exchanges of information about policy measures with competitiveness implications for the euro area, etc.. The Eurogroup can play a key role in the coordination process by identifying adjustment needs and fostering a common diagnosis.

The range of policy measures discussed hereafter should also be seen in the context of the design of exit strategies. As the economy is firming, policy responses to the crisis need to be broadened beyond short-term demand management to redress the supply-side forces of euro-area economies. The comprehensive and coordinated exit strategies in euro-area Member States need to take into account their impact on competitiveness and current account imbalances. In particular, the supply side measures taken in the context of exit strategies should contribute as much as possible to rebalancing competitiveness within the euro area and to facilitating necessary labour and capital reallocation.

2.1. GENERAL MACROECONOMIC POLICIES

A coordinated approach does not mean an identical policy response in all Member States. Due to large differences in the scope and nature of adjustment needs, the mix of proposed policy measures should be country specific. In particular, an important distinction should be made between current account deficit and surplus countries. Member States which have accumulated large current account deficits have also incurred large competitiveness losses. They need both to regain competitiveness and address the sources of persistent weakness in domestic savings. In contrast, surplus countries should tackle structural impediments to domestic demand. The policy response to intra-euro-area macroeconomic imbalances should obviously not include a call for reduced competitiveness in surplus countries as this could only lead to higher unemployment in these countries. Moreover, strong competitiveness of all euro-area Member States, including surplus countries, is in the interest of the euro area as a whole.

A few Member States face large accumulated losses in price/cost competitiveness which must be addressed urgently. Commission Autumn 2009 projections suggest that with unchanged policies, there will be little rebalancing of competitive positions in 2010-11. In the absence of policy intervention, there is a high risk that current-account differences will widen again in the euro area in the coming years. To avoid such a scenario, price and cost adjustment (i.e. depreciation of the real effective exchange rate) would be particularly needed in Member States which have accumulated large losses in competitiveness in recent years. In Ireland, the ongoing depreciation of the real effective exchange rate should be allowed to continue. In all the countries concerned, the cuts in relative unit labour costs needed to restore competitiveness should be achieved via a

([34]) Country references build upon and are fully consistent with the Commission's existing policy priorities as identified in the Council Opinions on the Stability and Convergence Programmes as well as recommendations under the Lisbon strategy.

combination of wage adjustments and faster gains in labour productivity. Provided that this does not affect public finances, measures to reduce non-wage costs could also be considered.

Even in the absence of national monetary policy, policy makers can influence inflation rates and wages. In most Member States, wages are formed in a collective bargaining process between employers' and employees' representatives without formal involvement of governments. Nevertheless, policy-makers can affect wage setting processes via a number of ways, including the provision of information or wage rules, tripartite agreements and changes to wage-indexation rules. Governments may also try to influence the outcome of wage bargaining by offering changes to labour taxation, including social security contributions to increase wage-earners' net income. In the current context, it is important that such changes do not weigh on public finance conditions by increasing deficits; the measures should be compensated elsewhere. As the recent example of Ireland shows, they can also set a signal through agreements on public sector wages. As discussed in Part III, bringing public sector wages in line with inflation and productivity trends emerges as an important issue in Member States such as Greece, Italy, Cyprus and Malta. More generally, the role of government in guiding wage formation should be seen as quite important in Member States facing large competitiveness adjustments. Competitiveness adjustment processes reverting competitiveness losses tend to be more orderly and less costly in terms of employment if they are the result of coordinated efforts by social partners rather than deteriorating labour market conditions. This, however, necessitates the emergence of a strong consensus among social partners about the need to monitor competitiveness, avoid external imbalances or correct them once they have arisen.

The correction of external imbalances within the euro area will also be helped if Member States which accumulated large current account surpluses in pre-crisis years address the sources of structural weakness in domestic demand. As highlighted above, in the absence of policy intervention, there is a high risk that current-account differences will widen again in the euro area in the coming years. To avoid such a scenario, there is a need to identify and tackle the structural sources of persistent weakness in some parts of private sector demand in current-account surplus countries. This implies looking at a range of possible factors including the drivers of household savings and of disposable income, balance sheet consolidation processes in the corporate sector, the sources of persistent weakness in investment and insufficient growth in the service sector.

Continued surveillance of the domestic imbalances that underlie external imbalances appears warranted. This is particularly true of domestic imbalances rooted in credit and housing markets. In spite of recent signs of balance sheet adjustment in the private sector, further consolidation appears needed in some Member States with large current account deficits, particularly in the corporate sector. Furthermore, it is difficult to assess to what extent the ongoing adjustment is of a cyclical or a more permanent nature. As the recovery sets in, signs of re-emergence of excesses in some of these markets cannot be excluded and would then call for appropriate policy measures. As discussed further in Sections II.2.4 and II.2.5, there is also a need to address the factors that hinder competition and the adjustment capacity of both surplus and deficit countries. In particular, in some surplus countries more competition is needed to unleash the growth potential of the service sector.

Adjustment will also have strong sectoral implications which will require specific policy measures. Member States facing a competitiveness adjustment problem will need to redirect both capital and labour resources from the non-tradable sector to the export sector. Conversely, Member States which accumulated large current account surpluses in pre-crisis years will need to boost their non-tradable sector (particularly services). Additional sectoral challenges relate to the impact of the crisis on specific industries (particularly financial services and automotive construction). Overall, sectoral reallocation processes associated with the correction of external imbalances will require an effective financial sector and would benefit from policies aimed at facilitating labour and capital mobility. This could, however, imply trade-offs between the short-term needs to cushion the impact of the crisis (particularly on employment) and competitiveness rebalancing considerations.

Policies aimed at facilitating competitiveness adjustment should also take into account the likely

effect of the crisis on potential output. Current European Commission estimates suggest that the negative impact of the economic and financial crisis on potential growth could be significantly stronger in some countries also facing significant competitiveness adjustment needs. In these countries, the case for implementing policies targeted at raising potential output and offsetting the effect of the crisis is even stronger than in the rest of the euro area. As such policies take time to play out – and to the extent that the crisis impacts potential via reduced productivity growth – it is also critical that wage bargaining systems fully take account of the combined constraints posed by competitiveness rebalancing and reduced productivity.

2.2. PUBLIC FINANCES

Fiscal consolidation requirements must give due weight to the impact of competitiveness adjustment on revenues and debt dynamics. In the countries with large current account deficits and accumulated losses in competitiveness, public finances were particularly hard hit in the downturn and now face serious challenges. These countries are likely to experience sluggish growth in the years to come due to persistent balance sheet adjustment, sectoral re-allocations and a possible reduction of potential growth. In addition, fiscal revenues could be particularly affected as tax-rich income components shrink. For example, tax revenues related to the property market have already fallen strongly in Ireland and are likely to remain weak. Recent budgetary decisions in Ireland have already responded to that challenge.

In order to forestall sustainability problems arising from a drastic revision in growth, the December 2009 Council decisions on the Excessive Deficit Procedures recognised for the first time explicitly the role of external imbalances as an important relevant factor for determining the deadline for correction and the pace of fiscal adjustment, including the year when consolidation should start. *Ceteris paribus*, Member States with large current account deficits, are required to undertake particularly sizeable fiscal consolidations, addressing the relatively large fiscal adjustment needs. Swift and determined consolidation efforts – in line with the measures announced on 3 March – are particularly needed for Greece where sizable fiscal imbalances can be considered one of the root causes of macroeconomic imbalances and where fragilities and heightened sustainability concerns in the public sector finances are widely acknowledged as a primary source of the country's vulnerabilities. In countries where weaknesses in the fiscal framework contributed to fuelling external imbalances in the past, primary expenditure control and increasing the effectiveness and efficiency of public finances will be imperative.

Fiscal policies aimed at speeding up structural adjustment and reducing current account imbalances should be considered when designing exit strategies.([35]) The composition of the consolidation should take into account competitiveness challenges. The size of consolidation needs suggests for most Member States to pursue a consolidation strategy that combines measures on the expenditure and the revenue side. Competitiveness can be affected by changing the composition of taxes and expenditure. For example, raising VAT while reducing labour taxes or corporate taxes raises the competitiveness of a country and reduces its relative unit labour cost. ([36]) Similarly, productive (e.g. R&D) vs. non-productive spending has competitiveness effects. While in full respect of the overall consolidation needs, countries with large external deficits and competitiveness challenges could take measures that reduce unit labour costs and thereby contribute to a depreciation of the real exchange rate. Conversely, countries with large external surpluses should refrain from measures that would result in a further reduction of relative unit labour costs. More generally, countries should avoid measures that increase competitiveness imbalances during the consolidation process. Instead, fiscal policy measures should facilitate necessary adjustment

([35]) For further discussion see Barrios, S., S. Langedijk and L. Pench (2010), "External imbalances and public finances in the EU". Proceedings to the Annual Workshop on Public Finances (27 November 2009) European Economy. Occasional Papers, European Commission, Directorate General for Economic and Financial Affairs, forthcoming.

([36]) See for example, Calmfors (2003), Fiscal policy to stabilize the domestic economy in the EMU: What can we learn from monetary policy?, CESifo Economic Studies 49(3), 3-19 and Lane and Perotti (2003), The importance of composition of fiscal policy: evidence from different exchange rate regimes, Journal of Public Economics 87, 2253-2279.

processes by, for example, facilitating labour reallocation across sectors.

2.3. CREDIT MARKETS AND BALANCE SHEETS

Effective measures to restore the full functioning of financial intermediation need to be taken urgently to reduce the impact of the crisis on potential growth and facilitate competitiveness adjustments. Financial sector measures will be especially needed in countries with large and/or fragile banking sectors. The restoration of financial markets is also particularly important in countries with significant competitiveness adjustment needs as, for example, the necessary reallocation of production factors across sectors requires well-functioning financial intermediation. Moreover, in most current-account deficit countries the banking sector also plays a critical role in channelling foreign capital inflows to the private sector. In the ongoing crisis, banks in the concerned Member States have continued to receive capital through the generous liquidity provision of the Eurosystem. Once the recovery takes hold and the ECB withdraws its exceptional liquidity provision, the financing of current account deficits will crucially depend on the ability of banks in the respective Member States to secure financing in the international capital market.

Policy measures targeted at facilitating balance sheet adjustment in the non-financial sector would also ease the adjustment to external imbalances. Member States which entered the crisis with competitiveness problems also face various degrees of balance sheet stress in the private sector. The partial correction of these balance sheet problems has contributed to the sharp falls in domestic demand observed during the crisis and further correction will likely take place in the short to medium-term. Policy measures targeted at speeding up balance sheet adjustment would also facilitate competitiveness adjustment. For example, measures aimed at fostering companies' use of external funding and at reducing the cost wedge between external and internal funds (e.g. by facilitating access to securities market) could be useful in this respect. In addition, there is also a need to look into the determinants of past and persistent corporate balance sheet consolidation in some surplus countries. ([37])

2.4. LABOUR MARKETS

Reforms in labour markets should naturally be top of the agenda to improve the functioning of competitiveness adjustment. Econometric evidence confirms that structural characteristics of the labour markets affect the effectiveness and speed of the competitiveness channel. ([38]) Low labour mobility hinders the reallocation of production factors across sectors and increases the burden of nominal adjustment. Moreover, some features of wage formation processes can reduce wage flexibility and fuel unit labour cost growth. Finally, labour market reforms should be conducive to increasing labour supply, which is particularly pertinent in the current situation of decelerating potential growth. Reforms that improve flexicurity, promote labour mobility across regions and occupations and enhance the response of wages to productivity developments contribute to the adjustment of external imbalances. Reform priorities differ considerably across euro-area countries, both in terms of labour market outcomes and institutions, and in terms of constraints on account of the fiscal situation and external competitiveness.

The detailed assessment in Part III shows that issues related to wage setting are important competitiveness factors. It is especially the case in countries with significant external deficits, including the catching-up new euro-area members, but also for several countries in surplus or with moderate deficits. The realignment of wages with (regional and sectoral) productivity developments appears important in Italy, given the marked deterioration in cost and price competitiveness, and against the background of severe market share losses. In Germany, against the background of low aggregate wage growth, insufficient wage

([37]) As suggested by the German example, incentives imbedded in the tax system could be examined in that context. For more discussion see European Commission (2010), 'The impact of the global crisis on competitiveness and current account divergence in the euro area', Quarterly Report on the Euro Area, No. 1.

([38]) European Commission (2008), 'EMU@10 – Successes and challenges after 10 years of Economic and Monetary Union', European Economy No. 2/2008, European Commission, DG Economic and Financial Affairs.

differentiation remains a key issue, hampering inter alia the development of a services sector. In this country, reforms addressing the structural weaknesses in the tax-benefit system would contribute to strengthening the domestic sources of growth and support a rebalancing of export-based growth. Overall, an efficient wage setting process reflecting productivity developments and allowing for sectoral wage differentiation is central for tackling competitiveness challenges. Policies should facilitate the reallocation of production factors across sectors and thereby reduce the burden of adjustment in particular regarding wages and prices. Policy measures aimed at, for instance, retraining workers and reducing skills mismatches would be instrumental in allowing for a rapid reallocation of productive resources across sectors and regions. Measures should secure employability rather than saving specific jobs and firms.

Rebalancing the degree of *employment protection legislation* between different segments of the labour market while ensuring the provision of adequate income support is needed especially in countries such as BE, DE, EL, ES, FR, IT, PT and SI. In line with the "flexicurity" approach, this needs to be implemented in parallel with the introduction of ambitious and effective activation and training measures, along with increased capacity and cost-effectiveness of public employment services. *Activation policies* could be enhanced in most euro-area countries. The Commission has stressed the importance of reforms that shift the focus from protection on the job to insurance in the market. ([39]) These reforms should reconcile workers' demands for protection from unemployment and income risks with the need of firms to respond quickly to swings in consumers' preferences and to the challenges and instability created by technological progress and globalisation. Increasing the *effectiveness and efficiency of public employment services* is also important in PT, SI and SK. Reducing *benefit dependency* is also important. In particular, countries such as BE, DE, EL, FR, MT, NL, AT, SI and FI should aim at removing inactivity and unemployment traps.

Finally, increasing participation and the effective retirement age are crucial to minimise the social consequences of the crisis, to preserve European human capital and, ultimately, to return to strong growth. ([40]) Pressures on the labour market resulting from the strong fall in demand should not be used to engage in early retirement schemes or lower participation as these would further burden potential growth and not resolve the underlying competitiveness problems. As indicated in Part III, raising labour force participation levels should be high on the agenda in Italy and Cyprus. Increasing the effective retirement age by enabling and motivating people to work longer through labour market policies promoting better age-management practices in work places and ambitious reforms of work incentives in pension systems should be high on the agenda of some countries, in particular in AT, BE, FR, EL, LU and SI. The effective implementation of such measures would take place over a longer period of time, but decisions taken now would help anchor expectations which, in turn, would help to underpin the present economic recovery. In particular, pension reforms that improve the sustainability of public finances, even only in the long run, are likely to reduce risk premiums particularly in high debt countries. To the extent that they increase labour supply, such reforms would furthermore increase potential output and help keep wage developments supportive of price competitiveness.

2.5. PRODUCT MARKETS, KNOWLEDGE AND INNOVATION

Reforms in product markets are also instrumental to reducing competitiveness divergence. Econometric evidence confirms that structural characteristics of the product markets affect the effectiveness and speed of the competitiveness channel. ([41]) Tight product market regulation appears either to reduce the responsiveness of the competitiveness channel to demand differences or to slow its functioning.

Measures that improve the functioning of product markets help to contain divergences in

([39]) European Commission Communication "Towards Common Principles of Flexicurity", COM(2007) 359 final.

([40]) See European Commission "2009 Ageing Report", European Commission European Economy, No 2, May 2009.

([41]) European Commission (2008), 'EMU@10 – Successes and challenges after 10 years of Economic and Monetary Union', European Economy No. 2/2008, European Commission, DG Economic and Financial Affairs.

competitiveness and improve the adjustment capacity. More flexible product markets facilitate the changes in relative prices necessary to adjust to accumulated losses in competitiveness. Policies that support higher productivity developments are also relevant, in particular policies to increase the level and quality of investments.

The role that prices of non-tradables play in the adjustment process suggests that policies that improve productivity, flexibility or competition outside the export sector also matter, in particular policies that promote competition in the services sector (largely non-tradable) are useful.

The review provided in Part III shows that, in a number of Member States, there is a need to strengthen competition in domestic goods and services markets and improve the business environment. In countries with external deficits, accumulated losses in competitiveness or structural weaknesses in the export performance, strengthened competition should help to achieve a more efficient allocation of resources and facilitate price adjustment. With a view to unlocking the potential of the services sector to spur domestic demand, they are also relevant in some surplus countries (DE, NL). Improving the business environment and reducing administrative burden would also facilitate adjustment (EL, IT, LU, PT and SK).

Efforts to boost non-prices competitiveness are needed both in Member States facing large price adjustment needs and those which suffer from structural weakness in the export performance. In current-account deficit countries, policies aimed at improving non-price competitiveness would reduce the necessary price adjustment. These include measures aimed at fuelling innovation, raising product quality, focusing more on fast-growing destinations and facilitating access to exports markets by small and medium sized enterprises. ([42]) In Belgium and France, there is a need to tackle a structural weakness in the export sector and marked losses in export market shares, which can only partly be explained by losses in price competitiveness.

Accelerating productivity growth and raising the technology-intensity of the economy rank high on the competitiveness agenda. Speeding up productivity growth by improving the knowledge economy would obviously be beneficial in all Member States but benefits would be particularly high in countries facing large competitiveness adjustment both because faster productivity growth would facilitate necessary labour cost adjustment and because productivity could be more strongly impaired by the crisis in these countries. Moreover, specific needs to improve parts of the knowledge economy also exist in some other Member States. For instance, there is scope to improve R&D and innovation policies in IE, EL, ES, IT, CY, NL, SI, SK. Further challenges linked to productivity developments in the longer term relate to improvements in education systems and human capital formation (BE, DE, IE, ES, FR, IT, CY, NL, AT, PT and SI).

2.6. LOOKING AHEAD – SOME MEDIUM-TERM CONSIDERATIONS

Looking further ahead, i.e. beyond pressing competitiveness adjustment needs, it is also important to reflect on possible avenues for improving the surveillance of intra-euro-area imbalances and preventing/tackling their future emergence. This sub-section briefly sketches a number of policy areas where further reflection is necessary to make surveillance of external imbalances in EMU more effective.

Countercyclical fiscal policy can dampen competitiveness and current account divergence but its impact should not be overestimated. In particular, improving the government balance can contribute to reduce the economy's current-account deficit by lowering domestic demand pressures. The empirical literature has generally found that fiscal policy affects aggregate demand, even though the fiscal multiplier is lower than one. Nevertheless, the scope for active countercyclical budgetary policy to stem competitiveness losses and related overheating dynamics is relatively limited. First of all, its effectiveness in dampening current account divergence should not be

([42]) For instance, a survey conducted for the European Commission shows that further harmonisation of regulation in the Single Market could have a significantly positive effect on the participation of small and medium sized enterprises in the cross-border trade in the EU. See European Commission, 2008, Business attitudes towards cross-border sales and consumer protection. Flash Eurobarometer 224.

overestimated since government savings are partly offset by private sector de-savings. Moreover, the largest part of current account divergence in the euro area in the last decade was driven by private sector decision. While macroeconomic fiscal policy can somewhat counteract these private sector dynamics, it cannot effectively address their root causes (e.g., exuberant expectations regarding asset prices or future income prospects).

Much of the intra-area external imbalances accumulated during the early years of EMU can be traced back to excessive credit cycles and asset price bubbles. This has increased considerably the exposure of the countries concerned to the financial turmoil and led to much more abrupt correction processes than had previously been expected on the basis of the sole working of the competitiveness adjustment mechanisms. A key challenge for policy makers is therefore to detect the emergence of excessive credit cycles and asset price bubbles as well as prevent or reduce their formation. Against this background, it is necessary to devise and put in place structural reforms that limit the occurrence of credit and asset price excesses but also devise specific instruments to cool-off credit and asset markets if necessary. The issue is particularly critical in the euro area where credit and monetary dynamics have proved to be quite heterogeneous across euro-area Member States and where regional credit cycles that do not have aggregate effects cannot be addressed by monetary policy.

In particular, reducing the pro-cyclicality of credit supply via appropriate regulation appears to be particularly relevant in a monetary union. Regulatory measures to reduce the pro-cyclicality of credit supply that are currently being discussed in economic and policy circles should also be seen in the context of country-specific credit cycles. Further work is necessary to assess whether and how regulatory measures on bank balance sheets would also contribute to dampen regional – as opposed to euro-area wide – credit cycles and asset price bubbles. Without prejudice to the internal market, this could mean to ensure that bank capital requirements duly reflect regional differences in asset risks as measured, for instance, by regional measures of overvaluations in asset prices. For banks operating across borders, capital requirement could then be linked to the residency of the borrower.

Structural features of the housing market such as tax incentives as well as mortgage-related regulation clearly influence housing markets and can increase the likelihood of housing bubbles. A central determinant of house prices is the after-tax nominal interest rate, which is the difference between the nominal interest rate and the tax wedge. Policymakers could therefore re-examine their taxation systems and carefully balance the cost and benefits of subsidies to the housing sector such as allowing deductions for mortgage interest payments.

The existence of financial imbalances underlying current account and competitiveness divergence should also be seen in the context of potential systemic risk implications. Strong and mutually reinforcing dynamics in credit markets and asset prices have been identified as key drivers of current account divergence in the euro area leading to the build-up of significant imbalances in private sector debt. The financial crisis has shown that imbalances in some parts of the financial market can trigger chain reactions with effects on the system as a whole. Fast-growing credit in specific sectors or regions is therefore also a concern for macro-prudential supervision as it could imply a build-up of systemic risk. These considerations raise the issue of the link between competitiveness surveillance, the prevention of harmful competitiveness divergences within the euro area and the macro-prudential risk assessment to be carried out by the European Systemic Risk Board.

Finally, in-depth assessment and monitoring of the allocation of capital inflows into current account deficit countries appears warranted in the euro area. Since the inception of the euro, inflows of foreign capital into Member States with large current-account deficits had tended to be mostly channelled to the household and housing sectors via the banking sector. In contrast, capital inflows into productive sectors via corporate bonds and equity markets had remained comparatively weak. Uncovering the determinants of the relative unattractiveness of corporate investment therefore appears warranted.

Table II.2.1: Synopsis of country-specific competitiveness developments and challenges (I)

	REERs (EA) 99-08; forecast 09-11	Over-/ under-valuation	CA balance 99-09	Export performance 99-09	Underlying macroeconomic imbalances and/or challenges
BE	stable	fairly valued in 2009 and 2010	falling surplus; balanced in 08-09	marked losses	unfavourable geographical and sectoral export composition; wage formation; low productivity growth
DE	depreciation; continues in 10-11	undervalued in 2008 and 2009 (slightly)	improving until 07; strong surplus; falling in 08-09	gains	weak infrastructure investment and domestic demand /high saving rate; underdeveloped competition in services sector/ unbalanced growth structure; insufficient wage differentiation
IE	marked appreciation until 2008 (ULC); marked improvement thereafter	(slightly) overvalued in 2008 and 2009	deteriorating until 08, large deficit; returning to balance in 09	strong gains, stable over 03-08, gains in 09	need for adequate wage setting in line with (sectoral) productivity growth; reallocation of resources from housing to more productive sectors; relatively high level of external debt; asymmetries due to strong exposure to US/UK (strong real appreciation)
EL	(marked) appreciation; continues after 09	overvalued in 2008 and 2009	deteriorating until 07, very large deficit; improvement in 09	marked losses (slight recovery in 08-09)	labour market rigidities, wage growth outpacing strong productivity growth; unfavourable geographical and sectoral export composition; high external debt, rising debt service burden; need for wage moderation in public sector
ES	overvalued in 2008 and 2009	deteriorating until 07, very large deficit; large reduction in 09	only slight losses (reduced mark-ups)	marked losses (slight recovery in 08-09)	high private sector indebtedness; low productivity growth; need for reallocation of resources from housing to more productive sectors; high external debt, rising debt service burden
FR	stable (slight depreciation based on export prices)	(slightly) overvalued in 2008 and 2009	deteriorating until 08, deficit; slight improvement in 09	marked losses (despite reduced mark-ups)	unfavourable geographical and sectoral (MHT) export composition; limited number and small size of exporting firms; need to contain increase in ULC; rather low productivity growth
IT	(marked) appreciation; particularly export prices, continues 09-11	(slightly) overvalued in 2008 and 2009	deteriorating until 08, deficit; slight improvement in 09	very large losses (less in values)	low productivity growth; low participation rates; high administrative burden; limited competition in services, incl. regional public services; insufficient sectoral and regional wage differentiation, incl. in public sector

Source: Commission services.

Table II.2.2: Synopsis of country-specific competitiveness developments and challenges (II)

CY	(marked) appreciation, continues after 09 (depreciation in 07-09 based on ULC)	NA	deteriorating until 08, very large deficit; partly reversed in 09	marked losses	high private sector indebtedness, rapid credit expansion (until 2008); insufficient sectoral wage differentiation, not reflecting productivity growth; need for wage moderation in public sector; low female and old-age participation rates
LU	NA	NA	stable, large surplus (dip in 08)	NA	unfavourable geographical export composition; wage formation; low productivity growth
MT	stable; appreciating trend in 09-11 (ULC)	NA	large deficit; improving over 07-09	Very large losses	low productivity growth; low sectoral export diversification; insufficient sectoral wage differentiation, not reflecting productivity growth; need for wage moderation in public sector
NL	(slight) appreciation; up in 09-11 (ULC)	slightly undervalued in 2008, fairly valued in 2009	strong surplus; down in 08-09	slight gains over 09-11	strong dependence on re-exports (less added value than domestic exports); low R&D expenditure
AT	(slight) depreciation, up in 09-11	slightly undervalued in 2008, fairly valued in 2009	surplus, down in 09	gains, stable since 02	unfavourable sectoral export composition, shift to higher value-added output needed
PT	(slight) appreciation, up in 09-11	overvalued in 2008 and 2009	chronic very large deficit	Relatively contained losses, sta-ble since 05	unfavourable geographical and sectoral export composition; insufficient competition; rather low productivity growth; high external debt, rising debt service burden
SI	appreciation	rather fairly valued in 2009 and 2010	deteriorating to large deficit in 08; reversal in 09	strong gains; loss in 09, stable afterwards	wage setting in line with productivity growth; catching-up (BS effect); unfavourable sectoral export composition
SK	sharp appreciation; slowing down over 09-11	overvalued in 2008 and 2009	stable large deficit	strong gains; loss in 09, stable afterwards	strong real appreciation v-à-v non-euro neighbours; catching up (BS effect); wage setting in line with productivity growth
FI	depreciation (but ULC up in 08-09, stable after)	slightly undervalued in 2008; fairly valued in 2009	falling surplus (close to balance in 09)	gains; strong loss in 09	wage growth not reflecting sectoral productivity differentials; low sectoral export diversification

Source: Commission services.

Part III

Competitiveness Developments In Euro-Area Countries

The country-specific competitiveness fiches all follow the same format. The first section sets the stage for the subsequent analysis by summarising the characteristics of foreign trade and its performance, with a particular focus on openness indicators and developments in the balance of trade. The second section provides an overview of developments in a wide range of indicators measuring competitiveness, including real effective exchange rates (REER) indicators, components of the balance of payments, export market shares, terms of trade, FDI flows and profitability measures, as well as structural indicators characterising sectoral specialisation and comparative advantages.[43]

The content of the subsequent focus section varies according to the issue considered most pertinent for the country in question. The individual topics are as follows:

- Belgium: Productivity and unit labour costs in manufacturing and services
- Germany: Financial flows and the current account surplus
- Ireland: Openness and exposure to non-euro-area countries (especially the UK and the US)
- Greece: Twin deficits in Greece and the role of fiscal and structural policies
- Spain: A permanent correction of the Spanish current account balance?
- France: Demography of firms - recent progress in promoting the growth of firms
- Italy: Has there been a qualitative upgrading of Italian exports
- Cyprus: The structure of the current account balance and its financing
- Luxembourg: Sectoral and geographical composition of Luxembourg's exports
- Malta: Diversifying the export sector towards fast-growing sectors
- The Netherlands: Wage developments and unit labour costs
- Austria: Austrian FDI in the Central and Eastern European Countries
- Portugal: The external balance beyond the balance of goods and services – the importance of transfers and primary income in Portugal's external balance
- Slovenia: Preserving competitiveness in the euro area
- Slovakia: Has Slovakia lost its edge during the crisis?
- Finland: Factors behind the vulnerability of exports

The concluding section draws on the analysis in the preceding sections to arrive at key messages and discusses possible policy responses in case of harmful divergence in competitiveness as well as the implications of competitiveness developments for adjustment in the euro-area context. Apart from reflecting structural challenges identified in earlier notes to the Eurogroup on labour markets and potential growth, it also recalls earlier policy recommendations and invitations on structural adjustment needs issued under the opinions on updated Stability Programmes, EDP recommendations and the strategy for growth and jobs.

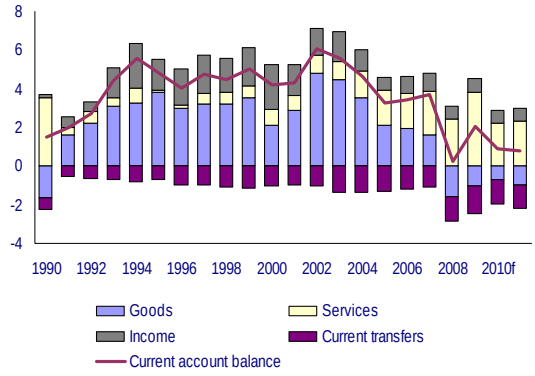
[43] The cut-off date for all data in the country-specific fiches is mid-March 2010. Where 2010 and 2011 are concerned, the fiches draw on the Commission Services' autumn 2009 forecast.

1. BELGIUM

1.1. SETTING THE STAGE: FOREIGN TRADE CHARACTERISTICS

Belgium has a very open economy, which is the result, inter alia, of its central location within the euro area and its extensive (transport) infrastructure. Measured in terms of export and import volumes as a share of GDP, openness stood at 172% of GDP at the end of 2008. The degree of openness has risen continuously in recent years, but declined in 2009 as a result of the sharp drop in both imports and exports in conjunction with the global economic crisis. Goods account for 80% and 82% of total exports and imports, respectively, which exceed the euro area average (80% for both exports and imports). The share of services in total trade has remained broadly stable since 2000.

Graph III.1.1: **Evolution of the current account balance (% of GDP)**



Source: Commission services.

Exports are mainly oriented towards other euro area countries, with neighbouring Germany, France and the Netherlands accounting for about half of total exports. Belgium appears to be specialised in medium-technology goods that are easy to imitate, such as chemicals and steel and less in high technology goods that are difficult to imitate, such as telecom and office (ICT) equipment.

The current account balance improved between 1981 and 1994, reaching a record surplus of 5.6% of GDP in the latter year. After a period of fluctuations around 5% of GDP, the current account balance started to deteriorate from 2003 onwards, with the surplus shrinking to 0.2% of GDP in 2008 (Graph III.1.1). The deterioration of the current account balance between 2003 and 2008 resulted mainly from the goods balance, which evolved from a 4.8% of GDP surplus in 2002 to a 1.6% of GDP deficit in 2008. The deterioration was particularly strong in 2008 (from a surplus on 1.6% of GDP to a deficit of equal size). At the same time, the surplus of the services balance showed a marked increase, reaching 2.4% of GDP in 2008, compared to 0.9% of GDP in 2002.

The deterioration can be largely attributed to the deterioration of the terms of trade (by 4% between 2002 and 2008), as a result of the strong increase in oil and other commodity prices. The rise in commodity prices was particularly important in 2008 and led, together with the depreciation of the euro in the second half of the year, to a strong reduction in the current account surplus (to 0.2% of GDP compared to 3.7% of GDP in 2007). Additionally, export volumes have been growing more slowly than import volumes since 2003, which may be explained by the sustained growth of Belgian domestic demand, partly the result of an expansionary fiscal policy, coupled with a disappointing export performance. Indeed, import volumes increased by an average 5.6% per year, while export volumes only rose at an average annual rate of 3.7% (compared to annual world trade growth of 8.2%). This effect was particularly marked in 2008 as domestic demand, in particular investment, remained resilient while external demand softened, especially in the last quarter, in view of the economic crisis.

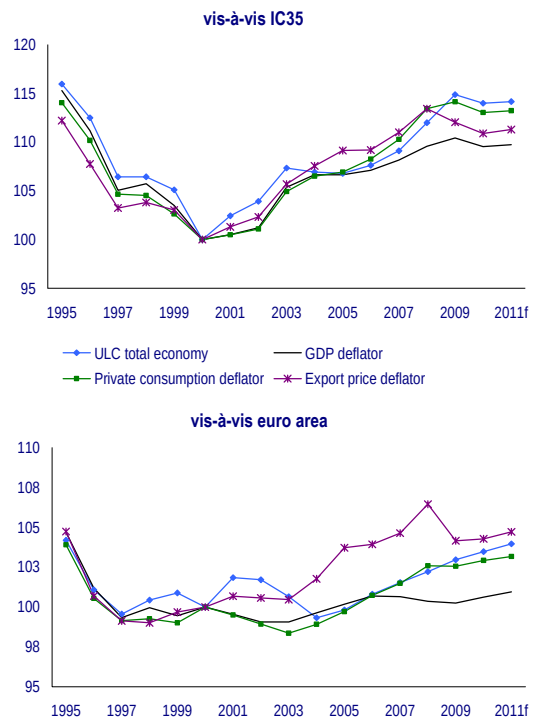
In 2009 the current account balance improved to 2.0% of GDP, while a smaller surplus of 0.9% of GDP is expected in 2010. In 2009, the terms of trade improved, mainly in view of the important fall in commodity prices, and the fall in import volumes was even sharper than the slide in export volumes. In 2010, the improvement stems from the weakness of imports in view of subdued consumption and investment, in combination with a stronger pick-up of external demand. The terms of trade are forecast to deteriorate slightly. This is projected to continue in 2011 and would, together with a considerable pick-up in domestic demand, lead to a slight decline of the current account surplus in that year (to 0.8% of GDP).

1.2. INDICATORS OF COMPETITIVENESS

Belgium's unsatisfactory export performance in recent years is partly explained by its geographical specialisation: its exports are mainly oriented towards other euro area countries, whose import growth has been considerably lower than world trade growth in recent years. On the other hand, the share of fast-growing markets in Belgian exports is relatively low. As a result, external demand addressed to Belgium has expanded by considerably less than world trade growth (with average annual growth rates in the period between 2003 and 2008 of 5.3% and 8.2%, respectively). In addition, Belgium's weak export performance also results from its structural loss of market share.([44]) From 2003 to date, the cumulative loss of market share amounted to 8.5% and this appears to hold for both goods and services. Belgium lost market share in particular for high-tech products, such as office and communication equipment and, to a lesser extent, transport equipment. This loss of market share beyond what other mature economies have experienced in the recent past, points to a deterioration of the country's competitive position.

Belgium is more specialised than other euro area countries in steel, chemicals and car manufacturing. The strong demand for these products in the recent past has led to an increase in Belgium's exports. On the other hand, Belgium is less specialised in office and telecom equipment (ICT), for which demand also rose strongly. As a result, product specialisation only had a very small positive impact on Belgium's export performance. The positive impact of the sectoral specialisation characterising other euro area countries, in particular neighbouring countries, has been considerably higher.([45]) Moreover, the demand for products in which Belgium is specialised (in particular low technology goods) may start to grow more slowly in the future, as already observed for transport equipment, and price competition may become even stronger, thereby putting pressure on export growth.

Graph III.1.2: **Real effective exchange rate using different deflators (2000 = 100)**



Source: Commission services.

All four indicators of the real effective exchange rate (private consumption deflator, GDP deflator, export price deflator, ULC-total economy deflator) exhibit an appreciating trend from 2000 to 2008, both vis-à-vis a set of 35 industrialised countries (IC35) and vis-à-vis the euro area (Graph III.1.2). The highest appreciation was recorded for the real effective exchange rate (REER) deflated by export prices (17.2% and 8.1%, respectively). At the same time, the REER deflated by unit labour costs has appreciated by 14.2% vis-à-vis IC35 and by only 2.2% vis-à-vis the euro area since 2000. Labour costs increases can thus only explain part of the rather strong increase in relative export prices, in particular vis-à-vis the euro area. The remaining part may be explained by a more rapid increase in unit capital costs, including a dynamic development of profit margins. Between 2000 and 2005, unit capital costs in manufacturing and market services increased by 1.9 pps per year more on average in Belgium than in the EU15.([46])

([44]) As calculated by the growth differential between Belgian export markets and Belgian exports.
([45]) National Bank of Belgium (2009), "Rapport Annuel 2008".
([46]) Biatour, B. and C. Kegels (2009), "La position relative de l'économie belge en Europe, Federal Planning Bureau, *Working Paper*, n. 5-09.

Another explanation may be that Belgium is relatively specialised in exporting goods for which prices have increased substantially, such as plastics, steel and iron. Indeed, these three goods accounted for 9.2% of Belgium's exports on average since 2000, compared to 5.4% in the euro area.

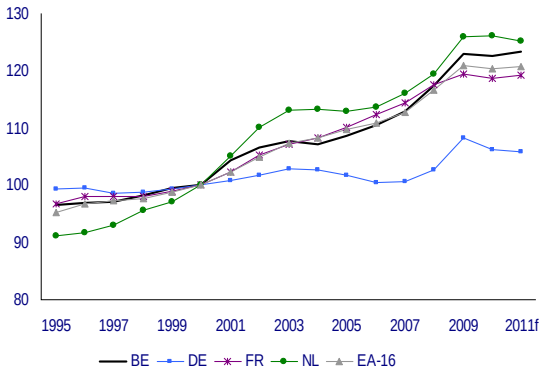
Technological competitiveness, driven by the capacity to innovate as well as to increase efficiency and reduce costs, is also an important element influencing export performance. R&D spending as a percentage of GDP (providing an indication of technological potential) amounted to 1.8% in Belgium in 2006; this is equal to the euro area average, but lower than the average for Belgium's main competitors. R&D expenditure is moreover concentrated in a limited number of often foreign-owned companies. Finally, Belgium's R&D expenditure is geared more towards low and medium-to-low-tech industries and less to medium-to-high-tech industries, which seems to be related to the sectoral composition of the Belgian economy.([47]) The relatively low level, high concentration and adverse composition of Belgian R&D have a negative impact on the country's innovation potential. For instance, the sale of new-to-market products is much more limited in Belgium than in the euro area. Also, the share of high tech exports in total exports is much lower than the euro area average. Another structural element which may negatively influence export performance is that, compared to the euro area, only a limited number of mainly large Belgian firms are involved in exporting.([48]) This concentration is related to the fact that small and medium sized companies (SMEs), which are very important in Belgium, tend to export considerably less as a result of the fact that: (i) SMEs' fixed costs are high; and (ii) few of them have the necessary (technological) competitive advantage to successfully compete in international markets.([49]) This is similar to the situation in France. Finally, some existing weaknesses in the business environment may also have a negative impact on the country's competitive position. According to the World Bank's most recent "Doing Business" ranking, Belgium is placed 22nd among 183 economies for "ease of doing business". The country's weakest points include the level of taxes and the time needed to register a property.

([47]) Conseil central de l'économie (2006), "Diagnose van het Belgisch innovatiesysteem".
([48]) Muuls, M. and M. Pisu (2007), "Imports and exports at the level of the firm: evidence from Belgium", *Working Paper*, n. 114, National Bank of Belgium.
([49]) Moen, O. (1999), "The relationship between firm size, competitive advantages and export performance", *International Small Business Journal*, 18/53.

1.3. SPECIAL FOCUS: PRODUCTIVITY AND UNIT LABOUR COST IN MANUFACTURING AND SERVICES

One of the most quoted factors behind Belgium's weak export performance compared to other euro area countries is its high wage cost. Given that Belgium is specialised in products that are relatively easy to imitate and is thus increasingly subject to competition from lower-cost countries, unit labour cost (ULC) developments are indeed an important determinant of its competitive position.

Graph III.1.3: **Nominal unit labour costs (2000=100)**



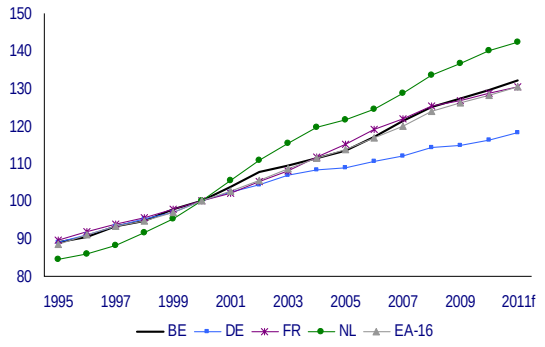
Source: Commission services.

Over the period 2000-2008, unit labour costs developed more or less in line with the average for the euro area (Graph III.1.3), suggesting that cost competitiveness has remained more or less intact. However, ULC tended to increase somewhat more in Belgium than in the euro area from 2005 onwards. While this should not be the case in 2009, the Commission services autumn 2009 forecast expects this trend to continue in 2010 and 2011. Divergences in both productivity and wage developments are behind this trend.

In order to moderate wage growth, the government has gradually reduced the tax wedge on labour since the beginning of the decade and introduced a

mechanism in 1996 to ensure that wages would develop in line with those in Germany, France and the Netherlands. According to this mechanism, social partners must determine biennially an indicative maximum rate of hourly wage increases for the subsequent two years (i.e. the wage norm), taking into account projected wage growth in the three neighbouring countries. On the basis of this indicative norm, further wage negotiations take place at sector and firm levels. Since the entry-into-force of the mechanism, six wage norms have been adopted. Taking into account actual wage developments in the neighbouring countries, data show that the wage norm was respected during the periods 1997-1998, 1999-2000 and 2003-2004, but labour cost increases in 2001-2002, 2005-2006 and 2007-2008 exceeded those set by the norm. This illustrates that the mechanism of automatic wage indexation in Belgium may hamper wage adjustment.

Graph III.1.4: **Compensation/employee (2000=100)**



Source: Commission services.

In spite of this, wages increased in Belgium on average at the same pace as in the euro area until 2005. Thereafter, slippages seem to have occurred in 2006 and 2007 (Graph III.1.4), which have contributed to the more rapid increase in ULC in these years. In addition, as of 2005, productivity growth in Belgium fell below the euro area average, which also contributed to the more rapid rise in ULC since then. The lacklustre development of productivity may be due to the fact that less productive workers started to enter the labour market, i.a. as a result of government schemes to increase the employment of low-skilled (e.g. cheques services).

However, marked differences appear to exist between the development of unit labour costs and productivity in the manufacturing sector and the sector of market services, as illustrated by EUKLEMS data for 2000-2005.([50]) In manufacturing, unit labour costs in Belgium increased by more than in the euro area, as productivity growth in Belgium was slightly lower than in the euro area. The main reason for this was the lacklustre performance of total factor productivity, which measures the efficiency with which production factors are combined, *inter alia*, reflecting the innovation capacity, economies of scale, the degree of competition and the business environment. In the case of market services, the evolution of ULC was more favourable in Belgium than in the euro area, because labour productivity grew more rapidly in Belgium. This reflects a more significant increase in (ICT) capital intensity, whereas the contribution of TFP was low, as was the case in manufacturing. Belgium is specialised in services to businesses, logistics, road and air transport and financial services.

It appears that in both manufacturing and services, the same factors have been at work also after 2005. In particular, productivity in manufacturing has deteriorated further. This might be explained to some extent by the fact that Belgium is specialised in mature sectors, where it is more difficult to achieve further technological progress and, thus, further increases in TFP.

1.4. THE NEED FOR ADJUSTMENT ([51])

The continuous deterioration of the Belgian current account since 2003 is due to sustained domestic demand (which boosted imports), a deterioration of the terms of trade (as a result of rising oil prices), and a disappointing export performance. Indeed, Belgian exports grew more slowly than those of its main competitors which can be explained by a number of factors. First, the increase in relative export prices, which seems to

([50]) See Biatour B. and C. Kegels (2008), "Growth and productivity in Belgium", Federal Planning Bureau, *Working Paper*, n. 17-08.

([51]) The text which follows, including policy challenges, draws, *inter alia*, on already issued policy invitations and recommendations under various Community instruments, such as the updated Stability Programme, the EDP recommendations and the strategy for growth and jobs.

be partly due to a more dynamic development of production costs in Belgium, especially from 2005 onwards. Second, Belgian exports also suffer from an adverse geographical composition and a specialisation in goods with a relatively low technology content for which price competition is relatively high. Finally, the generally small size of firms and the low capacity and/or propensity of SMEs to export may contribute to the relatively weak export performance. Wage costs remain an important determinant of competitiveness, especially as Belgium is still specialised in intermediate products and will thus probably be increasingly subject to competition from lower-cost countries. The current economic downturn may have added to the need to take measures to restore competitiveness, as the most competitive economies will take greater advantage of the pick-up in world demand. The permanent increase in wage subsidies for certain target groups as of 2009, introduced as part of the stimulus package, has helped to lower labour taxation, but the required fiscal consolidation from 2010 onwards will make further cuts more difficult, even though well-targeted measures should not be excluded to the extent that they are fully compensated and do not delay consolidation.

In view of Belgium's competitiveness position in the euro area and its current account balance, adjustment in the context of the euro area would be facilitated by addressing the structural challenges underlying long-term export market performance.

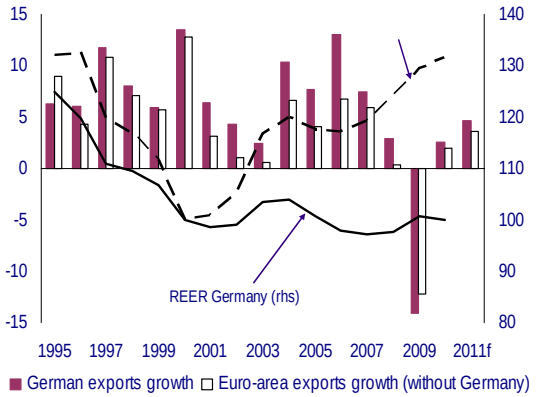
Against this background, an examination is warranted on the existing wage setting mechanisms, including the Competitiveness Law and the automatic indexation of wages, with a view to increasing wage flexibility. It is also important, in particular at the current juncture when ULC are coming under increasing pressure, to take measures to improve productivity growth, which has been rather disappointing in recent years. Such measures should specifically aim at improving total factor productivity, thus including measures to improve the business environment and to allow companies to benefit more from technological progress. In the area of the labour market, reforms could aim at increasing incentives for labour market participation through, *inter alia*, a reduction in the tax burden on labour and a better modulation of the level of unemployment benefits, as well as reinforcing activation programmes. Some steps to improve labour market efficiency were taken in 2009, including a further reduction of labour taxation, some reinforcement of activation and reorientation policies and an introduction of some regressivity over time for unemployment benefits. Household purchasing power may be usefully supported by improving competition and general market functioning in domestic markets, in particular in the network sectors and services. In addition, intensifying the ties with fast-expanding economies, including those outside the EU, and taking advantage of the opening-up of new markets should support export growth. Belgium will also need to diversify and focus on new goods and services for which demand is growing and where price competition is less fierce, in particular by reallocating resources towards products with a higher technological content. Export growth may also be supported by facilitating technological upgrading and specialisation in products and services with a higher technological content through focussing on key sectors such as biotechnology and health care and improving R&D intensity, as well as improving the business environment.

2. GERMANY

2.1. SETTING THE STAGE: FOREIGN TRADE CHARACTERISTICS

Despite its strong competitiveness position, Germany has been among the hardest hit economies in the current financial and economic crisis. Relying on a largely export-oriented economy with a strong focus on investment goods, Germany has been particularly vulnerable to the slump in global trade triggered by the crisis. German exports declined by around 14% in 2009, slashing the current account surplus by about 2pps. to 5% of GDP. As a result, the contraction of real GDP in Germany in 2009 was one of the deepest among all industrialised countries. However, with its comparative advantage in investment goods and its cost and price competitiveness in terms of the real effective exchange rate (REER) remaining broadly intact, Germany is well placed to benefit from the recovery especially in emerging market economies and should be able to reverse the loss in market shares encountered during the crisis. Exports already started to recover in the course of 2009 with export-orders indicating a further pick-up in 2010 and 2011 (Graph III.2.1).

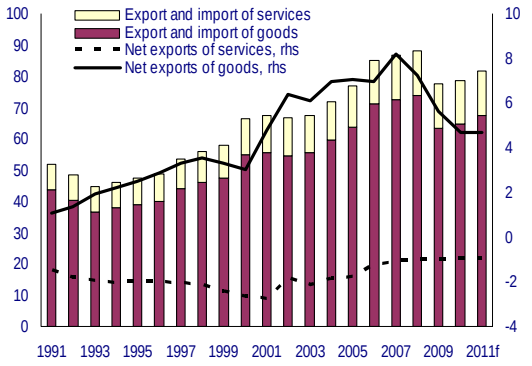
Graph III.2.1: **Growth of exports and REER**



(1) REER (unit labour cost) vis-à-vis 35 industrial countries
Source: Commission services.

Germany's export-orientation is rooted in the long-established openness of the economy, strong manufacturing traditions (*Mittelstand*) and the fact that Germany is relatively poorly endowed with natural resources. The degree of openness – measured by exports and imports as a percentage of GDP - rose by 35 pps. since 1991, peaking at 88% in 2008 (compared with 83% for the euro area average). This was due in particular to the strong expansion of trade in goods, while trade in services expanded only slightly and amounted to 19% of total trade (Graph III.2.2). The merchandise trade balance has been the main contributor to the large current account surplus in the recent years; the balance on services is slightly negative, which in particular reflects the negative tourism balance. With an loss in export market shares of about ½ pp. during the course of the crisis, German exports accounted for about 9% of all world exports in 2009 (13% of all euro area imports). So far, Germany is the only country among the large euro area Member States that was able to increase its share in world export markets despite stronger competition from Asian countries over the last few years.

Graph III.2.2: **Degree of openness (% of GDP)**

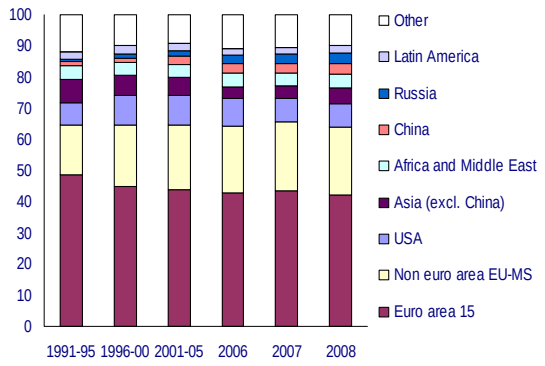


Source: Commission services.

The main trading partners of Germany are the other Member States of the EU, which absorb about 2/3 of all exports (Graph III.2.3). Within the EU, the share of exports shifted slightly in favour of the new Member States, now amounting to about 1/3 of the total. The share of exports going to the USA, Germany's most important trading partner next to the EU, declined slightly in the current decade, to 7.2% in 2008. Germany's export share to Asia has been relatively stable: between 1991 and 2008, the share of exports to China increased by 3 pps. to 3.5%, while Russia's share more than doubled to 3.3% in 2008. Overall, the

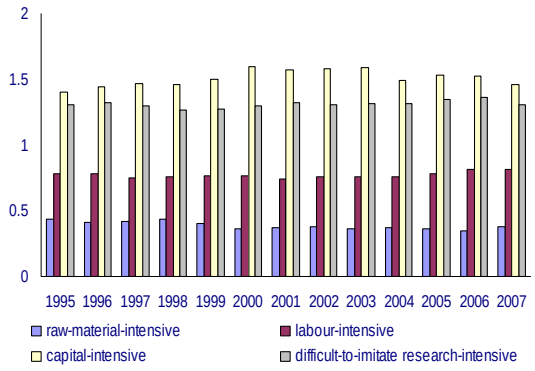
trade pattern has not diversified significantly during the last two decades.

Graph III.2.3: **Direction of trade (% of total exports)**



Source: Commission services.

Graph III.2.4: **Structure of trade (RCA for all exports (vs. world))**



Source: Commission services.

Compared with the rest of the euro area, the structure of German exports has shifted somewhat from capital-intensive to labour-intensive goods (Graph III.2.4). While retaining a (historical) comparative advantage in capital intensive goods (Balassa index([52]) above 1), Germany also gained in relative terms in labour-intensive goods during the last decade in line with sustained wage moderation. With the parallel improvement in the field of labour-intensive goods, the number of persons employed in the German export sector has increased steadily in the last few years. Furthermore, Germany has largely maintained its specialisation in the sector of research-intensive goods, although public investment in basic research has not been reinforced substantially in the last decade.

2.2. INDICATORS OF COMPETITIVENESS

Over the last 20 years, Germany's external competitiveness had been exposed to three major challenges: German reunification, global market liberalisation and integration into the euro area. In the course of the reunification-boom, the positive demand shock arising from gains in East German households' purchasing power pushed up wages and inflation, which led to a considerable loss in competitiveness in the first half of the nineties. All REER indicators appreciated markedly and export growth even turned negative in 1992/93. This was exacerbated by an effective appreciation of the Deutsche Mark during the ERM crisis.([53]) Germany's post-reunification loss in external competitiveness peaked in 1995, when the REER was some 20% higher than in 1991. Sustained wage moderation, with nominal wage increases averaging only 1.2% p.a., together with stronger average productivity growth of 1.7% driven by increased labour shedding, contributed substantially to the turnaround thereafter. While wage moderation clearly dampened private consumption, external price and cost competitiveness were restored. Since 1995, all REER indicators have exhibited a trend depreciation vis-à-vis the rest of the euro area (Graph III.2.5). This trend depreciation also benefitted from a sustained negative inflation differential compared with the euro area and sluggish demand in the aftermath of the reunification boom. In addition to low consumption, the latter reflects the correction of overinvestment in housing after the reunification-induced construction boom, weak corporate investment – which was dragged down by the relatively low efficiency and profitability of the German banking sector by European standards – as

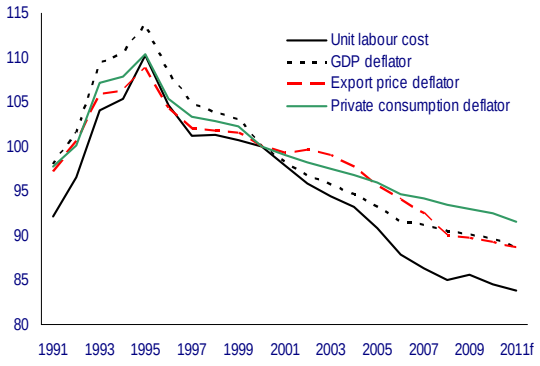
([52]) The measure used is the classic Balassa index of revealed comparative advantage, computed as the share of a goods category in the country's total exports, relative to the export share of that goods category for a benchmark region, here the euro area aggregate.

([53]) Furthermore, the Deutsche Mark did not depreciate when reunification led to a significant downward shift in the productivity level due to the integration of non-competitive companies from eastern Germany.

well as the fact that Germany entered the euro at a slightly overvalued exchange rate.([54]) As a result of continued depreciation, the REER vis-à-vis the euro area fell even below its reunification level.

In the course of the financial and economic crisis, the REER vis-à-vis the rest of the euro area based on unit labour cost appreciated slightly. This resulted from the adverse effect on productivity arising from the slump in the mainly export-based GDP growth in Germany, which exceeded the euro area average, and the increased use of short-time work, which shielded the labour market to a large extent from recession. However, with some lagged cutback in employment expected and a rebound of exports already apparent, productivity is set to pick up, leading to an improvement in competitiveness from 2010 onwards.([55])

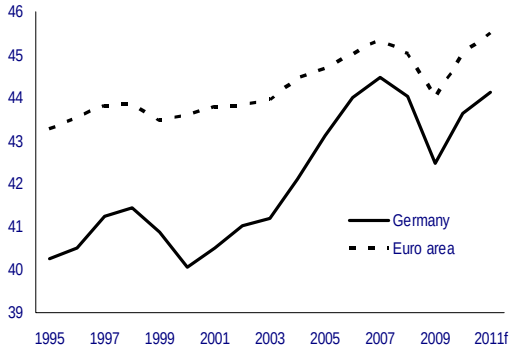
Graph III.2.5: **REER vs. rest of euro area**



Source: Commission services.

A different picture appears when the REER vis-à-vis a wider peer group of 35 industrial countries is examined (Graph III.2.5). While Germany's real depreciation was even more marked between 1995 and 2000 (reflecting in part the nominal effective depreciation of the ECU and the euro), Germany's REER has been rather flat thereafter. Thus, the competitiveness position of Germany outside the euro area (notably relative to the US and Japan) has effectively worsened, with the strong euro appreciation offsetting the steady reduction in relative unit labour cost through wage moderation. However, the corresponding REER for the remainder of the euro area countries started to appreciate in 2000 and a 30% gap in the REER has opened up since then between Germany and the rest of the euro area.

Graph III.2.6: **Corporate profitability (Gross operating surplus/Gross value added (%))**



Source: Commission services.

Rising labour cost during the short-lived reunification boom, the rapid catching up of East German wages towards western levels in the nineties and the relatively weak total factor productivity growth were also reflected in a shrinking profitability gap of the German corporate sector vis-à-vis that of the euro area (Graph III.2.6). As a consequence, the corporate sector sought to restore profitability by holding back domestic investment and resorting to labour-saving rationalisation or the relocation and outsourcing of production to lower-cost areas. Outsourcing in particular characterised the trade pattern with the new Member States, where increased bilateral trade and one-way foreign direct investment to the East suggest that parts of the low end of the value-added chain were located in the East, leaving production in Germany to specialise in the high-value end. This implied German gains not only in productivity but also in employment, when set against the alternatives of possible closure of companies or relocation of production further

([54]) Estimates provided by *Hansen* and *Roeger* suggest an overvaluation in effective terms of 2%. See *Hansen* and *Roeger* (2000), "Estimation of real equilibrium exchange rates", Directorate General for Economic and Financial Affairs (European Commission), Economic Paper, No 144.

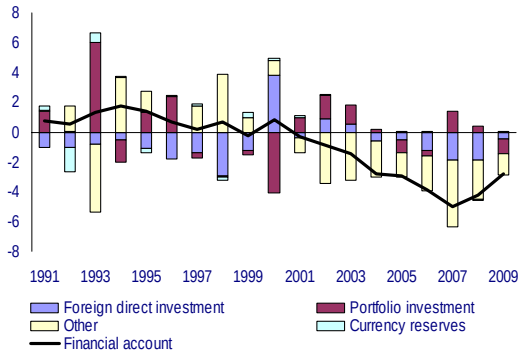
([55]) While this note focuses on competitiveness, IMF analysis also points to the importance of demand-pull and composition effects as a source of the strong German trade and current account surplus, with global demand for German investment goods rising substantially in catching-up economies and economies experiencing asset price bubbles. See *Danninger* and *Joutz* (2007), "What explains Germany's rebounding export market share?", IMF Working Paper No. 07/24.

away, involving consequently weaker supply links with the parent company. Rationalisation measures, together with moderate settlements in wage negotiations, allowed nominal unit labour cost to fall by around 20% since 1995 against the average of Germany's major trading partners. Furthermore, the wedge between declining unit labour cost and rising export prices suggests that the profit margins of German exporters had also risen significantly in the later years. Consequently, gap between the profitability of the corporate sector and the corresponding euro area average - in terms of the ratio of gross operating surplus to gross value added - narrowed considerably between 1995 and 2007. With unit labour costs temporarily rising (Graph III.2.5), profitability was dampened by the delayed response of the labour market during the economic crisis. However, as employment may still decline in 2010, the profitability gap vis-à-vis the euro area should narrow once again in 2010.

2.3. SPECIAL FOCUS: FINANCIAL FLOWS AND THE CURRENT ACCOUNT SURPLUS

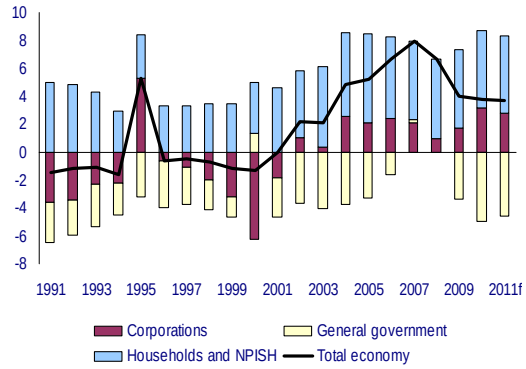
The large merchandise trade surplus since 2001 (Graph III.2.2) more than offset the negative balance of services and net transfers and pushed the current account balance into surplus in 2002 for the first time since German reunification. The current account surplus widened considerably, reaching a high of 8% of GDP in 2007, while the financial account turned negative, peaking at almost 10% of GDP in 2007 (Graph III.2.7). The large current account surplus reflects increased private household savings as well as the decreased needs of companies to finance investment – both translating into a net lending position of households and corporations (Graph III.2.8). A lower net borrowing position of the public sector in the last few years is set to be reversed in 2009/10 as a consequence of fiscal stimulus and stabilisation measures undertaken in the context of the financial and economic crisis. The traditionally high household saving rate stood at 12% of disposable income in 2008 (well above the euro area average of 8%) but fell temporarily by more than 1 pps in 2009 due to the crisis. The contribution of the corporate sector to net external lending became positive in the last few years. This is due to both efforts by the corporate sector to strengthen its balance sheets and weaker gross capital formation, which stood at 18% of GDP in 2009, down from more than 23% in 1991. Given that gross capital formation of the euro area is higher by about 2 pps, this implies a decrease in financing needs also in relative terms. According to its high savings-investment ratio, Germany became a net lender among the larger EU Member States.

Graph III.2.7: **Financial account (% of GDP)**



Source: German Bundesbank and Commission services.

Graph III.2.8: **Net lending (+) / borrowing (-) (% of GDP)**



Source: German Bundesbank and Commission services.

The biggest part of Germany's net foreign investment subsumed under "*Other*" items includes loans and trade credits (55%), bank deposits (40%) and other capital investment (5%) of notably monetary financial institutions and households. *"Portfolio investment"* shows no clear temporal pattern and has fluctuated around balance during the last two decades. The strong net inflow of portfolio investment since 2007 was dominated by net acquisitions of bonds, money market

certificates, while there were net outflows of investment certificates and financial derivatives. Following a period of capital imports between 2000 and 2003, net *"foreign direct investment"* (FDI) became negative afterwards and contributed significantly to overall capital exports in the last few years. The majority of *net* foreign direct investment is composed of re-invested gains (50%), equity capital financing (30%) and long- and short-term granting of credit by and borrowing from subsidiaries abroad (20%). The sectoral breakdown shows that only 25% of German FDI abroad is in manufacturing (in particular, the car and chemical industries) and about 75% is in services and venture capital companies. Since the beginning of the nineties, the German FDI stock has increased more than six-fold, with the majority of the stock located in the EU and the USA.

With respect to their destination, a breakdown of total German *net* capital flows on average over the last 5 years shows that most of the capital movement of some 470 bn EUR or about 19% of GDP p.a. took place within the euro area, where Germany is a net exporter of capital. Arguably, German companies took advantage of the opportunities offered by the creation of the single currency and later by the enlargement of the EU. The relocation of production increased net capital exports (especially FDI) to the new EU Member States considerably, although starting from a low base in the early nineties.([56]) Taking into account the strong – largely portfolio-driven – net capital imports from the UK, the net capital flow to the EU as a whole is only slightly negative. Strong net capital exports to North and Central America were also recorded. The net capital flow to and from Russia is broadly balanced, while net capital flow to Asia became positive (net capital imports) in the last few years.([57])

Overall, net lending of private households and corporations contributed strongly to the rise in the accumulated stock of net foreign assets and turned around the negative trend that had prevailed since German reunification. At the end of 2008 net foreign assets amounted to about 670 bn EUR or 27% of GDP, up from a trough of only 1% of GDP in 1998. The share of households and non-financial corporations in total net foreign assets currently amounts to 33% of GDP. While the contribution of monetary financial institutions (excl. the central bank), at 19% of GDP, is also strongly positive, that of general government is negative with net foreign liabilities amounting to 32% of GDP. The appreciation of the euro since 2006 has dampened the accumulated stock of foreign assets.

2.4. THE NEED FOR ADJUSTMENT ([58])

Germany's external competitiveness has been restored to pre-reunification-levels and, in relation to other euro-area Member States, Germany has even become more competitive than in the early 1990s. Since 2000, the increase in the degree of openness has gained momentum, the current account balance has moved into surplus, and the net external position has increased considerably, reflecting a healthy financial position of households and corporations. The slump of the German economy in the course of the financial and economic crisis only temporarily worsened corporate profitability and competitiveness in 2009, as productivity fell due to the delayed response of the labour market to the economic downturn. However, with the overall price and cost competitiveness position remaining broadly intact and global demand for German investment goods expected to continue rising in catching-up economies, Germany's export sector is well positioned to benefit from the global recovery.

In view of Germany's strong competitiveness in the euro area and its current account surplus, adjustment in the context of the euro area would be facilitated by a particular focus on strengthening the sources of domestic demand.

Against this background, insufficient wage differentiation to reflect productivity differentials remains a key issue, thus calling for reforms to enhance wage setting behaviour tailored to productivity developments. Furthermore, should

([56]) The FDI stock of Germany in the EU10 is now around 60 bn EUR, which is about 1% of the German capital stock. Most of the current stock (nearly 2/3) was built up ahead of enlargement in 2004.

([57]) See *German Bundesbank* (2009), "Balance of payments statistics" and "Foreign direct investment stock statistics", Special statistical publication 10.

([58]) The text which follows, including policy challenges, draws, *inter alia*, on already issued policy invitations and recommendations under various Community instruments, such as the updated Stability Programme, the EDP recommendations and the strategy for growth and jobs.

Germany succeed in raising productivity and potential growth more strongly, wages would show a more dynamic behaviour. In addition to a high savings ratio, moderate overall wage growth has contributed to the modest growth of private consumption. In order to contribute to strengthening Germany's (structural) competitiveness in the future and support a rebalancing of export-based growth, there is a need for reforms to address the weaknesses in the tax-benefit system, ensure high-quality education and an adequate education infrastructure to sustain comparative advantage in knowledge and research based growth. Such reforms include: reducing the high tax wedge to provide incentives for job creation, private investment, consumption and labour market participation as well as enhancing the framework for competition in services by further relaxing restrictive rules in regulated trades and services, lowering high entry and other regulatory barriers and improving public procurement procedures. Further tapping the potential of the services sector, which has already seen a dynamic growth recently, could lead to a further broadening of domestic demand in Germany.

3. IRELAND

3.1. SETTING THE STAGE: FOREIGN TRADE CHARACTERISTICS

Export growth played a critical role in the 1990s, when the export-based growth model enabled a rapid increase in Irish incomes. While exports and imports had accounted for around 80% of GDP in constant prices in the 1980s, this ratio peaked at 186% of GDP in 2001 and decreased, slightly, to some 180% in 2008. This reflects the move to domestic demand-driven growth, especially from the growing construction sector. Despite this, Ireland remains one of the most open economies of the euro area.

The trade balance moved into positive territory in the late 1980s and improved during the period of high export growth rates. On the goods side, the rapid expansion of exports led to an increase in the trade surplus in goods, which peaked at 28% of GDP in 2002 before declining to 14% in 2008. The services trade balance, traditionally negative, has been improving rapidly in the last few years, from a trough of -13% of GDP in 2000 to just -2% in 2008. This reflects a structural shift from exports of goods to exports of services since the beginning of this decade, with the share of goods in total exports declining from 78% in 2000 to 66% in 2008. Real exports of services grew by 16% on average over the period 2000-2008 and goods exports by only 2%. These developments are related to Ireland's long-standing strategy of developing knowledge-based export industries through an FDI-based strategy, thereby moving up the value-added chain faster than competitor countries. In a first phase, this took the form of moving towards manufacturing industries with higher technology intensity. A second phase, which may have begun at about the turn of the century, involves a gradual move from manufacturing to human-capital-intensive services. In a medium-term perspective, this move is beneficial to the current account position as the terms of trade for services are more favourable.([59])

More than 90% of export goods are industrial products, while the bulk of imports consist of materials for production (55% in 2008). The main categories for goods exports are chemicals (51% of total goods exports in 2008), especially organic chemicals and medical and pharmaceutical products, and machinery and transport equipment (21%), especially office machines. The sectoral composition of exports, in particular the importance of relatively acyclical chemical and pharmaceutical goods in total exports, has helped to contain the decline of Irish exports in the current crisis (by "only" 4.4% y-o-y in volume in the first three quarters of 2009) compared to other euro area Member States. Excluding the above-mentioned sectors, the decline was similar to that in other countries. The main import goods are likewise machinery and transport equipment (34% of total imports in 2008), and chemicals and related products (15%).

For services, the main exports relate to computer services (34% in 2008) and business services (31%). The latter category is the largest on the import side (44% in 2008), followed by royalties & licences (28%). Computer services make a large positive contribution to net exports, while royalties & licences and business services make large negative contributions.

Current account developments are mainly driven by the trade balance on goods and services. In particular, the deterioration from a broadly balanced current account position in the seven years up to 2004 to a deficit of more than 5% of GDP in 2007 is broadly explained by a weakening of the trade balance on goods and services to a level that was insufficient to cover the sizeable negative income balance. Looked at from the savings-investment side, the opening up of a deficit on the current account mainly reflected a housing-boom-related pick-up in the investment ratio (from an already high level compared with the EU average) since 2005 in particular, exacerbated by a reduction in the savings rate in 2007. In 2008 and the first three quarters of 2009,

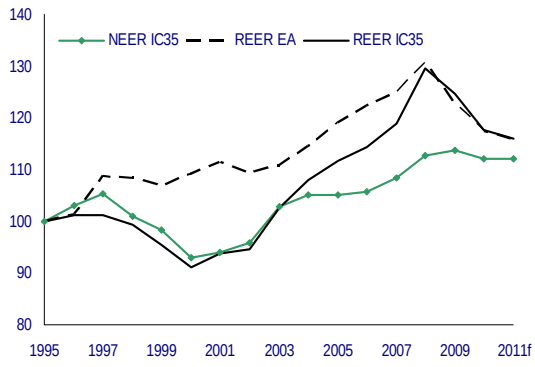
([59]) The switch to services is probably more apparent than real when it comes to computer services, which increased as a share of total exports from around 8% in 2000 to 15½% in 2008. Part of this increase, and a corresponding part of the decline in the goods share of total exports, reflects a change in the method of delivering software to customers. Previously software delivered as part of computer hardware of physical media was counted as a merchandise export but, as technological change has allowed software to be delivered electronically, it is now recorded as a services export.

the external deficit narrowed slightly in the context of the crisis, which led to a strong decline in investment associated with a marked decline in imports.

3.2. INDICATORS OF COMPETITIVENESS

Since 1995, Ireland has experienced a real appreciation vis-à-vis the euro area. Looking at the REER based on the deflators for private consumption and GDP, the appreciation took place between 1995 and 2003 with a stabilisation thereafter, reflecting the low inflation differential with the euro area. The ULC-based REER indicator was relatively stable between 1997 and 2003, but appreciated thereafter until 2008 by some 18% as wage growth remained high while productivity gains declined to rates more comparable with those in the euro area. Relative to the IC35, the real and nominal effective exchange rates depreciated from 1977 to 2000, putting Ireland in a very competitive position at the start of the decade.

Graph III.3.1: **Nominal and real (based on ULC) effective exchange rates (1995=100)**



Source: Commission services.

However, most of the REERs have appreciated since then, reflecting the appreciation of the euro as well as higher inflation and unit labour cost growth in Ireland than in its partner countries. Only the export-price-based indicator has tended to be relatively stable, pointing at Ireland's ability to maintain the price competitiveness of its exports at the cost of decreasing profit margins. As a small and very open economy, Ireland is a price-taker in international markets and its export prices closely follow nominal exchange rate movements, notably vis-à-vis the dollar and sterling.([60]) In 2009, despite a mild appreciation in the nominal effective exchange rate, some depreciation of all measures of the Irish real effective exchange rate is expected to have taken place. Specifically, the downward adjustment in prices and wages that appears to be taking place is helping to initiate a reversal of past competitiveness losses.

In the 1990s, Ireland managed to increase its share of exports to regions that grew more rapidly than the world average, thus allowing for market share gains. The increase in exports to the US, which was then the world's fastest growing region, reflected the ability to attract US multinational firms in high-technology sectors; much of the trade between Ireland and the US represents intra-firm trade between branches of US multinationals. Since 2000, Ireland has experienced losses in its share of world merchandise exports, which have however been offset by gains in its share of world exports of commercial services. Indices of revealed comparative advantage, broken down by technology intensity, show that Ireland has a high degree of specialisation vis-à-vis the euro area in high-technology products, especially in ICT. Ireland has also developed an advantage, albeit much less pronounced, in medium-high-tech products, especially chemicals. This pattern is mirrored by a revealed comparative advantage (broken down by factor intensity) in research-intensive (easy-to-imitate) goods. Ireland's traditional advantage in raw-material-intensive or labour-intensive goods has disappeared, with for instance the share of food products in total

([60]) Many of the usual macroeconomic data series for Ireland should be interpreted with caution for two reasons. First, while economic growth is usually measured in terms of GDP, GNI is probably a more appropriate measure for the Irish economy. The difference between GDP and GNI is net factor income, which is significantly negative in Ireland because of profit repatriations by multinationals. Irish GNI, which is about 15% smaller than GDP, is seen as a more suitable indicator of Irish living standards (among EU countries, Luxembourg is the only other country where the difference between the two measures is more than 10% of GDP). Second, some sectors with a marked presence of multinational companies are likely to be characterised by transfer pricing, attracted by Ireland's low tax rate on corporate profits. This distorts (i.e. exaggerates) standard measures of profits, output, productivity etc. (see Patrick Honohan and Brendan Walsh (2002), "Caching Up with the Leaders: The Irish Hare", *Brookings Papers on Economic Activity*, No. 1/2002, pp. 1-77).

merchandise exports falling from some 23% in the early 1990s to 8% in 2008.

The terms of trade for services were favourable between 2000 and 2008, increasing by 12%, while the terms of trade for goods decreased by 13%. Producer prices in the key merchandise export sectors (ICT and chemicals) display a declining trend as these sectors experience substantial downward pressure on output prices in the global market. Overall, also in view of the increasing weight of services in total exports, the terms of trade thus declined only slightly (by 7%) between 2000 and 2008.

The ratio of gross operating surplus to gross value added (GVA) for the total economy increased from 49% in 1995 to 57% in 2002, but has been on a broadly downward trend since then. At 54% in 2008, the ratio was the second highest in the euro area after Greece (61%), reflecting the presence of multinational companies recording huge profits in Ireland (and generating huge profit outflows). In 2007, two sectors had higher ratios than average: manufacturing (71%) and finance and business services (72%), which rank respectively in first and second place in the euro area. Market services have been expanding their share in the economic structure as well as in total exports, accounting for 44% of GVA in 2008. Business and financial services make up about 60% of market services GVA([61]) and generate about 65% of services exports. The net export position of international financial services companies amounted to 4% of GDP in 2008. Given their generally lower import content, an increase in exports of services tends to generate an increase in net exports. The crisis has hit the financial services industry more severely than other services sectors, as reflected in a more pronounced decrease in the value of exports of financial services (-11½% yoy in the first three quarters of 2009 versus -1½% for overall service exports).([62])

After the particularly high inflows of the 1990s, FDI inflows have been decreasing since 2003. With outflows continuing their general upward trend, the net liability position (stock) related to direct investment fell from 102% of GDP in 2000 to 12% of GDP in 2008. At the end of 2007 the services sector represented 61% of the total inward position, with particular emphasis on financial intermediation and insurance. Similarly, most of the outward direct investment position was accounted for by the services sector. Within total manufacturing, the chemical sector accounted for 65% of the inward FDI position in 2005. The share dropped markedly to 35% in 2006 due to outflows of other capital to affiliates abroad. This probably reflects "reverse investment", predominantly in the form of inter-affiliate loans, which offsets existing other capital investment in Ireland.

3.3. SPECIAL FOCUS: OPENNESS AND EXPOSURE TO NON-EURO-AREA COUNTRIES (ESPECIALLY THE UK AND THE US)

The Irish FDI- and export-based strategy for catching-up, which took off some 20 years ago, was marked from the start by relatively important economic ties to the US and the UK compared to continental Europe.([63]) Two questions arise: whether these patterns have shifted since the creation of monetary union; and whether they have influenced Ireland's relatively resilient export performance in the current crisis.

There is a high degree of foreign ownership in manufacturing and services. The significant growth in exports over the last two decades was mainly driven by the foreign-owned sector.([64]) The so-called "modern" manufacturing sector([65]), where production grew by 64% between 2000 and 2008, is particularly dominated by foreign multinationals. It includes the key export sectors "chemicals" and ICT, where foreign multinationals accounted for around 98% and 95% of GVA in

([61]) They generated 26% of total valued added and 14% of total employment in 2008.

([62]) According to Balance of Payments data for financial services and national accounts data for overall services.

([63]) There are other channels, such as financial and migration flows, which affect Ireland's potential exposure to US and UK. These fall outside the scope of this note.

([64]) According to the 2005 Census of Industrial Production, non-Irish firms accounted for 82% of total manufacturing gross output, but for less than half of manufacturing employment. Non-Irish firms exported 94% of their gross output, compared to just 33% for indigenous firms.

([65]) As defined by the Irish statistical office (CSO), comprising "reproduction of recorded media" (NACE 223), chemicals (NACE 24), "computers and instrument engineering" (NACE 30, 33) and "electrical machinery and equipment" (NACE 31, 32).

Table III.3.1: **Geographical distribution of Ireland's external trade**

in %	Goods				Services			
	Exports		Imports		Exports		Imports	
	2000	2008	2000	2008	2000	2008	2000	2008
EU	62.3	62.3	55.0	63.5	62.4	62.9	50.7	46.2
of which euro area (1):	38.2	42.2	21.1	28.1	33.5	35.0	33.3	26.8
UK	22.5	16.6	31.5	31.1	25.2	22.0	15.3	17.1
US and Canada	17.4	19.8	17.3	12.3	14.1	9.8	32.5	35.4
Rest of the world	20.2	17.9	27.7	24.2	23.5	27.4	16.8	18.4

(1) Data for 2000 and 2003 exclude Slovenia and Slovakia, Cyprus and Malta.
Source: CSO and Commission services.

2005, respectively, and exported around 98% and 97% of gross output, respectively. The so-called "traditional" manufacturing sector, where production grew by just 6% over the period 2000 to 2008, tends to be more embedded in the domestic economy in terms of employment intensity, domestic economy expenditures and the lower likelihood of companies relocating production to other countries. The main representative is the food sector, where the UK is the main origin of Irish food imports as well as the main market for Irish food exports. In spite of the difference in production growth rates, the nominal GVA shares of the modern and traditional sectors have hardly changed due to the much higher price increase for domestic sales than export sales, also reflecting the predominance of products with falling world prices in the output of the "modern" sector.

In the services sector, the dominance of foreign-owned companies is less pronounced. However, they still accounted for 46% of the GVA of total private services in 2005 (up from 37% in 2001). A higher-than-average degree of foreign ownership characterises business services, computer services and recreational services (64%). As with manufacturing, foreign ownership seems to be concentrated in the most export-oriented and least employment-intensive services sectors.([66])

Data on the stock of FDI at the end of 2008 show that EU countries accounted for the bulk of inward investment into Ireland (78%), up from 58% in 2001, with the UK share declining over this period, from 18% to 10%. The US share at end-2007 stood at 8%, down from 21% in 2001.

Concerning trade flows, the share of exports to and imports from the euro area is relatively low in comparison with other euro area countries. Two non-euro-area trade partners of particular significance are the UK and the US, which, taken together, accounted for a larger share of Irish goods exports than the euro area in 2000 (see Table III.3.1). By 2007, the shares of the euro area, but also of the US, in Irish merchandise exports had increased somewhat. On the imports side, the weight of the UK remains very high. The geographical distribution of trade in services differs from that for goods, especially on the imports side. From the limited data available, there is no evidence of a clear shift in trade patterns over time.

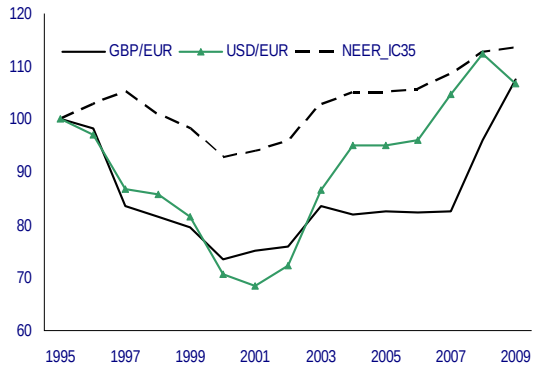
The outward orientation of the Irish economy remains very strong. However, the relative dominance of non-euro-area partners, namely the US and the UK, in both trade and FDI flows seems to have diminished since Ireland's entry into the euro area. This would imply that the scope for asymmetries in Ireland's performance relative to the euro area due to the particular orientation of its trade flows and FDI links may have lessened.

As a result of its trade patterns, Ireland is more exposed to movements in the exchange rate of the euro vis-à-vis the dollar and sterling than any other euro area member. Graph III.3.2 demonstrates the close relationship between Ireland's nominal effective exchange rate and the bilateral exchange rates USD/EUR and GBP/EUR. The euro appreciation of 64% against the USD and 28% against the GBP between 2001 and 2008 has significantly affected the competitiveness of

([66]) Business and computer services represented 42% of export of services, while amounting only to 12% of total private services. Foreign-owned services companies employed 24% of total employees in the sector in 2005.

Ireland's exports. By contrast, the recent depreciation of the euro especially against the USD might provide some support to Irish exports.

Graph III.3.2: **USD/EUR, GBP/EUR and Ireland's nominal effective exchange rate (1995=100)**



Source: Commission services.

Recent empirical evidence confirms the high exposure of the Irish economy to developments in the US when compared to the rest of the euro area: a 1% fall in US private demand (both consumption and investment) would lead to a much more significant drop in GDP in Ireland than in Germany or Italy.([67])

In the current crisis, nominal goods exports to the UK have declined more markedly than those to the rest of the EU (in the period January 2008-November 2009, the average year-on-year growth rates were -9.4% versus -2.3% respectively). However, the value of exports to the US actually increased (at an average rate of +9.1% over the same period). Together with the fact that the decline in exports has been less drastic for Ireland than for other export-oriented Member States, this appears to indicate that the sectoral composition of exports has played a more important role in determining Ireland's export performance in the current crisis than the geographical trade pattern.

([67]) Germany represents countries with a trade exposure to the rest of the world in line with the euro area average, while Italy stands out for its specialisation in traditional sectors and is thus more exposed to competition from emerging markets. See European Commission (2008), "EMU@10: successes and challenges after 10 years of Economic and Monetary Union", *European Economy* 2/2008, box II.4.1: Simulations with DG ECFIN's QUEST model. See also Daniel Kanda (2008), "Spillovers to Ireland", *IMF Working Paper* No WP/08/2.

3.4. THE NEED FOR ADJUSTMENT ([68])

Price and wage inflation pressures together with a decline in productivity growth have gradually eroded Ireland's competitive position and the external deficit has been on the increase since 2004. The recent depreciation of sterling, to which the Irish economy is more exposed than other euro area members, has added to this development. At the same time, in terms of savings/investment balances, the recent deterioration in the external position mainly reflects recent overinvestment in non-productive housing.

The latter stopped with the bursting of the housing market bubble which, together with global developments, has led to a deep economic and fiscal slump in Ireland. A protracted recovery phase is generally expected to follow the current recession given the extent of the necessary adjustment. The need to rebalance growth domestically (via the reallocation of resources to more productive sectors and a corresponding re-skilling of workers) and restore fiscal stability - where significant first steps have already been taken by the authorities in 2009 - makes for a particularly challenging environment for policymakers and implies that domestic demand could remain subdued during the adjustment phase. This underlines the importance of ensuring that Ireland can fully benefit from any upswing in external demand in the near to medium term. Sustainably reversing past losses in competitiveness will therefore be crucial. While the external deficit is set to improve markedly in the current crisis and should narrow further as the economy returns to balanced growth, the high level of external debt implies sustained net income outflows, contributing to a (small) external deficit even in the medium term.

In view of Ireland's competitiveness position in the euro area and its current account balance, adjustment in the context of the euro area would be facilitated through the continuation of the ongoing relative price and cost adjustments and the shift of resources from the non-tradable to the tradable sector.

([68]) The text which follows, including policy challenges, draws, *inter alia*, on already issued policy invitations and recommendations under various Community instruments, such as the updated Stability Programme, the EDP recommendations and the strategy for growth and jobs.

Against this background and in view of the possibility of a subdued and drawn-out recovery of domestic demand, the Irish FDI-led strategy, which has been very successful in the last two decades, should be continued. As foreign-owned companies tend to be less well-connected to the domestic economy and are, especially in the services sector, rather footloose, it is essential to strengthen the attractiveness and competitiveness of the domestic economy. In particular, within the constraints imposed by the need to consolidate the public finances, thereby providing a stable macro-fiscal framework, adequate public services and good infrastructure should be ensured, while further productivity-enhancing measures should be taken to stimulate R&D investment and technology diffusion from multinational companies to the wider economy. Especially given the possible shift in migration patterns, continuing to guarantee a well-educated workforce will also be crucial. In this context, supporting the re- and up-skilling of the newly-unemployed will be important to prevent the latter from turning into long-term unemployed, especially since young and low-skilled workers are among the hardest hit. It will also be important to improve product market functioning (e.g. in network industries and regulated services) to allow for a more active role of competition in the allocation of resources.

While for internationally-traded services labour costs proper may be less important than the factors mentioned above, an adjustment to restore wage competitiveness seems essential for the economy as a whole. Indeed, with higher exposure than the rest of the euro area to the downturn in the US and UK and to the appreciation of the euro vis-à-vis their currencies over the last years, a stronger adjustment vis-à-vis the euro area will be necessary to regain competitiveness. After the substantial wage adjustment in the public sector in 2009 helped to initiate the necessary change in labour costs, adequate wage settlements in this sector should be sustained in the medium term to encourage wage moderation in the private sector. Whereas in the past, Ireland displayed flexibility in successive national wage agreements, the social partnership approach has evidently not been able to prevent the current misalignment between wages and productivity. However, it could now play an important role in fostering and framing the necessary adjustment process and ensure the required labour cost flexibility at firm or sector level.

4. GREECE

4.1. SETTING THE STAGE: FOREIGN TRADE CHARACTERISTICS

Although the degree of openness has been rising over the last 15 years, Greece remains a relatively closed economy. Measured in terms of the sum of export and import volumes as a share of GDP, trade openness increased significantly from close to 43% of GDP in 1995 to almost 60% in 2008, a still relatively modest figure compared to the average of the euro area as a whole (around 88% of GDP in 2008). This increase reflects uneven developments in exports and imports. Linked with buoyant and sustained domestic demand and a steady worsening of competitiveness (see below), import penetration rose by 10 percentage points, from around 26% of GDP in 1995 to nearly 36% in 2008, while the share of total exports in GDP increased by around 7 percentage points from 17% to 24% over the same period. As a result, the external balance of the Greek economy deteriorated rapidly from 1997 onwards, with the current account deficit reaching 14¾% of GDP in 2007 and declining somewhat to 13¾% of GDP in 2008. This development was mostly due to a growing deficit of the trade in goods, which registered 16½% of GDP in 2008 (4½ percentage points more than in 1997).

Trade in goods and trade in services have followed different growth patterns over recent years. Indeed, trade in goods grew moderately at around 6% in real terms on average over the period 1995-2008, while the corresponding figure for trade in services was almost double this figure. This reflects not only the higher demand elasticities for services but also the strong performance of the tourism industry and the sea freight transport services, which have also been the most dynamic sectors of the Greek economy in recent years.

Interestingly, the increase in trade openness has not been driven by enhanced integration of Greece in the euro area. Although the euro area remains the country's most important trade partner, its share in total trade has diminished. Indeed, trade in goods and services with the euro area represented less than half of total trade in 2008, compared to almost 58% in 1995. Moreover, in the case of trade in services, the euro area accounted for just one third of the total trade in services between 1995 and 2008. Germany and Italy, which have been traditionally the main trade partners of Greece, have seen their shares in Greek total trade in goods shrink from 35% in 1995 to around 22% 2008. The steady erosion of competitiveness vis-à-vis the euro-area partners has contributed to a change in the geographical specialisation of Greece towards neighbours with high economic growth, such as the Balkans and countries of south-eastern Europe. The share in total exports of goods accounted for by Bulgaria, Romania, Cyprus, Turkey, Croatia and Former Yugoslav Republic of Macedonia grew from just above 10% in 1995 to 24½% in 2008, while, in parallel, the share of goods in total imports from Russia, China, South Korea and Japan almost doubled over the same period.

In terms of product specialisation, the share of low-tech and labour-intensive products remains significant, although declining. Products in the categories of 'Food and live animals' and 'Crude materials' represented almost 25% of total exports in 1995 and almost 20% in 2008. In contrast, the share in total exports of products in the category 'Mineral fuels, lubricants and other related material' almost doubled between 1995 and 2008 from 6% to 11%, especially to countries outside the euro area. On the import side 'Mineral fuels, lubricants and other related materials' saw its share increase from 7% to almost 12%, reflecting not only higher oil prices, but also the importance of refining activity in Greece, which acts as the main provider of petroleum products to neighbouring Balkan countries. In the realm of medium-to-high tech products using highly skilled labour, the chemical industry has been the most dynamic in Greece over recent years, with the export share of 'Chemical and related products' having risen significantly, from around 5% in 1995 to more than 13% in 2008. The share of high value-added (high-tech) exports has edged slightly higher over the last few years, although it remains much lower than in the euro area.

At around 14% of GDP in 2008, exports of services have been much more significant than exports of goods (at around 10% of GDP in 2008), while imports of services have diminished to around 7¼% of GDP in 2008 (from 8½% in 2000). Travel and transport services represent almost 90% of the total exports of services. Travel services were mainly exported in the form of tourism

inflows, mainly originating from euro area countries, although tourism from Eastern Europe and Russia has grown in the most recent years. Transport services, especially sea freight transport, are mainly directed outside the euro area, reflecting the important penetration of Greece's commercial fleet in world trade in sea transportation.

4.2. INDICATORS OF COMPETITIVENESS

All four indicators of the real effective exchange rate (based on the GDP deflator, the private consumption deflator, the export price deflator and ULC-total economy) recorded an appreciating trend vis-à-vis the IC35 from 2000 onwards – the degree of appreciation between 2000 and 2008 based on price measures varies from around 16% (export price deflator) to 13% (GDP deflator). When considering REER vis-à-vis the rest of the euro area, an appreciating trend is also apparent, reaching its peak in 2008. These developments are unsurprising given the persistence of the inflation differential between Greece and the euro area, which has hovered around 1 percentage point over the 2000s. Persistently high inflation appears to be mainly the result of non-competitive behaviour and rigidities in product and labour markets, while the Balassa-Samuelson effect seems to be less important. Summing up, most estimates of the equilibrium exchange rate suggest that the real effective exchange rate of Greece is overvalued with respect to its long-term equilibrium.

The appreciation of the ULC-based REER for the total economy (more than 14% in 2008 since 2000 vis-à-vis the IC35) results from much higher wage growth than in the euro area and the IC35. Labour market rigidities and wage-setting institutions seem to lie behind high wage growth in Greece and the concomitant widening gap in unit labour costs with its main trading partners. The positive increase in the wage differential, which has been especially significant since 2002, put pressure on inflation and price competitiveness, in spite of fast-growing productivity, which has exceeded that in the euro area. Persistently higher inflation and competitiveness losses may also be related to imperfections in the functioning of product markets, as reflected by rapidly-growing mark-ups.

Greece has not fully benefited from the expansion in international markets since 2005, as revealed by trade in goods and services and flows of portfolio investment and FDI. The pace of real growth in exports of goods and services exceeded 10% on average over the period 1995-2000, although it turned temporarily negative in 2001 and 2002 (-4¼% on average) before regaining a positive real growth rate of more than 6% on average between 2003 and 2008. Growth in exports has been consistently below that of imports, especially since the late 1990s. Export market shares have been on a downward trend, falling from 0.22% in 1995 to 0.16% in 2002 and stagnating afterwards at around 0.17%. In spite of this negative outcome, it is worth noting that the country seems to have lost relatively little in market shares when viewed against the deterioration of competitiveness. Thus, Greece compares favourably with other euro area countries, which experienced more pronounced losses in market shares.

Wholesale and retail trade, personal services (hotels/restaurants) and financial intermediation and business activities have been recording significantly higher mark-ups since 2001, revealing a more rapid evolution of mark-ups in services compared to the manufacturing export sectors. Higher mark-up growth in services can be partly attributed to limited exposure to international competition. Although the regulatory environment has become more supportive of product market competition in Greece since the late 1990s([69]), the Internal Market Restrictiveness Index in Services (IMRIS)([70]) suggests that the services sector is less exposed to competition than the goods sector, both domestically (such as the heavily regulated professional services by lawyers, accountants, etc.) and internationally. In parallel, the income convergence process has led to a demand shift towards those service activities with higher income elasticities (e.g. private healthcare services), thus putting further pressure on prices in these sectors and contributing somewhat to the inflation differential with the euro area.

([69]) According to the OECD Product Market Regulation database

([70]) ECB (2006), "Competition, productivity and prices in the euro-area services sector", Occasional paper No 44, April 2006, p.43.

4.3. SPECIAL FOCUS: TWIN DEFICITS IN GREECE AND THE ROLE OF FISCAL AND STRUCTURAL POLICIES

The combination of high economic growth, persistent fiscal imbalances and deteriorating competitiveness in the last decade has worsened the external balance of the Greek economy, with the current account deficit peaking at 14¾% of GDP in 2007 before declining somewhat to 13¾% of GDP in 2008, from a close-to-balance position in the mid-1990's. The widening external imbalance was mostly due to a growing deficit of the trade in goods, which registered around 17% of GDP in 2008 (almost 6 percentage points more than in 1995). More specifically, the performance of merchandise exports was disappointing over the last decade, while imports growth was strong, in line with buoyant domestic demand. Trade in services, on the other hand, has gone in the opposite direction. The balance of net exports of services has improved over time reaching a surplus of more than 6% of GDP in 2008, 1 percentage point higher than in 1997. However, this improvement fell short of compensating for the deterioration in the balance of goods.

The relatively poor export performance of goods can also be explained by the geographic structure of external trade. Almost half of Greek exports are directed to extra-EU countries, mainly to the Balkans, Turkey and the Mediterranean basin. Although some of these countries have been recording relatively high growth rates in the recent past, the size of their markets is relatively small compared to the euro area. In addition, the high share of extra-EU trade and in particular extra-euro-area trade has increased the exposure of the economy to the exchange rate fluctuations of the euro. This is particularly significant now that the currencies of some of Greece's main trade partners are depreciating, thus aggravating Greek's competitiveness losses further.

With the share of imports of goods in GDP increasing over time, from 24% in 1997 to around 26% in 2008 – implying a high import elasticity with respect to domestic demand – there is evidence that the economy is facing structural difficulties in substituting imports with domestic production and in adjusting to external competition. In contrast, the growth rate of exports of goods has been slower than GDP, leading not only to a further gradual decline of their already low share in GDP, but also to losses in market shares.

In parallel, the balance of primary income and current transfers has deteriorated over time, reaching a deficit of around 3½% of GDP in 2008, compared to a surplus of more than 4½% of GDP in 1997. This reflects a dynamic feedback between the current account deficit and debt accumulation, through increasing interest rates. Surpluses on the capital transfers account, on the other hand, remained largely stable until the early 2000s at around 1¾% of GDP per year. Nevertheless, while capital transfers were sufficient to offset the external imbalance and the net borrowing position of the Greek economy in the late 1990's, they gradually diminished in the beginning of the new millennium and turned negative, with the current account deficit increasing rapidly. As a result, the net external borrowing position of the economy exceeded its historical high of 12% of GDP in 2007, before declining somewhat in 2008. Whereas FDI inflows are relatively small (less than 1½% of GDP in 2008), the growing external imbalance is being financed mostly through portfolio investment and government bonds, reflecting the role of the public sector in the origin of the current account deficit.

The progressive deterioration of the net external borrowing position of the economy reflects both rising investment and falling savings. The public and private sectors have alternated during the last decade as the driving force of this deterioration. In particular, three different periods can be distinguished, ending just before the current recession: a first period of fiscal consolidation and private sector dis-saving (1997-1999); a second period of dis-saving in the public sector and strong investment activity, mainly in infrastructure (2000-2004); and a third period of fiscal adjustment and strong private investment, mainly in dwellings, between 2005 and 2006. After 2007, however, and especially in 2008 and 2009, fiscal consolidation came to an end with the general government deficit on the rise once again.

More specifically:

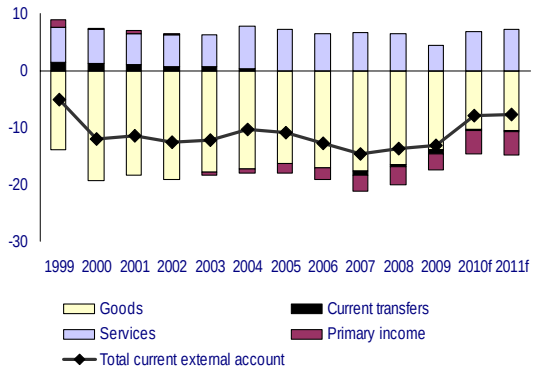
(1) On the road to the euro, the government implemented a revenue-led fiscal consolidation programme that cut the deficit by nearly 2½

percentage points of GDP. Rising private investment, however, led to dis-saving by the corporate sector and a fall in household savings, thus pushing the combined net balance of the private sector into deficit by 1999. As a result, while in the mid-1990's private sector savings largely compensated for public deficits, the public deficit could no longer be financed by domestic saving in the early 2000's, thus further increasing the external borrowing needs of the country.

(2) Fiscal consolidation came to a halt in 2000. During the period 2000-2004, fiscal policy became expansionary, as reflected in the downward trend of the cyclically-adjusted general government primary surplus, which turned into a deficit in 2003, in a context of high output growth and output gaps. Although part of the increase in public deficits financed public works and other major projects linked to the organisation of the Olympic Games, infrastructure investment contributed only marginally to the mounting public deficit, which reached 7½% of GDP in 2004. While the private sector improved its financial position slightly, the growing public deficit offset these gains.

(3) With the current account deficit remaining high, the fiscal stance became restrictive again in 2005. The government implemented a significant fiscal adjustment programme that cut the budget deficit to just below 3% of GDP in 2006. At the same time, the cyclically-adjusted deficit was reduced by the same amount. The structural balance, in turn, (i.e. the cyclically-adjusted-balance net of one-offs and other temporary measures) improved by 3½ percentage points of GDP. Despite the containment of the public sector deficit, the financing needs of the economy still remained high and growing, reflecting further significant dis-saving by the private sector due to rising private investment (mainly in housing) associated with improving economic prospects and a buoyant housing market. As a result, given the lower but still present public deficits and the worsening net financial position of the private sector, the net borrowing position of Greece vis-à-vis the rest of the world deteriorated further (see Graph III.4.2).

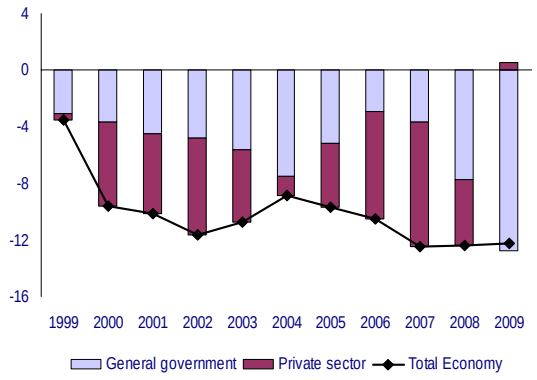
Graph III.4.1: **Current account balance (% of GDP)**



Source: Commission services.

In 2007, the fiscal stance eased mainly due to current primary expenditure slippages and, in spite of still good economic times, the structural balance deteriorated by a ½ percentage point of GDP. The fiscal deterioration continued in 2008, with the headline deficit reaching 7¾% of GDP and the structural deficit widening by 3¼ percentage points of GDP. According to the authorities' estimations, the fiscal deterioration continued in 2009. A further fall in private (mainly households) sector savings led to a jump in the net borrowing position of the country to double digit levels, exceeding 12% of GDP in 2007 and in 2008. In 2009 however, the deterioration in the general government deficit was the main factor behind negative external borrowing, which reached 12¼% of GDP.

Graph III.4.2: **Net lending (+) / Net borrowing (-): Sectoral breakdown (% of GDP)**



Source: Commission services.

External imbalances can result from different factors. Available evidence suggests that in Greece, structural factors and persistent competitiveness losses might be the most significant. In other words, although relatively sluggish growth in Greece's main trade partners and strong domestic demand can largely explain the limited net export growth until 2000, cyclical factors may fall short in explaining the size of the current account deficit in more recent years.

The build-up of external imbalances carries with it a risk of lower medium-term growth. The patterns of sector and geographical trade specialisation show that Greece not only exports too little, but its exports of goods are mainly concentrated in low-technology and slow-growing demand products. Moreover, the bulk of imports is mainly made up of consumer goods, while equipment and investment goods account for a relatively smaller share. An additional important factor is that, while FDI inflows are relatively small, the growing external imbalance is being financed mostly through portfolio investment and, reflecting the public-sector origin of the current account deficit, through government bonds.([71]) As mentioned in the previous section, the rapid rise observed in wage costs and mark-ups in excess of the significant growth in productivity has led to the deterioration in competitiveness over the last ten years, which is reflected in the sizeable appreciation of the real effective exchange rates (REER).

4.4. THE NEED FOR ADJUSTMENT ([72])

The rapid deterioration in the lending position of the Greek economy mirrors a combination of both rising investment and falling savings, including a significant deterioration of the fiscal position over the past several years with the public sector absorbing the main part of the available external financing. The growing and persistent external imbalances have led to the build-up of a high foreign debt, bringing with it a clear risk to the economy's medium-term growth prospects. Moreover, the pace of external debt accumulation in recent years is likely to be unsustainable in the long-run and needs to be corrected by appropriate policies. In the context of the ongoing economic crisis, the implied re-pricing of risk and possible implications for the financing of large current account deficits require an adequate and comprehensive mix of macroeconomic and structural policies to tackle the factors underlying the external imbalances.

In view of Greece's weakened competitiveness in the euro area and its persistent current account deficit, adjustment in the context of the euro area would be facilitated by relative price and cost adjustments and a shift of resources from the non-tradable to the tradable sector.

Against this background and in view of Greece's widening domestic and external imbalances, policy efforts will be needed to address the various dimension of the challenge. The structural nature of external imbalances in Greece implies that the emphasis should be put on policies aimed at tackling the rigidities in the product and labour markets and promoting innovation. In other words, implementing the policy measures reflected in the updated Stability Programme, the recommendations and invitations on structural adjustment needs identified in the Council Recommendation with a view to ending the inconsistency with the broad guidelines of economic policies and the strategy for growth and jobs should contribute to attenuating the persistence of the inflation differential between Greece and the euro area. Moreover, although labour productivity growth has been relatively high, unit labour costs have been increasing at a faster pace than in Greece's main trade partners in the euro area, thus worsening the competitive position of the country. A recovery of competitiveness can be supported by: improving product and services market functioning to allow for a more active role for competition in the allocation of resources; fostering wage behaviour that takes due account of productivity developments; ensuring that tax and benefit systems make work pay; and improving the functioning of the public administration and public resources management, which could be channelled towards investment in knowledge and in human

([71]) According to the Bank of Greece, foreign investors' purchases of government bonds have been the main source of net inflows under portfolio investment.

([72]) The text which follows, including policy challenges, draws, *inter alia*, on already issued policy invitations and recommendations under various Community instruments, such as the updated Stability Programme, the EDP recommendations and the strategy for growth and jobs.

and physical capital. The public sector has an important signalling role for wage moderation, with a view to bringing labour cost increases significantly below the euro area average.

Fiscal policy developments in Greece in the recent past reflect inefficient control of public expenditures, in particular current primary expenditure, not only in periods of fiscal expansion, but also in those of fiscal consolidation. This is evident in deviations of actual fiscal outcomes from budgetary targets as a result of both revenue shortfalls and expenditure overruns. These systematic slippages in the execution of the Budget Laws, which had an effect similar to expansionary policies, fed domestic demand also at times when the Greek economy was already growing above its potential. The inadequacy of the budgetary stance also contributed to inflation, thus leading to a sizeable appreciation of the real effective exchange rate vis-à-vis the euro area. Given the unsustainable path of public finances in Greece over the past years, there is a need to pursue prudent fiscal policies with a view to ensuring a credible budgetary consolidation towards a balanced position, together with measures to control current primary expenditure.

5. SPAIN

5.1. SETTING THE STAGE: FOREIGN TRADE CHARACTERISTICS

Although the openness of the Spanish economy has grown significantly in the last few decades, the country is still a relatively closed economy. Rising from 44% of GDP in 1995, the degree of openness (measured in terms of the sum of export and import volumes as a % of GDP) reached 61% in 2009, compared to 88% for the euro area average. The main driver of this process was imports, which contributed more than twice as much as exports to the increase in openness. The behaviour of imports was the result of buoyant and sustained domestic demand in the period 1995-2007. In 2009, given the collapse of world trade, the Spanish economy saw its openness fall by eight percentage points, slightly more than the average for the euro area.

Spanish external trade is mainly driven by trade in goods. In 2009, goods accounted for 70% of total exports and 80% of total imports. These shares have changed only slightly since 1995 (69% and 83%, respectively). The stagnation of the exports of services in terms of total exports reflects the situation of the tourism industry that, after strong growth in the last 40 years, now suffers from strong competition from emerging-country destinations. Consequently, whereas tourism accounted for around 63% of total exports of services in 1995, it contributed only 44.5% in 2009. Among non-tourism services exports, business services have recently been the most dynamic.

Geographically, around 57% of Spanish exports of goods went to the euro area in 2009. More specifically, France absorbed almost 20% of exports, Germany nearly 11%, and Italy and Portugal between 8% and 9% each. Among the non-euro-area EU countries, the United Kingdom appears as the major export destination with over 6% share of the total. With regard to the rest of the world, the major economies do not have any significant weight in Spanish exports. Thus, the USA accounts for around 4%, China 1¼% and India 0.5%. Latin America, with a share of less than 5%, has been an important destination in view of its rapid economic growth. On the other hand, exports to Africa have continued to grow rapidly resulting in a share of more than 5.9% by 2008.

Since the early seventies, the weight of Spanish exports in world trade has been increasing in parallel with the opening up of the economy. This process was boosted by integration into the EU in the mid-eighties. In the period 1996-2003, Spanish exports reached their largest share in world trade, around 2%, thanks to both the increasing economic integration in the EU and the depreciation of peseta in the early nineties. Since 2004, the share of Spanish exports in global trade has been weakening (1.7% in 2008), in line with the deterioration of its competitiveness and the growing role of emerging economies.

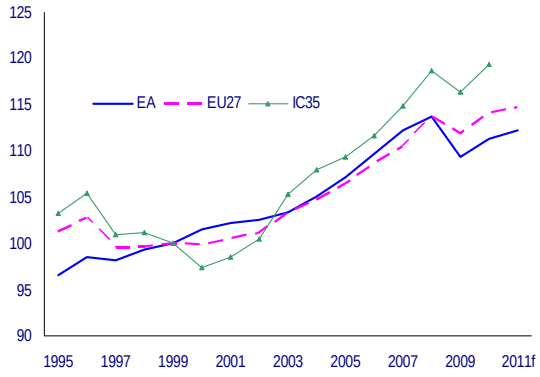
A breakdown of exported goods by product category shows that almost half of Spanish exports (45%) are in medium-quality goods. Inside this group, the car industry represented around 17% of total exports in 2009, reflecting the important role of Spain as car maker (after Germany and France). Although the most advanced technological industries have a reduced presence in Spanish external sales (almost 10%), they seem to be the most dynamic sector in external trade.

5.2. INDICATORS OF COMPETITIVENESS

All four indicators usually used in the calculations of the real effective exchange rate (DPC, GDP deflator, export price deflator, ULC-total economy) exhibit an appreciating trend vis-à-vis the IC35 from 2000 to 2008 – the degree of appreciation varies from 17% (export price deflator) to 24% (GDP deflator). The appreciation of the nominal effective exchange rate was about 14% over the same period. Against the rest of the euro area, the real appreciation trend ranged from around 9% (DPC) to about 13% (GDP deflator), and also saw a slight correction in 2009. Indeed, most estimates of the equilibrium exchange rate, suggest that the real effective exchange rate of Spain has been overvalued with respect to its long-term equilibrium. After a temporary depreciation in 2009, the real effective exchange rate is expected to appreciate once again, making further current account adjustment difficult. The temporary depreciation owes much to cyclical factors, as reflected in expected negative output gaps of above 3% between 2009 and 2011. Indeed, the underlying current account balance corrected

for the cycle is expected to improve by less than the actual current account balance.

Graph III.5.1: **REER based on ULC (total economy, 1999=100)**



Source: Commission services.

The indicator based on ULCs in the total economy (Graph III.5.1) seems to be the most appropriate to measure the competitiveness performance of domestic products in international markets (tradables). Despite some recent adjustment in view of the recession, Spain remains among the countries experiencing the highest appreciation against other euro area countries since the creation of the euro area in 1999. These trends are unsurprising given the persistence of a positive inflation differential between Spain and the euro area, which appears to be mainly the result of structural elements. Indeed, income convergence, higher wage growth coupled with lower productivity growth than in the euro area, and the presence of non-competitive behaviour and market rigidities in some sectors seem to be key elements behind the persistently higher inflation in Spain, while the Balassa-Samuelson effect does not appear to be a significant factor in explaining the differential. From close to zero in 1999-2000, productivity growth (in terms of output per hour worked) remained almost flat at less than 1% between 2002 and 2006. Although productivity growth has accelerated substantially in 2009, this seems to be a temporary factor, reflecting the high number of lay-offs recorded in Spain, especially in the construction sector. While structural rigidities remain, the rapid and severe worsening of economic activity in 2009 has led inflation to fall sharply, reducing the differential with the euro area.

Not surprisingly, in view of the ongoing expansion of international markets over the period extending from the early nineties until the onset of the global financial and economic crisis, Spain experienced considerable growth in trade in goods and services and flows of portfolio investment and FDI. The openness of the economy, as defined in section 1, doubled between 1990 and 2008, while net portfolio investment more than doubled its share in GDP over the same period. However, the contraction in world markets since late 2008 is pushing the economy's openness back towards the level of 2000. The pace of real growth in exports in goods and services decelerated from on average 5% between 2000 and 2007, to -7% in 2008-2009. From gains in export market shares during 2001-2003, Spain experienced losses in the subsequent years up to 2009 (except for 2007), although it seems to have lost relatively little in market shares when compared with the deterioration of competitiveness. This might be explained by efforts of domestic exporters of manufactures to keep markets by reducing mark-ups. All in all, Spain compares favourably with other large euro area countries (France and Italy), which suffered larger losses in market shares. Spain partially owes this relatively favourable result to: its low degree of specialisation in goods, such as clothes and textiles, which experienced strong international competition; an above (euro-area and EU) average share of services in total exports; and limited exposure to the contraction in manufactured products.

Competition is lower in less tradable services than in manufacturing where, as mentioned above, mark-ups had to be limited in order to maintain market shares. Although competition from low cost countries in sectors such as tourism has the potential to adversely affect Spain's tourism industry, so far this has not translated into lower market shares. The terms of trade for services picked up rapidly between 2001 and 2003, while the improvement for goods has been more gradual. The expansion of exports of services in Spain was greatest in the category of "Other services", which includes insurance, financial services, ICT and communication, all of which experienced rapid growth in recent years. On the other hand, the share of goods in total exports has been declining. While many other euro area countries were able to take advantage of growing niche markets or quality-enhancing processes for goods, marginal

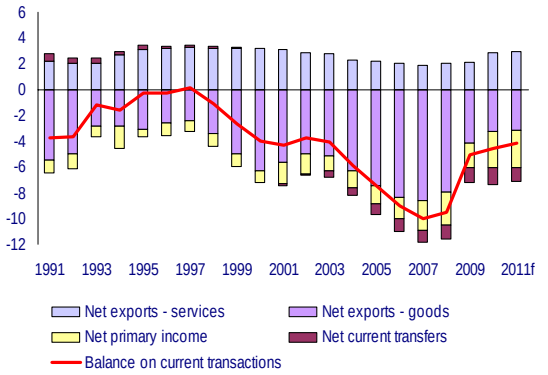
changes in technology and in diversification indices suggest that this was not the case for Spain.

After peaking at close to 8% in the early nineties, Spain's share in world FDI inflows fell to 3% in 2007. In net terms, FDI outflows have exceeded inflows almost continuously since 1997. Analysis suggests that the downward trend in FDI inflows since 2002 may be attributed to rising wage and non-wage costs, the administrative burden for doing business and, later on, increased competition from new Member States following EU enlargement. While FDI flows played an important role in Spain's economic development in the 1980s and the early 1990s, positive spillovers to the rest of the economy appear to have been more limited in recent years.

5.3. SPECIAL FOCUS: A PERMANENT CORRECTION OF THE SPANISH CURRENT ACCOUNT BALANCE?

The Spanish current account deficit widened rapidly over the last decade. From 1% of GDP in 1998, which may be considered small by historical standards, it rose to a peak of 10% in 2007 of GDP, moderating to 9.5% in 2008 and further to just above 5% in 2009. This high current account deficit reflects the traditionally-elevated trade balance deficit and the primary income deficit, driven by the negative net investment position of the country. Net outflows of primary income, linked particularly to the debt burden, and immigrants' transfers abroad (until 2007), have also contributed recently to the current account deficit([73]). Spain's current account imbalances stem from both cyclical and structural factors. First, cyclical factors reflect the strong economic growth in excess of its main trading partners, namely those in the euro area. Second, structural factors explain why growth in exports has always been below that of imports, particularly in the last decade. These structural factors are associated with persistent inflation differentials between Spain and the euro area, together with low productivity growth and the concomitant deterioration in competitiveness, which has resulted in a steady increase of import penetration and a widening trade deficit.

Graph III.5.2: **Current account balance in Spain (% of GDP)**



Source: Commission services.

The widening external deficit of the Spanish economy has led to a significant increase in the accumulated stock of liabilities incurred by Spanish economic agents relative to the rest of the world. Spain's external debt position is comparable to other euro area members, but its rapid increase in the last decade may be a cause for concern. Moreover, the bulk of the long-term debt, which represents over two-thirds of the external debt, has been issued at variable interest rates, thus increasing the potential exposure of borrowers to rising interest rates. During the current crisis, the non-financial private sector has faced some difficulties in raising funds in international markets, as reflected in both prices, through higher risk premia, and quantities, via lower credit availability.

In spite of the strong deceleration of activity in 2008, the current account deficit remained close to two-digit levels as a percentage of GDP, the second largest among developed economies following the United States. However, external imbalances are currently diminishing due in particular to the sharp drop of imports as a result of falling domestic demand and the current account deficit halved in 2009 to around 5% of GDP. The change in credit conditions and the economic environment will continue to affect external imbalances in the near future. Just as easy credit conditions fuelled the external imbalance in a context of weak productivity growth and an overheating economy, the now *de facto* tighter

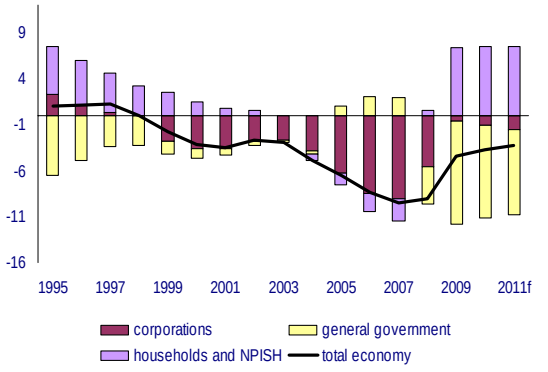
([73]) Martinez-Mongay C. and Maza Lasierra L. A. (2009), «Competitiveness and growth in EMU : The role of the external sector in the adjustment of the Spanish economy », European Commission, Economic Papers No.355, DG ECFIN, January.

credit conditions in a recessionary context are leading to a reduction of the external deficit. The expected improvement over the medium term is nonetheless likely to be much more moderate. Further improvements will not be achieved via a 'denominator' effect, as nominal GDP growth fell by about 3½% in 2009 and is projected to remain subdued, by historical standards, in subsequent years.

Spain will also probably record slight temporary improvements in measured competitiveness as the result of the change in sector composition, the corresponding job losses in less productive sectors, especially the construction sector, and some moderation in private sector wage growth. However, this change has more of an effect on non-tradable activities than on tradables and implies only a temporary improvement, which will not be enough to structurally change the loss in price competitiveness accumulated during the last decade.

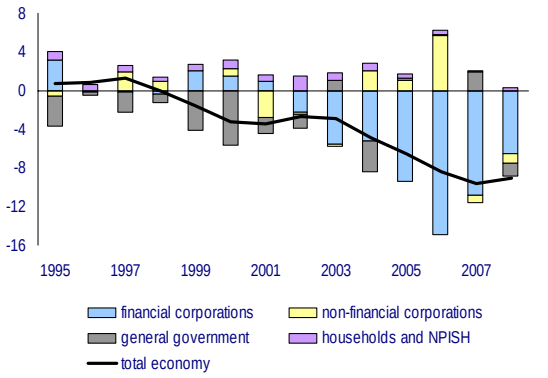
The increase in borrowing needs over the last decade was driven by a steady worsening of the net financial position of both households and corporations (see Graph III.5.3), on the back of a strong fall in risk premia and an easing of financial conditions. This deterioration in private balances was partially offset by an increase in public sector savings. With the crisis, Spain is experiencing a correction of the external imbalances, in particular in the trade deficit, which represented 2.1% of GDP in 2009. This is a consequence of the decrease in domestic demand and the increase in savings. In addition, the economy is going through a rebalancing in the composition of the current account deficit. The correction of the current account deficit is explained by the reduction in the financing needs of the private sector, which has been only partially offset by greater indebtedness on the side of the government. The latter reflects the public sector's need to finance the sizeable increase in expenditure, as a result of the discretionary fiscal stimulus and the working of the automatic stabilisers, e.g. the sharp shortfalls in tax revenue and increases in expenditure, for example on unemployment benefits.

Graph III.5.3: **Net lending (+) / Net borrowing (-). Sectoral breakdown (% of GDP)**



Source: Commission services.

Graph III.5.4: **Net financial transactions with the rest of the world. Sectoral breakdown (% of GDP)**



(1) A negative (positive) sign indicates that the rest of the world grants (receives) financing to (from) the counterpart sector.
Source: Bank of Spain.

Given that Spanish households and most non-financial corporations are small and cannot borrow funds directly from abroad, their borrowing positions are covered by funds from the domestic financial sector, which in turn gets its funds from external markets (see Graph III.5.4). The financial sector has acted as an intermediary particularly since the creation of the euro area, distributing external funding to the private and non-financial sectors of the economy. The onset of the international credit crunch in August 2007 saw a tightening of international credit conditions. Lending to households and businesses has, in turn, been scaled back rapidly along with the percentage

of external funding captured by the Spanish financial sector.

All in all, a significant adjustment of the current account is taking place due to cyclical and structural factors. Strong contraction of domestic demand has allowed imports to decline sufficiently to substantially reduce the trade deficit. Given the adjustment in the construction sector, adjustment is also structural in nature. Nevertheless, the loss in price competitiveness accumulated during the last decade, due to persistent inflation differentials between Spain and the euro area, together with low productivity growth, call for more adjustment in the euro area through gains in relative ULC.

5.4. THE NEED FOR ADJUSTMENT ([74])

The Spanish current account deficit has been widening rapidly over the last decade, peaking at 10% in 2007. Spain's current account imbalances stem from both cyclical factors and structural factors, which are associated with persistent inflation differentials between Spain and the euro area average, together with low productivity growth and the concomitant deterioration in competitiveness. The widening external deficit of the Spanish economy led to a significant increase in the accumulated stock of liabilities to the rest of the world. Several factors will shape the external adjustment to the current crisis. As discussed above, currently, a significant adjustment of the current account is taking place through cyclical and structural factors. Further reductions in the current account deficit require the tackling of structural elements such as subdued productivity growth, eroded competitiveness and a vulnerable financial position of private agents due to high debt levels.

In view of Spain's weakened competitiveness in the euro area and its persistent current account deficit, adjustment in the context of the euro area would be facilitated by relative price and cost adjustments and a shift of resources from the non-tradable to the tradable sector.

Against this background and in view of Spain's productivity differential vis-à-vis the euro area and its eroded cost position, efforts are required in several areas to produce a sustainable improvement in competitiveness. In this respect, measures to support the resilience of the supply side could be beneficial in the light, *inter alia*, of the productivity gap of Spain vis-à-vis the euro area average and an eroded cost position. The cost structure could be improved further by fostering wage behaviour that allows for wage moderation and better aligning wages with productivity. The productivity gap could be narrowed through a variety of channels. Scant productivity growth in Spain during the last decade (around ½% on average) mirrored a relatively high allocation of investment to the construction sector and some low-productivity services. Although measured productivity is estimated to increase in 2009 by around 3¼%, thus above the euro area average, this is mainly due to the sharp contraction of the abovementioned activities rather than a significant improvement in the structural drivers of total factor productivity.

Enhancing productivity in a more sustainable way would involve further investment in and enhancing the efficiency of expenditure in research, development and innovation, as well as improving the efficiency of R&D expenditure are crucial for achieving productivity advances. Further improvements of the education and life-long learning systems and investment in human capital should also be envisaged. This may be achieved, *inter alia*, by ensuring the effective implementation of widespread education reforms in addition to upgrading the skills and increasing mobility of the labour force to promote a swift transition into employment, and reducing segmentation in the labour market. Reducing dualism in the labour market would involve reforming employment protection legislation with a view to reducing the large gap between conditions for workers on permanent versus temporary contracts and closing the gap between the firing costs of permanent and temporary contracts. Reforms in the labour market would also include increasing the strictness and strengthening enforcement criteria for receipt of benefits, improving coordination between the administration of benefits and activation policies, as well as modifying the regulation on opt-out clauses, as a

([74]) The text which follows, including policy challenges, draws, *inter alia*, on already issued policy invitations and recommendations under various Community instruments, such as the updated Stability Programme, the EDP recommendations and the strategy for growth and jobs.

means of fostering wage bargaining decentralization and facilitating wage differentiation. Moreover, a better allocation of resources would be facilitated by improving product market functioning through increasing competition in services, including professional services, and in network industries.

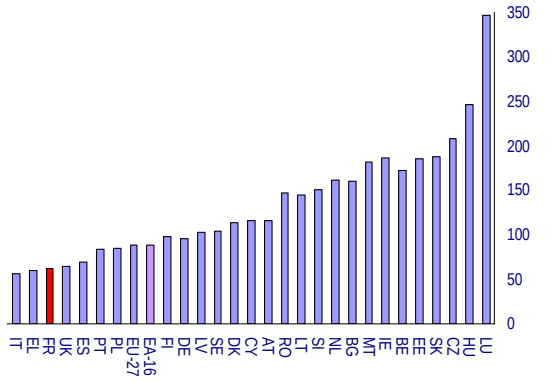
In addition, a correction of the external imbalances will also be facilitated by ambitious fiscal consolidation. The fiscal stimulus has undoubtedly played an important role in the adjustment of the Spanish economy to the current shock, but looking forward, fiscal consolidation will contribute to reducing the external imbalances.

6. FRANCE

6.1. SETTING THE STAGE: FOREIGN TRADE CHARACTERISTICS

The French economy is among the least open in Europe and, in particular, less open than euro area countries such as Germany or Spain. As measured by the share of (volumes of) exports and imports of goods and services in GDP, openness stood at 62% in 2008, almost 6 pps. higher than in 2000. However, at the same time, the euro area average rose by 16 pps (to 89% - see Graph 1), boosted by the impressive 28.7 pps increase in Germany's openness (to 95% in 2008). French exports may be defined as "generalist", consisting of some high technology sectors (such as aeronautics and pharmacy), but with a large share of low-technology-intensity products that are exposed to competition from both industrialised and emerging economies. France's main trading partners (Germany, Italy, Spain and the UK) account for around 50% of its exports and imports.

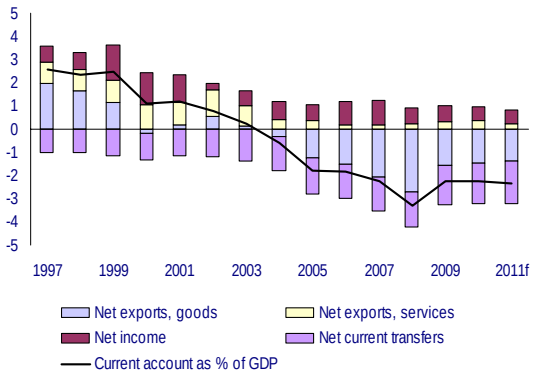
Graph III.6.1: **Openness of EU economies, 2008 (exports and imports as a % of GDP)**



Source: Commission services.

The current account balance followed a deteriorating trend from the beginning of the decade to 2008, when it reached a record deficit of 3.3% of GDP (see Graph 2). While current transfers were persistently negative over the period 1997-2008 (due notably to the remittances of foreign workers in France), the trade balance in goods became negative only in 2004, after having been positive in the previous years (with the exception of 2000). The balance of trade in services, previously one of the bright features of the French economy, remains positive but has also experienced a downward trend: services intensity in total exports fell by 3¼ pps. between 1997 and 2008. The current account deficit is estimated to have narrowed significantly to 2.3% of GDP in 2009 mainly as a consequence of the improvement in the terms of trade prompted by the decrease in commodity prices. Thus, even if exports are estimated to have shrunk at a double-digit rate in value terms, imports are estimated to have decreased even faster. In terms of export performance, France has lost ground compared to its European neighbours, which is evidenced by the fact that the ratio of French exports to euro area exports has been on a downward trend since 1998. Similarly, France's share of exports of goods in world trade (including intra-EU exports) decreased by 2.2 pps over the same period (1998-2008) whereas its main trading partners (Germany, Italy, Spain, UK), facing the same international environment, have seen their foreign trade shares decrease by only 1.2 pps on average. When the financial crisis broke out, French exports were already in a difficult position. They fell sharply in the fourth quarter of 2008 and in the first quarter of 2009 (-6.6% and -6.7% q-o-q), in the wake of the sharp contraction of world demand. Exports recovered from the second quarter of 2009, growing again in the last three quarters of the year, notably thanks to the performance of the automotive industry, which was stimulated by car-scrapping schemes put in place in other EU Member States.

Graph III.6.2: **Evolution of the current account balance and its main components**



Source: Commission services.

Since 2003, the balance of trade for the manufacturing industry has deteriorated, moving

from a surplus of 0.8% of GDP to a deficit of 1.1% of GDP in 2008. The trade balance of transport machinery contributed 0.7 pp. of GDP to this development, moving from a surplus of 0.6% of GDP to a deficit of 0.2% of GDP. Notably the poor performance of equipment and telecom goods over the same period added to the decline of the trade balance for manufacturing industry. The deterioration in the deficit for energy products (mainly natural oil), which increased from 1.4% of GDP in 2003 to 2.8% of GDP in 2008, explains the remainder of the worsening in the trade balance for goods.

French exports are mainly oriented towards the EU15, in particular towards neighbouring countries. In comparison with its European partners, and particularly with Germany, France's exports have been performing rather poorly in the Near and Middle East, in major industrialised non-EU countries, and especially in emerging Asia. Consequently, French exports are structurally more oriented towards slow-growing areas. This could play a role in explaining the moderate pace of export growth, at least in the short term. Recent studies have however shown that this factor alone fails to explain completely the differences in trade performance between France and its neighbours. ([75])

6.2. INDICATORS OF COMPETITIVENESS

A brief look at competitiveness data shows that the increase of almost 14% in the real effective exchange rate (based on ULC) against 35 industrial countries from 2000 to 2008 was well above the average experienced by France's main trading partners (+8¾% on average for Germany, Spain, Italy and UK) (see Graph 4). This relatively large increase is linked to the dynamics of real unit labour costs, which decreased by 1% between 2000 and 2008, against -2.8% in France's main trading partners. However, as regards price competitiveness, the REER based on the export price deflator increased by only 4% from 2000 to 2008, which is much less than the average increase of 8.5% in its main trading partners during the same period of time (see Graph 3). This suggests that French export firms have tried to a large extent to offset the decline in cost competitiveness, notably through a reduction in their profit margins, by much more than other euro area countries, and particularly Germany, Spain and Italy([76]).

According to empirical analysis,([77]) French export performance is particularly sensitive to price-competitiveness. Still, as was previously mentioned, the loss in price competitiveness has been relatively limited and cannot by itself explain the weakness of the export performance. Consequently, the continuous deterioration of French export-market shares suggests that there may be other factors besides price competitiveness that adversely affect the performance of French exports.

As stated above, French exports are focussed largely in the category of low and medium-high technology intensity, implying a significantly higher importance of price competitiveness than for countries positioned in high technology sectors. This, coupled with a limited degree of product differentiation within its medium-to-high range production, magnifies the exposure of France to international competition from rapidly developing countries such as China and India. Consequently, France has become more vulnerable to competitive pressures from emerging markets than other industrialised countries that are closer to the technological frontier and have a greater degree of product differentiation.([78]) Although France has a good position in one high value-added segment of high-tech products, namely aeronautics, excessive concentration on a single sector is a source of vulnerability. The country is currently not in a position to respond adequately to the observed losses in cost competitiveness by shifting to the production of high-technology goods that have a lower price elasticity of demand.

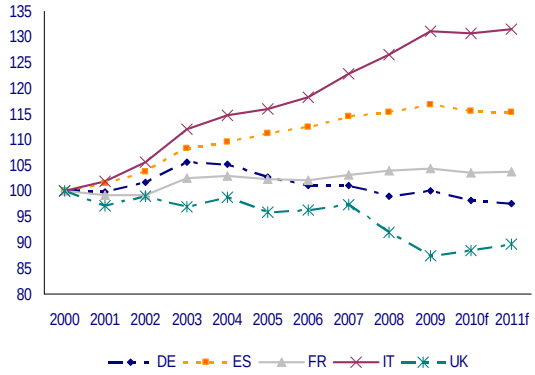
([75]) See, for example, J.-P. Villetelle and D. Nivat, "Les mauvaises performances du commerce extérieur de la France sont-elles liées à un problème de demande?", Bulletin de la Banque de France, février 2006, or M. Cochard, "Le commerce extérieur français à la dérive", Revue de l'OFCE, juillet 2008.

([76]) See L. Fontagné and G. Gaulier, *Performances à l'exportation de la France et de l'Allemagne*, Rapport du Conseil d'Analyse Economique, sept. 2008

([77]) See, for example, J.-P. Villetelle and D. Nivat, 2006, op. cit.

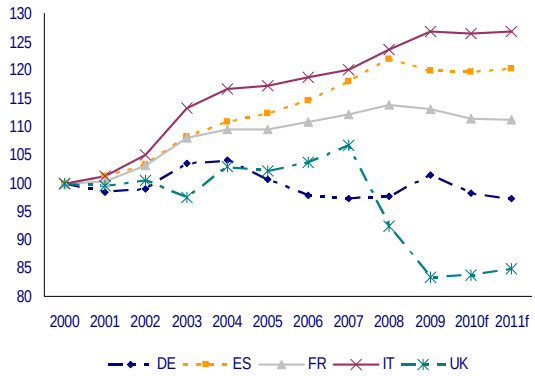
([78]) P. Sillard, C. L'Angevin and S. Serravalle, « Une analyse structurelle de l'évolution des exportations de la France par rapport à ses principaux concurrents », 2006.

Graph III.6.3: **REER (vs. 35 IC) based on export price deflator (2000=100)**



Source: Commission services.

Graph III.6.4: **REER (vs. 35 IC) based on ULC (2000=100)**



Source: Commission services.

In this context, it is worth underlining that France's gross domestic expenditure on R&D as a percentage of GDP is just above the euro area average (2.1% against 1.9% for 2007, latest available data), but lags behind Germany (2.5%), the US (2.6%) and Japan (3.4% in 2006). Moreover, the share in GDP of resources devoted to R&D has been on a downward trend since 1993 when the ratio stood at 2.4% of GDP.

6.3. SPECIAL FOCUS: DEMOGRAPHY OF FIRMS - RECENT PROGRESS IN PROMOTING THE GROWTH OF FIRMS

The economic literature has discussed the relationship between firm size and exports extensively, concluding that the larger the size of the firm, the higher the probability that it is an exporting firm.([79]) Indeed, exporting firms have to bear fixed costs to sell their products abroad; these costs are related to administrative, institutional or cultural obstacles. Although France's export weakness seems to point to a wide range of issues such as low investment in research and development, insufficient competition and low labour market flexibility, a more specific concern is that there are only very few firms that are big enough to sustain their position on export markets.

Three stylised facts emerge from a cross-country study by Mayer and Ottaviano (2007).([80])

First, there is considerable heterogeneity among firms within the same sector, with large disparities in terms of size and productivity and hence export performance. In all the countries under review, only a minority of firms are exporters and a very small number of firms account for the bulk of exports. In France, for example, the top 1% of exporting firms represents almost 45% of aggregate exports, and the top 10% account for 84% of the total. Apart from these few big exporters, a large majority of exporting firms are only marginal participants in international trade, as they export to a very small number of countries (mostly neighbouring countries) and their exports represent a very limited share of their turnover. Whereas the largest contribution to German exports comes from the middle range of firms, exporting between 50% and 90% of their turnover, the contribution to French exports comes predominantly from the extremes of the range, i.e. either from firms exporting between 10% and 50% of their turnover or from firms exporting more than 90% of their turnover.

Second, exporting firms perform better than non-exporting firms in terms of employment, value added, wages, capital intensity and skills. They are also the most productive in their sector. However, the question of the direction of causality remains open, in other words, whether the "selection effect" (i.e. trade selecting firms which have highest productivity levels) or the "learning effect"

([79]) See for instance J. Wagner, "A Note on the Firm Size-Export Relationship", *Small Business Economics*, 17(4), 229-237, 2001.

([80]) T. Mayer and G.I.P. Ottaviano, "The happy few: the internationalisation of European firms", Bruegel blueprint series, 2007.

(i.e. firms' performance improves under the pressure from increased competition) predominates.

Third, most of the variation in French exports relative to other countries is due to the variation in the number of exporters rather than to the average volume exported by each firm.

Thus, competitiveness in France is hampered by the size and number of exporting firms, which are in turn influenced by several administrative and statutory requirements. The authorities have undertaken several reforms that could help alleviate this problem.

As a firm grows, an additional administrative burden is placed on it, creating an incentive to stay small and thus hampering expansion. For a firm with 49 employees, for instance, recruiting an additional employee triggers the application of 34 additional laws and decrees, with resulting costs to the tune of 4% of the total compensation of employees.([81]) The 2008 law of modernisation of the economy (LME) has taken steps to reduce the financial impact of some of these thresholds: a three-year freeze and a four-year adjustment period for the financial consequences linked to crossing the 10- and the 20-employee thresholds have been put in place. The issue will however remain significant, given the quantity of existing thresholds (there are ten size thresholds in all).

Several measures were taken in 2007 and 2008 with a view to improving financing conditions for SMEs: the LME limited payment delays in the private sector to a maximum of 60 days (previously there was no such maximum); a mechanism similar to the US "Small Business Act" was adopted as part of the LME, which gives SMEs preferential access to public procurement (up to 15% of procurements can now be earmarked for SMEs); tax incentives to invest in SMEs were put in place as part of the TEPA package (2007).([82]) There is room for improvement, however, in the system of public subsidies in favour of firms. As was underlined by the OECD in its 2009 Economic Survey for France, this system remains particularly complicated: some 6000 different types of subsidies currently coexist.

A "growth SME" (*PME de croissance*) status was created in 2007, granting tax breaks to fast-growing firms with between 20 and 250 employees. More generally, a number of measures regarding taxation were undertaken, which could help improve the competitiveness of firms (most notably the suppression by 2011 of the annual fixed tax and the suppression of the local corporate tax in 2010).

These measures constitute significant progress. However, there is still room for improvement, and many hurdles hindering the growth of SMEs are still in place.

6.4. THE NEED FOR ADJUSTMENT ([83])

Net trade has hampered French growth in a significant way over the last six years. This is not due to a single factor but is rather the symptom of a series of weaknesses on the supply side, which impinge more on the competitiveness position of the country rather than on adjustment in the euro-area context. The underperformance of French exports is related to, *inter alia*, the deterioration of cost competitiveness. Exporting firms have reduced their profit margins in order to compensate for this, thereby containing the loss in terms of price competitiveness. However, given the pressure on prices from competitors in emerging economies, even such pricing behaviour could not limit the rapid loss of market shares. Moreover, there are limits to how much profit margins can be squeezed. Analysis of the underperformance of French foreign trade also clearly points to the medium-high technology positioning of French exports, linked with relatively low and decreasing expenditure on R&D, and leading to a situation of innovation follower. Indeed, French exporters have difficulties in differentiating their products from

([81]) According to the Attali report (J. Attali, *Rapport de la Commission pour la libération de la croissance française*, Paris, XO Éditions, La Documentation française, 2008); the report was published before the law of modernisation of the economy entered into force.

([82]) The so-called TEPA package (Loi en faveur du Travail, de l'Emploi et du Pouvoir d'Achat) was adopted on 22 August 2007; it comprises various tax cuts.

([83]) The text which follows, including policy challenges, draws, *inter alia*, on already issued policy invitations and recommendations under various Community instruments, such as the updated Stability Programme, the EDP recommendations and the strategy for growth and jobs.

exports from cheaper countries and have largely established markets in countries whose growth rates are relatively low. The performance of French exports is also being jeopardised by the limited number of exporting firms. A number of initiatives have been taken in this area (see previous section), but there is still room for improvement.

In view of France's competitiveness position in the euro area and its current account balance, adjustment in the context of the euro area would be facilitated by addressing the structural challenges underlying long-term export market performance.

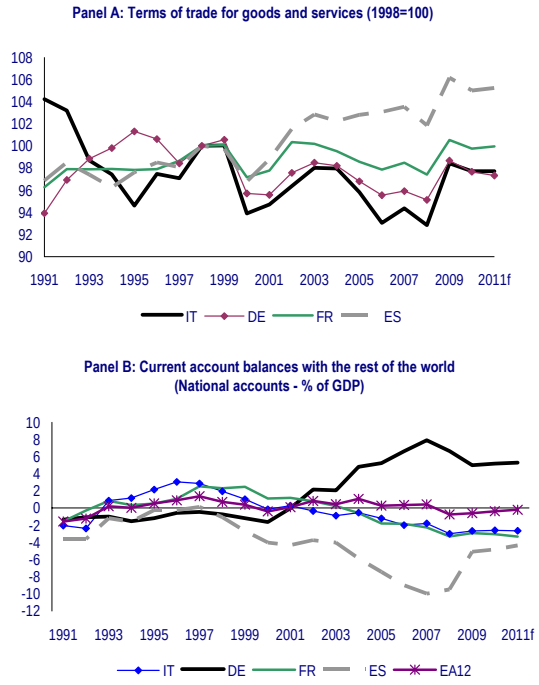
Against this background, there is a need to tackle the supply weaknesses of the economy. In order to deal with the deterioration in cost competitiveness, social partners should work together to ensure wage developments in line with productivity developments, bearing in mind that the current fiscal situation does not leave room for uncompensated tax reductions. Future increases in the minimum wage should consider the need to ensure wage differentiation at the lower end of the wage scale. The introduction of the "competitiveness clusters" in 2004 is in line with the efforts to build a critical mass necessary to face international competition; it is important that such clusters are organised in such a way as to avoid a dispersion of efforts. An in-depth simplification of all administrative obligations for companies of less than 250 employees could further promote the growth of SMEs. Additionally, as has been underlined by the OECD in its 2009 Economic Survey for France, a large-scale reform and simplification of the system of public subsidies could serve as a means to better promote competitiveness and innovation. Investing in knowledge and innovation in the framework of the strategy for growth and jobs could help France to limit the losses of market shares, which it has been experiencing over the last five years, and would also foster productivity growth. Possible measures include a continuation and strengthening of ongoing reforms in R&D coupled with further efforts to strengthen higher education and lifelong learning, as well as an improvement in the technology intensity of French exports. In this respect, the planned reform of the French research and innovation framework could improve the technology intensity of French exports and would thus be a step forward, provided that it is compensated by budgetary savings in other areas. Measures have also been taken to stimulate business R&D intensity (such as the *Crédit Impôt Recherche*). The organisation and functioning of Public Research Organisations and the attractiveness of researchers' careers were identified by the European Commission as two main issues to be tackled; they are currently being addressed by the French authorities.

7. ITALY

7.1. SETTING THE STAGE: FOREIGN TRADE CHARACTERISTICS

In value terms, Italy's exports account for less than one third of GDP, a share broadly in line with that of France and Spain but much lower than in Germany. Imports also represent less than one third of GDP, below most other euro area countries. As a consequence, the openness of the economy, measured in terms of the sum of exports and imports as a share of GDP, was among the lowest in the EU in 2008, having increased by only 10 percentage points over the previous decade. Growth of exports has been particularly subdued and was outpaced by that of imports, which has been relatively modest, reflecting sluggish domestic demand and equipment investment.

Graph III.7.1: **Terms of trade and current account balances**



Source: Commission services.

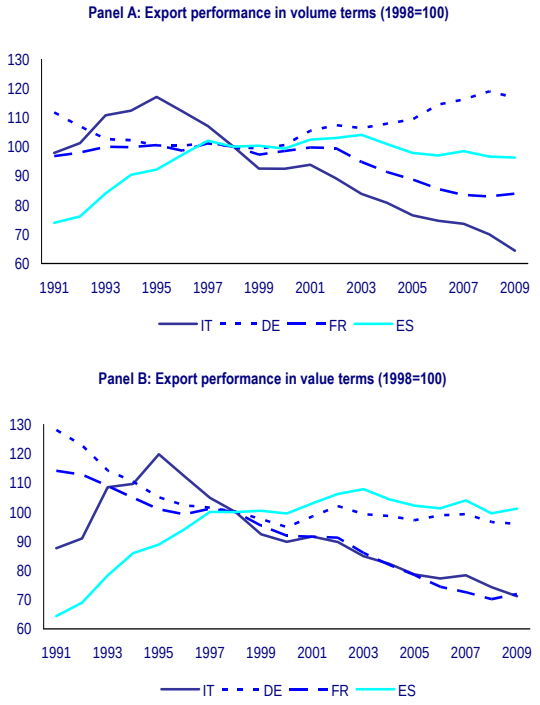
A worsening trade balance contributed to the steady deterioration of Italy's current account, which moved from a surplus of 1.9% in 1998 to a deficit of 3% of GDP in 2008 (Graph III.7.1, Panel B). In 2009, the trade balance returned marginally positive, thanks to improved terms of trade (Graph III.7.1, Panel A), while the income account worsened, dragged down by a growing net debtor position. As a result, the current account improved slightly. The sharp slowdown in international trade was reflected in a decline of Italian exports, which fell by almost 20% in the year as a whole. A corresponding drop in imports was recorded, on the back of the retrenchment in investment, which did not fully offsetting the export drag on the economy and thus translated into a negative contribution of net exports to growth and a sharp contraction in the degree of openness of the economy.

In the next two years, the assumed improvement of the global environment and, especially, of domestic demand in EU countries, which account for around 57% of Italy's total merchandise exports, is projected to drive the recovery in exports. However, it can be expected that recouping the heavy losses in competitiveness accumulated since the start of this decade will be very difficult in the short term, and that export growth will therefore remain subdued, thus depriving the Italian economy of an important source of growth. As domestic demand and in particular investment is set to recover, imports are expected to regain strength but the still-improving terms of trade should allow the trade balance to improve slightly.

Italy's exports mainly consist of manufactured goods, with the share of services in total exports remaining broadly stable at around 20%, in line with the euro area average, for at least one decade. A breakdown of exports by product category reveals a relative predominance of labour-intensive products and low-technology goods. Little change in this specialisation pattern has been observed over the years, although there is some evidence of a shift from low- to high-quality products (see Section III.7.3 below). From a geographical perspective, around 44% of Italy's exports go to other euro area countries, whereas extra-EU countries account for almost 43% of exports. Within the euro area, the country's main trading partners are Germany and France. Outside, the US and the UK together absorb around 11% of total exports. Russia, other CIS and MENA countries together represent more than 10% of total Italian exports, a bigger share than for the other large euro area countries. Indeed, over recent years, the geography of Italian exports has shifted away

somewhat from the main developed markets, namely the US, Japan and the EU, towards expanding markets and oil producers, demonstrating some responsiveness to the evolution of global demand.

Graph III.7.2: **Export performance**



(1) Performance relative to the rest of 35 industrial countries; double export weights.
Source: Commission services.

The evolution of the external position of the Italian economy has been a distinguishing factor of Italy's slow growth over the past decade.([84]) The most striking manifestation of Italy's weak export performance has been the steady loss of market shares experienced by the country since the mid-1990s. While a mature economy can be expected to lose some market shares, Italy's performance nevertheless compares unfavourably with other large euro area countries. When measured in volume terms, Italy's loss of market shares for goods and services over 2000-2009 was close to 3½% per year on average, continuing a trend that had already started in 1996 as the lira appreciated in nominal terms from the low point attained early that year (Graph III.7.2, Panel A). This contrasts with the export performance of Germany, which recorded a gain of market shares of almost 1¾% per year over the same period, whereas France lost only 1½% per year. When measured at current prices (Graph III.7.2, Panel B), however, the contraction of market shares was broadly in line with that of France and, since 2001, slightly more contained than when measured at constant prices, although still marked if compared with that of Germany and other euro area countries. This gap has widened in the last two years, showing that the weakness of Italy's relative export performance has persisted during the crisis.

After having recorded a moderate recovery in 2007, the Italian export share in world markets declined again in 2008 and 2009 in both constant and current prices, on the back of an erosion in cost competitiveness and the plunge in global demand for some of the products in which Italy is specialised, namely traditional products like textiles and clothing, leather and footwear, furniture and wood products, as well as mechanical engineering products. No recovery of market shares is expected in 2010 and 2011.

7.2. INDICATORS OF COMPETITIVENESS

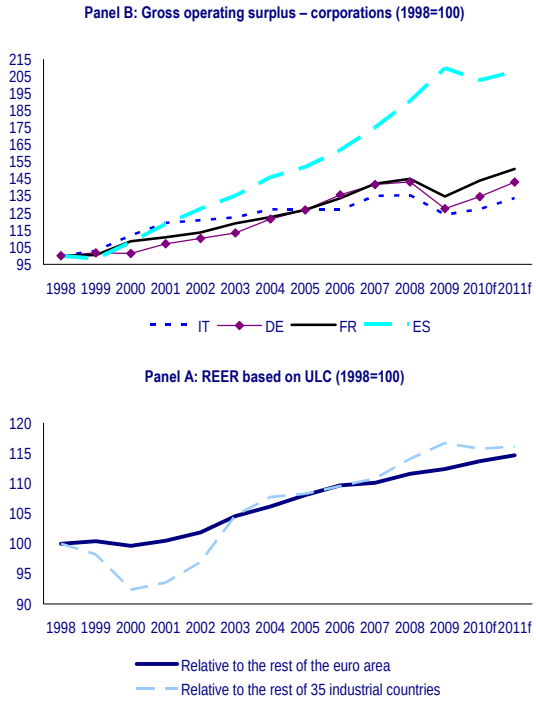
Measured by a series of standard indicators, Italy's price and cost competitiveness has consistently worsened since 2000. Indicators of the real effective exchange rate exhibit an appreciating trend against both euro area and non euro area countries from 2000 onwards. Vis-à-vis the IC35, much of the increase may be explained by the appreciation of the euro against the currencies of non euro area trade partners, a trend shared by all euro area countries.

Looking at individual indicators, the appreciation of the REER based on the deflators for private consumption or GDP vis-à-vis the rest of the euro area is more contained and is explained by differential inflation developments up to 2005. However, the degree of appreciation is much larger when looking at the indicator based on unit labour costs in the total economy (ULC), which shows the opening up of a large competitiveness gap with respect to Italy's euro area peers, Germany in particular. The gap widens even further when the

([84]) See Bardone, L. and V. E. Reitano (2009), 'Italy in the Euro Area: the Adjustment Challenge', in Buti, M. (ed.), *Italy in EMU: The Challenges of Adjustment and Growth*, Palgrave MacMillan.

REER based on the export price deflator is considered. This could be partly due to measurement problems (see Section 3).

Graph III.7.3: **REER based on ULC and the gross operating surplus in the corporate sector**



Source: Commission services.

The stagnation in productivity growth in Italy since the end of the 1990s is the key factor behind the rise in the REER based on unit labour costs (Graph III.7.3, Panel A). Such stagnation, which was widespread in both the tradable and non-tradable sectors, went largely beyond the wage moderation achieved since the incomes' policy agreements with the social partners of the early 1990s. Low productivity growth was especially evident in manufacturing, the sector most exposed to international competition.

Overall, developments in the REER indicators reviewed above suggest the opening up of considerable competitiveness gaps versus other euro-area members, which undoubtedly shaped and is expected to continue shaping Italy's weak export performance. It is true, however, that there is some uncertainty in determining the size of this gap, as also evidenced by the estimates of the equilibrium exchange rate that are presented in the horizontal part of this note, which indicate a more limited overvaluation of the REER.([85]) However, there is enough evidence to show that the economy suffers from competitiveness losses that need to be tackled with some urgency. In addition, gross operating surplus developments in the corporate sector suggest that, since 1998, Italian (and German) firms have been experiencing lower profitability growth compared to those located in Spain and France (Graph III.7.3, Panel B). This may have hampered private investment.

Costs and prices are not the only factors that determine the degree of competitiveness of an economy. Non-cost factors matter as well and an analysis of competitiveness must take into account the role played by diminishing barriers to trade and global developments (i.e. globalisation). With an export mix that competes with, rather than being complementary to, that of the emerging economies, Italy may have been more exposed than other euro area countries to increasing global competition. As already mentioned above and supported by an analysis of exports according to their technological content, Italy's trade specialisation pattern shows little sign of change. On the contrary, Italy appears to have actually strengthened its specialisation in labour-intensive products, while making no progress or even losing ground in the production of high-technology goods. In this context, ISAE (2007)([86]) argues that closer European integration may have left Italy, and in particular its Southern regions, more exposed than other partners in the area to the competitive shock of globalisation.

The results of a constant market share analysis conducted by the Italian Institute for External Trade (ICE, 2009)([87]), which decomposes the change in market shares in value terms between 1999 and 2008 into structural effects (related to the commodity composition and market distribution of

([85]) Other econometric estimates point to equilibrium, if not slight undervaluation, of Italy's REER at the time of euro adoption. See: Alberola, E., S.G. Cervero, H. Lopez, and A. Ubide (1999), 'Global Equilibrium Exchange Rates: Euro, Dollar, "ins," "outs," and Other Major Currencies in a Panel Cointegration Framework'; and International Monetary Fund (2007), Italy: Selected Issues, IMF Country Report, No. 07/65, Washington.

([86]) Le previsioni per l'economia italiana. L'Italia nell'integrazione europea - March 2007

([87]) L'Italia nell'economia internazionale. Rapporto ICE 2008-2009 – June 2009

exports) and a competitiveness effect, seem to confirm the importance of both effects in the case of Italy. In particular, the competitiveness effect was able to explain half of the loss in market shares. The same exercise carried out on French market shares reveals a predominant role of the competitiveness effect in explaining the experienced loss, with structural effects being broadly neutral. The competitiveness effect has had a clearly positive effect on German market shares, particularly in the first half of the current decade, but this has been partly dampened by structural effects. In the two year period 2007-2008, the competitiveness effect has had a negative effect on each of the three countries' export performance.

Finally, developments in foreign direct investment (FDI) provide further evidence of the low degree of market integration of the Italian economy. Both the stock and inflow of FDI from abroad remain well below those of most other euro area countries. In 2007, the accumulated stock of inward FDI amounted to 15% of GDP, only half or less the figure recorded in France, Spain and most other euro area countries. Italy also underperforms in terms of its capacity to invest abroad, largely due to its corporate governance and culture that contribute to maintaining highly fragmented industry structures with a prevalence of small-sized firms. The country therefore appears to be lagging behind as a potential location choice and, at the same time, Italian firms need to accelerate their transformation into "global players". The complexity and instability of Italy's legal system, inefficiencies in public administration, inadequate infrastructure and, in many instances, organised crime, could be important deterrents to FDI inflows. World flows of direct investment have been strongly affected by the financial crisis, owing both to the deterioration in the economic outlook and to firms' reduced self-financing capacity and access to credit. In 2008, FDI inflows to Italy fell by over 60%, in line with the fall recorded in Germany but in percentage terms twice that recorded in France.

7.3. SPECIAL FOCUS: HAS THERE BEEN A QUALITATIVE UPGRADING OF ITALIAN EXPORTS?

The combination of the steady loss of market shares experienced by the Italian economy and the sharp deterioration in some measures of cost competitiveness, along with fast growing export prices, has attracted a lot of debate among Italian researchers. Three alternative explanations for these developments have been put forward (Bugamelli, 2007)([88]): i) pricing strategies, whereby Italian firms have maximised profit margins while sacrificing export market shares; ii) composition effects leading to an increase in the average quality and thus prices of exported goods; and iii) measurement errors.

The hypothesis of pricing strategies of exporters aimed at maximising profit margins at the cost of losing market shares may have been valid for some exporters in the traditional sectors and in smaller firms, particularly those less oriented to the international markets. However, protecting profit margins is usually a short-term strategy that cannot be sustained over the long run.

There is some evidence([89]) of a restructuring process in the Italian manufacturing sector, whereby less efficient companies in the traditional industries have been forced to exit the market, with a consequent shift of production towards higher quality segments more sheltered from competition from emerging economies. Competitive companies have maintained healthy profits thanks to high quality output and specifically targeted markets that have provided them with some price-setting power. This has implied an overall shrinking manufacturing sector, particularly in the most traditional industries, with its share in total value-added declining from 21.7% in 1998 to 18.1% in 2008. Export developments in 2006 and 2007, indicating a stabilisation and even a recovery of market shares at current prices, were seen as evidence that the ongoing restructuring in the tradable sector was bearing some fruit, even though the recovery of Germany and strong

([88]) Bugamelli, Matteo (2007), "Prezzi delle Esportazioni, qualità dei prodotti e caratteristiche di impresa: un'analisi su un campione di imprese italiane", Banca d'Italia, Temi di Discussione (Working Paper) No. 634.
([89]) Lanza A. and B. Quintieri (ed.) (2007), Eppur si muove: come cambia l'export italiano, Fondazione Masi.

demand from oil-producing countries certainly also supported these developments. Further support for this explanation comes from the increase, albeit small, in average company size recorded in recent years and the greater frequency of closures in sectors that are more exposed to competition from developing countries, as well as among smaller and less capitalized firms. Over the last two years, however, both manufacturing output and exports worsened considerably.

Measurement issues appear to be another valid explanation for the apparent puzzle. In the field of trade statistics, making the breakdown between values and volumes is problematic in the absence of directly measured prices. The basic information available is often limited to total values and the total numbers of units of some groups of imported or exported products. The "price" indices built up from this information are usually referred to as "average unit value (AUV)" indices that measure the change in the average value of heterogeneous units. They may therefore be affected by changes in the mix of items as well as by changes in their prices. Even after a statistical revision carried out in February 2008, the price deflator of Italian exports based on such unit values increased by a cumulative 27% from 1998 to 2007, as against around 2½% in France and Germany. New sample-based evidence on producer price indices for industrial exports (PPIX) recently released by ISTAT further supports the proposition that the AUV index overstates movements in export prices. Over the period 2003-2007, the average annual increase in PPIX was lower than that recorded for average unit values and barely larger than that recorded in France and Germany. It was also lower than the average annual increase in the prices of the same goods sold in the domestic market, particularly in the case of exports to countries outside the euro area, probably in response to the recent appreciation of the euro. This indicates a propensity of Italian exporters to defend their shares in foreign markets through lower profit margins, contrary to what the AUVs suggest. If the difference in behaviour between the PPIX and the AUV indices were attributable entirely to changes in the composition of exports and improvements in quality, then the PPIX would more closely represent the ideal deflator. This would imply stronger growth in the volume of Italian exports than estimated on the basis of the AUV indices, and consequently a loss of market shares at constant prices between 2002 and 2007 that is broadly similar to that recorded at current prices.

However, even if there is under-estimation of some of the growth determinants for Italy, this is not such as to substantially modify the picture that emerges. The claimed structural improvement of production in response to competitive pressures predominantly concerns medium-large firms located in the Centre-North of the country, which are most able to compete globally, while many other firms have had to exit foreign markets and structural weaknesses continue to weigh on the rest of the economy.

In any case, at the current juncture, the pertinent question concerns the extent to which the restructuring process in response to competitive pressures has been affected by the crisis, as export-oriented firms are hit hard. Having heavily invested in opening up internationally and starting from a relatively low capitalisation, some firms - having taken on debt - had to cope with both tighter financial conditions and the fall in demand. The closure of firms that would have the ability to compete and expand when the global economy recovers would further undermine Italy's competitiveness and could adversely affect the potential growth of the Italian economy. For this reason, the government introduced temporary measures to facilitate small firms' access to credit and provide some relief on outstanding loans.

7.4. THE NEED FOR ADJUSTMENT ([90])

Italy's current account and trade balances with the rest of the world moved progressively from surplus for most of the nineties to deficit in recent years. Deteriorating cost competitiveness since the late 1990s accompanied Italy's steady loss of market shares and relatively weak export growth. The stagnation in productivity growth in Italy since the end of the 1990s is a key factor behind the rise in unit labour costs and the consequent deterioration in cost competitiveness. In addition, with an export mix that competes with, rather than being complementary to, that of the emerging

([90]) The text which follows, including policy challenges, draws, *inter alia*, on already issued policy invitations and recommendations under various Community instruments, such as the updated Stability Programme, the EDP recommendations and the strategy for growth and jobs.

economies, Italy may have been exposed more than other euro area countries to increasing global competition. As a partial response to these competitive pressures, a restructuring process has been taking place in the tradable sector in recent years. While maintaining its specialisation in the labour-intensive sectors, Italy's trade has moved up the quality ladder.

In view of Italy's competitiveness position in the euro area and its current account balance, adjustment in the context of the euro area would be facilitated by addressing the structural challenges underlying long-term export market performance.

Against this background and in view of Italy's productivity growth differential vis-à-vis the euro area, the key challenge for Italy is to quickly restore competitiveness on international markets. The international crisis makes it more urgent to tackle the structural problems of the Italian economy. There is scope for better balancing wage coordination at the national level with appropriate wage adjustment at firm and/or local levels, including in the public sector. While this would allow wages to better reflect productivity differentials across sectors and regions, thus helping to correct regional imbalances, it would also sustain private investment already in the short run and improve incentives in the labour market. The application of the newly-formed bargaining framework from 2010 onwards is expected to have a positive effect on unit labour costs. In the longer term, the key challenge for Italy is to ensure a swift and durable recovery in productivity growth. Competition, which so far has generated significant efficiency gains in manufacturing, needs to be strengthened in important sectors such as local public services, network industries and professional services. Business activity is hindered by red tape and shortcomings in the regulatory framework. Despite the progress made in regulatory simplification, the costs deriving from regulation and the administrative burden remain high and uneven across the country; the inefficiency of the civil justice system continues to entail high costs for firms. More generally, there is evidence that the efficiency and effectiveness of services provided by the public sector, including education, needs to be improved. Italy’s corporate governance and corporate culture contribute to maintaining highly fragmented industry structures with a prevalence of small-sized firms, which are relatively less conducive to investment in innovation and research. Despite the recent increases, employment and participation rates in Italy remain low by international standards, particularly for women, youth and older workers, and the educational attainment of the workforce is also low by international standards. There is thus a need to improve the functioning of the labour market within a flexicurity approach and with a view to raising the participation rates. This includes reducing the difference in the treatment of temporary and permanent workers (also by guaranteeing adequate flexibility in hiring and firing), continuing to tackle undeclared work and reinforcing activation strategies and incentives to work, while reducing the segmentation of the unemployment insurance system and introducing a system of social safety nets for all types of work contracts. Finally, shifting the high tax burden away from labour would help to recoup competitiveness, while a general government debt still well above 100% of GDP weighs on fiscal sustainability and limits the scope for public finances to be supportive of growth and jobs.

8. CYPRUS

8.1. SETTING THE STAGE: FOREIGN TRADE CHARACTERISTICS

Cyprus is a small, open, services-oriented economy, highly integrated in terms of trade and FDI both with the euro area and the EU27. This reinforces competition pressures on product markets and therefore promotes efficiency. However, the small size of the economy hampers the range of diversification of production activities and leads to a high degree of trade specialisation, which in turn increases its exposure to external shocks. The ongoing transition towards a more diversified, quality and innovation-driven economy is important for increasing the resilience of the economy to competitive pressures from lower-cost economies.

At about 115% of GDP in 2008, the degree of trade openness is well above the average for both the EU and the euro area as a whole. Nevertheless, it is below the average for the smaller EU Member States, which suggests that there is still scope for further integration. The EU is reinforcing its position as the country's main trading partner. In 2008, the share of intra-EU exports in total exports of goods was almost 70% (up from about 59% in 1999, the first year for which data exist), which is comparable to the share of intra-EU imports of goods in total imports.

Consistent with the orientation of the Cypriot economy towards the tertiary sector, the intensity of services (defined as the average share of exports and imports of services in total trade) reached almost 60% in 2008, the second highest in the EU. More specifically, exports of services accounted for almost 85% of total exports. Within the services sector, tourism, banking, financial and other business services (accounting, legal services, merchanting, shipping etc.) have held a predominant position. Export-oriented services have benefited from the country's abundant endowment of skilled labour and a good infrastructure, as well as its strategic geographic location.

The evolution of the balance of payments shows large disparities between the trade in goods and services. The persistently very high deficit in goods trade and the very high surplus in services trade reflect the shift of the Cypriot economy towards the tertiary sector. The negative trade balance in goods (-27¼% of GDP over 2000-2008) is only partly compensated by the surplus recorded in services trade (24¼% of GDP).

From a geographical perspective, the major trade partner of Cyprus is the EU. Among Member States, for both exports and imports of goods, the most important partners are Greece, Germany, the UK and Italy. The Near and Middle Eastern countries (including Jordan, Lebanon, Israel, South Arabia and UAE) represent the second most important destination for merchandise exports (about 13% of total exports). Where imports of goods are concerned, the second most important provider, after the EU Member States, is made up of a number of Asian countries (mainly China, Japan, South Korea, Thailand, India, Taiwan and Singapore), which accounted for 12¼% of total imports in 2008.

The share of intra-industry trade in total manufacturing with the EU remains among the lowest among Member States. With the exception of pharmaceuticals (which accounted for about 22½% of domestic exports in 2008), Cyprus' revealed comparative advantage is concentrated in low- and medium-low tech sectors, namely food, beverages and tobacco, non-metallic mineral products and clothing.

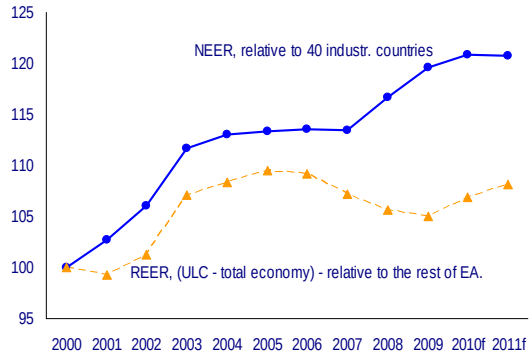
8.2. INDICATORS OF COMPETITIVENESS

Between 2000 and 2008, Cyprus experienced a substantial appreciation in the real effective exchange rate([91]) vis-à-vis the IC35. In 2009, this is expected to have continued at a slightly slower pace, as a result of the subdued economic activity and more benign inflation conditions. During the last nine years the degree of appreciation varied from 19¼% (GDP deflator) to 12¾% (export price deflator). In terms of the deflator of private consumption, the REER appreciated by about 16%. This has been affected by the increase in indirect taxes, as part of the VAT harmonisation process of Cyprus to comply with the EU acquis, as well as temporary factors, such as the rising

([91]) When deflated by the deflator for private consumption, the GDP deflator, the export price deflator, and ULC-total economy.

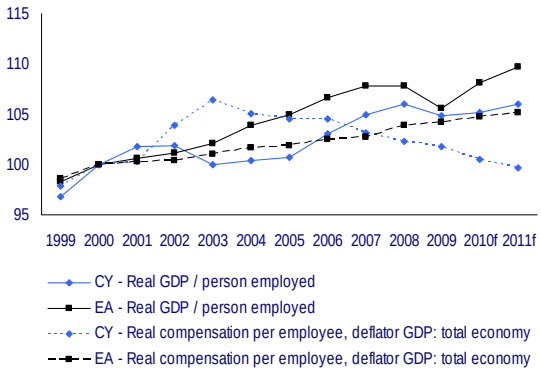
energy and commodity prices in 2008. Part of these competitiveness losses are also attributable to the appreciation of the nominal effective exchange rate (Graph III.8.1), which partially reflects the appreciation of the euro, to which the Cypriot pound was pegged before euro area entry.

Graph III.8.1: **REER - Cyprus vs. euro area,NEER - Cyprus vs. 40 industrial countries (2000=100)**



Source: Commission services.

Graph III.8.2: **Wages – Productivity, Cyprus vs. euro area (2000=100)**



Source: Commission services.

Against the euro area, developments in the real effective exchange rate were relatively more benign. The ULC-based REER appreciation over the period was about 6%, mainly reflecting wage growth above that in the euro area. Indeed, wages in Cyprus grew: by almost 4% on average, while average productivity increased by only 1% a year, i.e. a gap of 3 percentage points compared with a gap of 1¾ percentage points in the euro area. The productivity performance (in terms of levels) in Cyprus has been lagging behind the euro area average. However, since 2006, productivity growth has outperformed the euro area average (Graph III.8.2), in line with the increase of the GDP growth differential in favour of Cyprus. This was especially noticeable in 2008, as the negative impact of the international financial crisis came with a lag in Cyprus relative to its euro area partners.

Nevertheless, in the specific case of Cyprus, due to the high specialisation in services exports, developments in the REER should be interpreted with caution as they seem to have had a differentiated impact on services versus industry. In particular, while the manufacturing sector, which represents about 8% of the economy, followed a declining trend in recent years, export-oriented services prospered partly due to a better productivity performance. In addition, export-oriented services, such as accounting and legal services, are less price-sensitive as they are influenced more by other institutional factors such as the country's tax and legal frameworks.

Although due to the small size of the Cypriot economy, market shares are negligible by international standards([92]), the openness of the economy, measured by the share of trade flows (volume) in real GDP, increased further between 2000 and 2008 (from about 110% to just below 115%). Over the same period, imports of goods grew on average by 9% annually, while exports of goods grew by about 3¼%, compared with 7½% nominal GDP growth. In parallel, exports of services grew on average by 6½% annually during this period, benefiting from well-established trade links with the fast-growing markets of Russia and other CIS countries, as well as the Balkans, the Middle East and North Africa. On the other hand, imports of services grew by 8% on average, largely due to an increase in the number of Cypriots travelling abroad. The increase was particularly pronounced in 2006-2007. Overall, between 2000 and 2008, Cyprus' overall terms-of-trade (ToT) improved somewhat despite stagnating ToT for goods, due to gains in services, reflecting

([92]) Due to the small volumes and sizes associated with a small economy such as Cyprus, indicators tend to be relatively more volatile than in the case of larger countries. Therefore, caution should be exercised in their interpretation.

the growing specialisation of the Cypriot economy in services.

During the last few years, the growth of the tourism sector has been sluggish due to increased competition from, *inter alia*, low-cost neighbouring Mediterranean countries. However, overall, the services balance remained rather stable thanks to an improved performance of other export-oriented services. Export-oriented services in particular, such as insurance, banking and financial services, merchanting, shipping, and ICT services, recorded significant growth. The harmonisation process in the run-up to EU-accession (2004) and, later, euro area membership (2008) acted as catalysts in this respect, through the liberalisation of various sectors of the Cypriot economy, leading to strengthened competition and flexibility and an induced confidence effect. In contrast, while many other euro area countries were able to take advantage of growing niche markets or quality-enhancing processes for goods, the Cypriot manufacturing sector shrank. The main factors behind this gradual decline were the lack of investment in R&D and in innovation, as well as in modern productive and distribution processes, which impacted negatively on productivity growth. Moreover, rising production costs also contributed to the gradual decline of the Cypriot manufacturing sector. The combination of high wages and low productivity growth has led to low profitability the manufacturing sector, as reflected in the downward trend in the ratio of the gross operating surplus to value added over the past few years.

Net FDI inflows averaged 3% of GDP between 2000 and 2008. However, the figure slumped in 2008, largely due to a large one-off outflow associated with the purchase of a Russian bank by a Cypriot financial group. Also, FDI has been negatively affected since 2008 due to falling external demand from non-residents for purchases of holiday houses (lower inflows) in conjunction with the outflows associated with foreigners selling their properties in Cyprus. A large proportion of inward FDI also includes monetary flows in the form of retained profits (reinvested earnings) of firms with foreign shareholding based in Cyprus. In 2008, reinvested earnings amounted to 53.5% of inward FDI, the highest share since 2000. Export-oriented services associated with accounting, legal and other business services benefit largely from the presence of these foreign-owned enterprises. Thus, FDI flows into Cyprus tend to be associated with the positive export performance of services. At the current economic juncture, FDI outflows linked to the profits of foreign-owned companies are expected to decline in line with subdued economic activity and a dampened profitability due to the international economic crisis.

8.3. SPECIAL FOCUS: THE STRUCTURE OF THE CURRENT ACCOUNT BALANCE AND ITS FINANCING

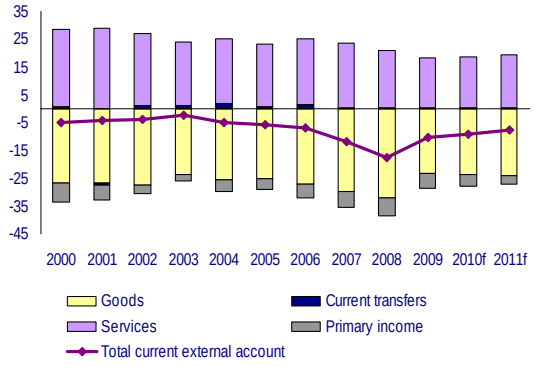
Cyprus's current account deficit reached a record high deficit of 17½% of GDP in 2008 (Graph III.8.3). Following a close-to-balance position in the mid-1990s, the current account balance has deteriorated over time and has been in the red since 2000. The evolution of the Cypriot current account balance shows large disparities between net trade in goods and services. The persistently very high deficit in goods trade and the very high surplus in services reflect the shift of the Cypriot economy towards the tertiary sector. The negative trade balance in goods (-27¼% of GDP over the period) is only partly compensated by the surplus recorded in services trade (24¼% of GDP).

The widening of the trade deficit in the recent past (Graphs III.8.3 and III.8.4) reflects also the acceleration and the composition of GDP growth, which was exclusively driven by domestic demand, as well as developments in commodity prices. High import elasticities led to a significantly increasing trade deficit. Especially in 2007-2008, the import elasticity increased to 1½, from an average of about 1 in the preceding years. The trade deficit was adversely affected by a fall in excise duties on cars in 2003, followed by an additional reduction at the end of 2006, which led to a large increase of car imports.([93]) Moreover, given Cyprus' large dependence on imported oil and foodstuffs, the trade balance has also been significantly affected in the last two years by temporary factors such as the soaring oil, food and commodity prices. The negative impact of higher

([93]) The rise looks large when compared with the lower sales of the previous year. As consumers were anticipating the then forthcoming reduction in excise duties, they held back car purchases until the measure was adopted.

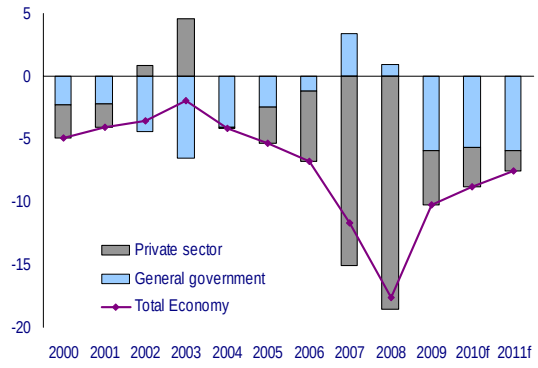
oil and food prices on import growth in 2008 was only partially mitigated by a positive growth of exports of goods, largely reflecting revamped re-export activity (7¾%), after two years of negative growth. In parallel, the services trade surplus during 2005-07 recorded only moderate growth, while it declined by 2¾ p.p. of GDP in 2008, due to the negative impact of the international financial crisis. In the coming years, the trade balance is expected to improve, mainly due to an improvement in the balance on goods associated with the dampening effect on imports of muted consumption and investment.

Graph III.8.3: **Current account balance (% of GDP)**



Source: Commission services.

Graph III.8.4: **Net lending (+) /net borrowing (-) broad sectoral breakdown (% of GDP)**



Source: Commission services.

The current account deficit also reflects a particular country-specific feature related to the statistical treatment of profits of firms with foreign shareholding based in the country. While these profits are accounted as an outflow in the income account, which is included in the current account, they are treated as a foreign direct investment (FDI) inflow in the financial account, when reinvested. As a result, part of the current account deficit is automatically compensated by capital inflows.

The external financing of the current account deficit includes a variety of instruments, which can be classified into three categories: direct, portfolio and other investments, which are recorded in the financial account. In the case of Cyprus, the financial account posts significant surpluses, mainly due to positive net FDI inflows and, to a lesser extent, to positive balances in portfolio and other investment. Net FDI inflows, which represent mostly reinvested profits of firms, have covered a substantial part of the current account deficit. In particular, they accounted for more than 100% of the current account deficit between 2000 and 2003, for 50-75% between 2004 and 2006, and a smaller share in 2007 and 2008. In 2008, the financial account posted a surplus of 18¼% of GDP, out of which net FDI inflows represented only 2% of GDP, due to a significant outflow associated with an investment by the largest financial group in Russia. As mentioned in the previous section, inflows were negatively affected by subdued external demand for housing from non-residents in 2008, while outflows resulted from sales by foreigners of their holiday properties in Cyprus.

Foreign capital is overwhelmingly concentrated in tradable services, particularly financial services, but also increasingly in other business services like accounting, legal and consulting, as well as IT activities. Beyond FDI, portfolio investment (essentially bonds, notes and money market instruments issued by banks and by the government) provides an additional source of financing, although it is characterised by high volatility as it depends on the investment decisions and strategy of private banks and financial institutions. Other inflows have also been sizeable especially in 2008, essentially reflecting a significant inflow of non-resident deposits, mainly from the CIS, held in the Cypriot financial sector. Capital transfers have been very low in net terms (0.06% of GDP and 0.03% in 2007 and 2008, respectively) as inflows from the EU were essentially offset by contributions to the EU.

The increase in the current account deficit in the last five years essentially reflects a steady worsening of the net financial position of the private sector([94]) (Graph III.8.4). On the back of a fall in risk premia and an easing of financial conditions, the private sector saving rate([95]) fell sharply. In 2008, credit([96]) expanded by around 18½%, compared to 22% in 2007. Credit to the private sector grew by almost 19¼% in 2008 compared to 21¼% in 2007, with growth concentrated in construction, real estate, renting, and business activities. In particular, about 47¼% of total lending went to non-financial corporations and 48½% to households, with 21½% going directly to house loans. Compared to 2007, lending to non-financial corporations increased slightly, while for households, insurance corporations and pension funds, lending remained about the same. However, the deterioration in private sector balances was partially offset by an increase in public sector savings, as government accounts still recorded a surplus of 1% of GDP in 2008, down from 3½% of GDP in 2007. Thus, public sector savings played a buffer role in meeting the increasing financial needs of private agents.

8.4. THE NEED FOR ADJUSTMENT ([97])

In the specific case of a small, open, services-oriented economy like Cyprus, joining the euro area has given a more prominent role to competitiveness as a channel of adjustment. Therefore, developments in productivity and wages play a crucial role. While productivity in Cyprus grew at the same pace or even slightly faster than in the euro area over the last decade, wages grew at a significantly higher rate. As a result, unit labour costs rose faster than in the euro area, implying a steady loss of Cyprus' competitiveness vis-à-vis its partners. At the same time, the current account deficit grew steadily, as the surplus in trade in services failed to counterbalance the growing deficit in merchandise trade. And while the deficit is shrinking due to cyclical factors, it is expected to remain relatively high and the trend appreciation in the real effective exchange rate is set to continue. The relatively important specialisation of manufacturing trade in low- and medium- technology sectors reflects the low level of technological sophistication of manufacturing. The small size of the economy hampers the scope for the diversification of production activities and leads to a high degree of trade specialisation, which increases its exposure to external shocks and to competition from lower-cost economies. The country is also characterised by constraints in term of labour supply, which are being exacerbated by a fall-off in the inflow of foreign workers flowing the deterioration in the country's short-term economic prospects. A sustained supply of labour would also appear to be paramount for ensuring wage moderation in Cyprus.

In view of Cyprus' weakened competitiveness in the euro area and its persistent current account deficit, adjustment in the context of the euro area would be facilitated by relative price and cost adjustments and a shift of resources from the non-tradable to the tradable sector, including in exports of services.

Against this background and in view of Cyprus widening domestic and large external imbalances, remedial efforts are needed in a number of areas. Restoring the link of wages to developments in productivity is crucial to support the competitiveness of the Cypriot economy. In this context, there is a need to ensure that labour market institutions do not unduly impede the efficiency of the wage-setting process. Allowing wages to reflect sector or company productivity gains would lead not only to a more competitive position at the sector level, but also to a more efficient allocation of labour. In view of this, a responsible stance is warranted by all actors in the traditional tri-partite wage-setting negotiations. Importantly, the wage drift and indexation (COLA), which adjusts wages based on inflation in the previous six months, could contribute to a sustained wage growth during a period of slumped productivity growth. Moreover, wage moderation in the public sector, in view of its size and spillover effects to the private sector, is important for overall wage developments. A sustained supply

([94]) Due to data availability, it is not possible to discriminate between households and corporations.
([95]) Gross saving - private sector, ESA95, declined from 17.7% of GDP in 2003 to 1.7% of GDP in 2008.
([96]) MFI loans to domestic residents by institutional sector excluding companies without physical presence.
([97]) The text which follows, including policy challenges, draws, *inter alia*, on already issued policy invitations and recommendations under various Community instruments, such as the updated Stability Programme, the EDP recommendations and the strategy for growth and jobs.

of labour would also appear to be paramount for ensuring wage moderation in Cyprus. Hitherto, large migratory inflows of foreign workers contributed somewhat to curbing wage pressures. Nevertheless, with Cyprus' short-term economic prospects appearing less bright, as the country is being affected by the international crisis with a lag, inflows of foreign workers are expected to subside. Given the overall tight labour supply conditions, an improvement in the participation rates of female and older-age workers would increase labour supply. While emphasising the importance of wage restraint, further productivity-enhancing structural reforms are also warranted. Redirecting resources to growth-enhancing areas, investing in human capital development (e.g. via vocational, education, training and apprenticeship systems) as well as further improving active labour market policies, investing in innovation and R&D would enhance the economy's growth potential and competitiveness. Reforms to improve the human capital of the labour force for market services would appear particularly appropriate, given the weight of these activities for Cyprus. Initiatives to develop a comprehensive research and innovation system, as well as improvements in the functioning of product and labour markets, could play a role in facilitating the restructuring of production towards more innovation-driven manufacturing and services activities. However, given the relatively small size of the Cypriot industry, Cyprus could benefit from concentrating on a limited number of market niches.

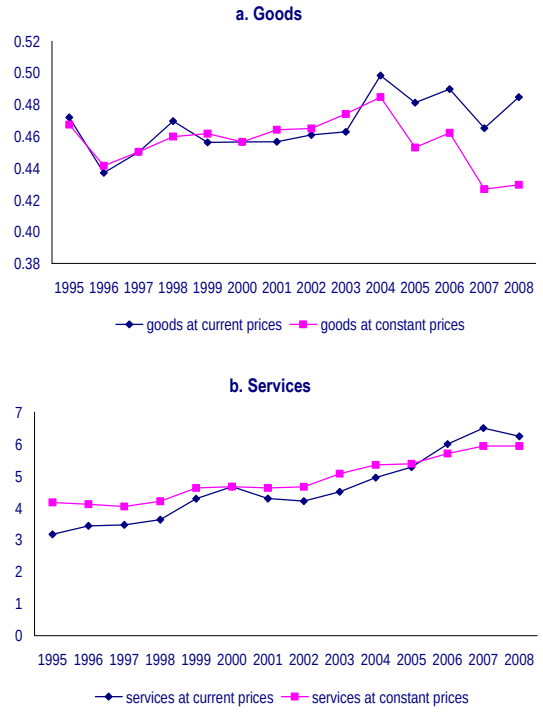
Given the country's high current account deficit, prudent fiscal policies are crucial. Public sector savings can play a buffer role in satisfying the financing needs of private agents. At the current juncture, this is particularly pertinent in view of the muted short-term economic outlook and prospects. With government revenues projected to decline in line with subdued economic activity and a less tax-rich composition of growth, controlling current primary expenditure, which has been on a continuous upward trend, would be paramount. Social support measures should be targeted to reach those in real need, in order to strengthen social cohesion without jeopardising the country's fiscal position. Efficiency in the use of public resources should also be improved through a restructuring of public expenditures towards growth-enhancing areas. In particular, public expenditure could become more productive through a reallocation towards public investment in knowledge, human and physical capital. This would increase the attractiveness of the country to business activities with higher technological content and added value.

9. LUXEMBOURG

9.1. SETTING THE STAGE: FOREIGN TRADE CHARACTERISTICS

With exports of goods and services amounting to 179% of GDP in 2008 and imports to 151%, Luxembourg is by far the most open economy in the EU-27. Foreign trade is strongly concentrated in services, which account for more than three-quarters of exports and about two-thirds of imports. Exports of services are chiefly directed towards Germany (18%), the UK (13%), Switzerland (11%), as well as Belgium, France and Italy (10% each). Exports of goods are for the most part directed to the EU (87% in 2008), mainly to Germany, France and Belgium. They are essentially made up of metal-made manufactures, machinery and equipment as well as the residual category "other" or "diverse" manufactures.

Graph III.9.1: **Luxembourg's share in total euro-area exports (in %)**



Source: Commission services.

In the last few decades, trade in goods and services recorded recurrent surpluses, which rose from about 12% of GDP in 1991 to 32½% in 2008. These surpluses were the combined result of large and broadly stable deficits in merchandise trade (about 10% of GDP on average) and surpluses in services that increased from about 25% of GDP in the early 1990's to 43% in 2008. In recent years, financial and insurance services have accounted for more than 90% of the total surplus in services. Simultaneously, the balance on net primary income from abroad has been increasingly negative since the mid-1990s, mainly because of the surge in the number of cross-border workers, which rose from less than 25% of total employment in 1991 to more than 40% in 2008. As a result, the current account surplus has remained fairly stable since the early 1990s at about 10% of GDP, reaching 12% in 2008.

The export performance of Luxembourg since the beginning of the 1990's has been quite different for goods and services. The country's share in total euro-area exports of services almost doubled in value since 1995 and rose by more than one third in volume, decreasing only during the 2001-2003 slowdown and in the current crisis (see Graph III.9.1 a).

Exports of goods present a more complex picture: Luxembourg's share in euro area exports (including intra-EA exports) increased slightly (though with relatively large fluctuations) from 1995 to 2004 (see Graph III.9.1 a). Afterwards, it diminished until 2007 before rising significantly in 2008. Up to 2003, developments in volume and in value were quite similar. However, since then, the price of Luxembourg's exports of goods has increased by about 30% in five years, leading to a 56.8% increase in value, compared with a 20.8% rise in volume. This increase in price compensated for a large part of the relative decline in volume in goods exports from 2004 to 2007: as Graph III.9.1 a shows, during that period, Luxembourg's share in euro-area exports of goods declined significantly in volume but barely in value.([98]) Similarly, the strong rise in goods exports recorded in 2008 (7½% in value) was mainly due to a surge in prices (almost 6%), since exports only grew by 1½% in volume. However, this picture could be somewhat blurred by the large increase in re-exports in recent

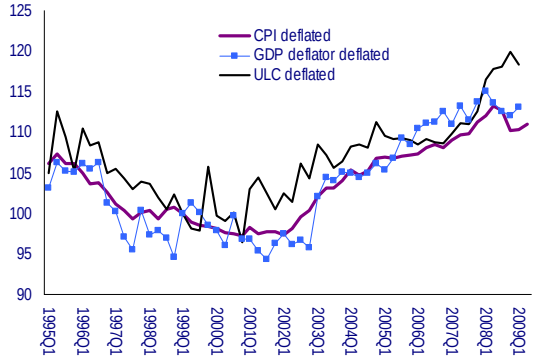
([98]) From 2004 to 2007, in real terms, Luxembourg's share in the EU-15 total exports of goods decreased from 0.40% to 0.36%, a 10% drop with respect to the 2004 level, while in value terms, it only declined from 0.42% to 0.41%.

years.([99]) As far as domestically-produced goods are concerned, Luxembourg's exports performance might thus be less favourable than exports statistics indicate.

9.2. INDICATORS OF COMPETITIVENESS

The cost-competitiveness of Luxembourg has unquestionably deteriorated in recent years. Since 2001, the rise in ULC has been one and a half time faster in Luxembourg than in the EU-15 as a whole, as well as in Belgium or in France. It was especially strong in manufacturing industry, where ULC increased by a cumulative 22.5% from 2000 to 2008, while in the economy as a whole, they rose by 18% over the same period. This strong rise in ULC in Luxembourg's manufacturing industry may contribute to explaining the rather subdued performance of exports of goods in recent years.

Graph III.9.2: **Luxembourg: real effective exchange rate indicators (2000 = 100) (IC36)**



Source: ECB, OECD, BCL and Commission services.

The increase in ULC was even stronger in financial intermediation, where they surged by a cumulative 28.1% from 2000 to 2008, essentially due to a 25.1% rise in wages.([100]) However, this does not seem to have had a commensurate effect on the country's performance in terms of exports of services. The prices of exports of services have also surged in Luxembourg since 2000: their cumulative rise reached 25.3% from 2000 to 2008 (the second strongest increase in the EU-15 after Ireland), despite a 6.3% decline over the years 2001 to 2003. This suggests that the Luxembourgish services-exporting sectors have been able to switch to higher-value added products and/or they are able to pass through cost increases into their prices.

The ECB harmonised competitiveness indicator (which is a real effective exchange rate based on relative HICPs vis-à-vis the group of Luxembourg's 36 major trading partners (IC 36) ([101]) confirms the deterioration of the competitive position of Luxembourg since the beginning of the current decade. Clearly, one reason for this deterioration is the appreciation of the euro since the end of 2000. However, this factor has played a role for all countries of the euro area (and also for those whose currency is pegged to the euro) and it is probably less important for Luxembourg, since its exports of goods are relatively more concentrated inside the euro area. Moreover, as the weight of oil products in the HICP is much larger in Luxembourg than in most other Member States (due to the massive purchases of car fuel by non-residents), the HICP tends to overstate domestic inflation during periods of rising oil prices. For this reason, the Central Bank of Luxembourg (hereafter BCL) computes indicators using the relative GDP deflators, the relative ULCs or the Luxembourgish national CPI, which excludes consumption by non-residents. As expected, the indicator based on the national CPI gives a less unfavourable picture of the competitiveness of Luxembourg during this decade than the HICP-based indicator, because the rise in the national CPI has been significantly smaller than that in the HICP (see Graph III.9.2). On the other hand, the indicators based on the GDP deflators and on the relative ULCs give an even more unfavourable

([99]) Luxembourg-Findel is the 5th European airport for freight ahead of e.g. Brussels, Madrid and Munich.

([100]) Since 2000, the rise in ULCs was weaker in the financial sector than for the economy as a whole. This is due to a very strong decline in the sub-sector "intermediation and insurance auxiliaries", where ULCs dropped by nearly one third thanks to a very strong increase in productivity (value added per person employed surged by a cumulative 76.3% from 2000 to 2007). In the sub-sectors "insurance" and "financial intermediation", the rise in ULCs was stronger than on average in the economy as a whole.

([101]) The ECB indicators based on the GDP deflators and on ULCs are compiled vis-à-vis the other 15 euro area countries and a group of 21 trading partners, which comprises the 11 non-euro-area EU Member States plus the 10 other most important trading partners. The ECB indicators based on HICPs are additionally calculated vis-à-vis the other 15 euro area countries and a group of 41 trading partners, which comprises the group of 21 plus the 20 other most important trading partners.

picture of competitiveness developments in Luxembourg in recent years.

As Table III.9.1 shows, the reason for the stronger rise in ULC in Luxembourg since the beginning of this decade is twofold: a faster rise in wages and a slower increase in productivity.

Table III.9.1: **Luxembourg and neighbours: wages, productivity and unit labour costs (2001 - 2008)**

(average annual % change)	LU	BE	DE	FR	Euro area
Nominal compensation per head	3.2	2.9	1.6	2.9	2.7
Real GDP per person employed	0.8	1.0	1.5	1.0	1.0
Nominal unit labour cost	2.4	1.8	0.1	2.0	1.9

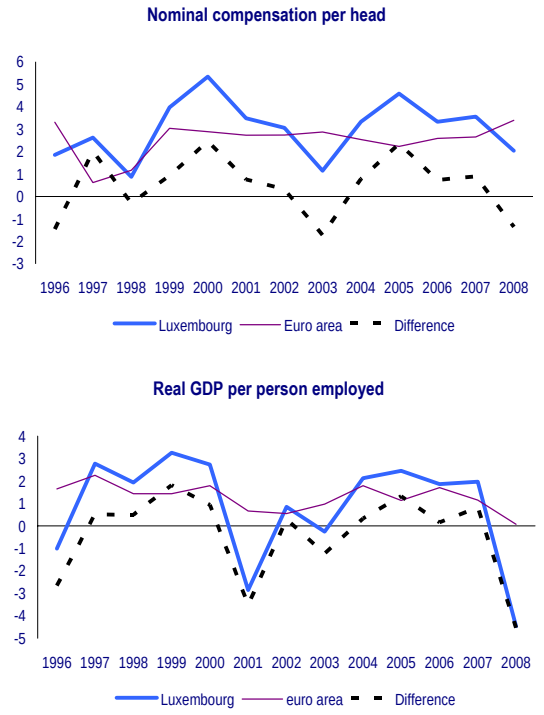
Source: Commission services.

Wages, which had increased by less in Luxembourg than in the rest of the EU from 1995 to 1998 and by hardly more in the strong growth years of 1999 and 2000, decelerated less during the 2001-2003 slowdown and re-accelerated more from 2004 to 2007. In 2008, however, they decelerated markedly, rising by 2.6%, to be compared with 3.4% in the euro area. (see Graph III.9.3). This faster rise in wages compared with the euro area since 2001 may be related to the fact that both job creation and inflation have been stronger in Luxembourg:

Since 2001, employment has been much more dynamic than in the euro area as a whole. However, this was also the case from 1995 to 1998, when wages were rising more slowly in Luxembourg than on average in the EU. Moreover, the existence of a large pool of available workers in neighbouring regions reduces tensions on the labour market in fast growth periods. The role of the stronger job creation in the faster rise in wages in Luxembourg is thus not completely clear-cut.

The role of the stronger inflation seems less ambiguous. Since 2001 the rise in consumer prices has been faster in Luxembourg than on average in the euro area, while it had been slower than average during the period 1995-1998. In order to improve competitiveness, it was agreed with the social partners in April 2006 that the existing wage indexation mechanism, under which wages were indexed each time the CPI had risen by 2.5%, would be replaced until 2009 by 2.5% wage increases at pre-determined dates (about once a year) regardless of the actual rise in the CPI. This measure has probably reduced that part of the rise in wages that is due to indexation with respect to what it would have been under the "normal" system. However, it did not prevent wages from rising rather fast in 2006 and 2007 (by 3.1% and 4.3%, respectively).

Graph III.9.3: **Luxembourg and euro-area yearly % increase in wages and productivity (in %)**



Source: Commission services.

On the other hand, the average increase in productivity has been slower in Luxembourg since 2000, chiefly because both during the 2001-2003 slowdown and the current recession, job creation reacted with a sizeable lag to the slowdown in output: GDP slowed down strongly from 2000 (+8.4%) to 2001 (+2.5%) but employment hardly decelerated, still growing by 5.6% and 5.5%, respectively. Due to this massive labour hoarding, GDP per person employed dropped by 2.3% over the period 2001-2003. However, from 2004 to 2006, productivity grew faster in Luxembourg, as is generally the case during strong growth periods, the opposite being true during phases of slowdown. Finally, something similar to the 2001 episode took place on an even larger scale in 2008: real GDP stagnated, while total employment,

though decelerating strongly during the last few months of the year, still grew by 4.8% in annual average. As a result, GDP per person employed fell by 4.5%, which, together with a 3.4% average increase in nominal wages, resulted in a 6.8% surge in nominal ULCs (compared with 3.4% on average in the euro area).

9.3. SPECIAL FOCUS: SECTORAL AND GEOGRAPHICAL COMPOSITION OF LUXEMBOURG'S EXPORTS

A study by the Central Bank of Luxembourg([102]) concludes that the loss of cost competitiveness since the beginning of the decade has been partially compensated by a favourable "product effect" resulting from the sectoral specialisation of Luxembourg's industry but reinforced by an unfavourable geographical distribution:

From 2002 to 2007, the demand for products exported by Luxembourg rose faster than average world demand. This was exclusively due to the metal-made manufactures, with the contributions of all other categories of goods to this effect being negative or insignificant.

The geographical distribution of exports had a negative influence on their growth: Luxembourgish exports are mostly directed towards the EU-15, especially the comparatively slow-growing neighbour countries, with proportionally little going to the new member states and other fast-growing regions like the BRICs.

Developments in cost competitiveness had a negative effect on average but they were very diverse across sectors. Competitiveness improved in the sectors of "other manufactures" (i.e. not metal-made) and transportation material, while it deteriorated in the sector of metal-made manufactures, where growth in exports, though stronger than average, was thus less dynamic than the rise in exports markets would have suggested.

Developments in cost competitiveness also varied according to the country of destination: on average, cost competitiveness deteriorated in the Belgian, French and UK markets but improved in Germany, other euro area countries and the new member states. This is a quite paradoxical result since, as already mentioned, the loss of cost competitiveness since 2000 has been much larger compared to Germany than to France and Belgium, while ULC have even increased marginally less in Luxembourg than in the UK.

No similar study has been found for exports of services. It is, however, possible that the strong performance of services exports up to 2007, despite a very significant rise in labour costs, is due to a kind of "product effect" similar to that observed in goods exports: from 2003 to 2007 the demand for financial services, in which Luxembourg specialises, most probably increased faster than the demand for most other types of services.

In some neighbouring countries (e.g. France), the small size and limited number of exporting firms, as well as the relatively low R&D expenditure of enterprises, have been identified as factors hampering export performance. There is no evidence that these factors play a similar role in the case of Luxembourg. Indeed, total R&D expenditure is comparatively low, but this is partly due to the very low public spending on R&D (which is, however, set to increase significantly with the development of the University of Luxembourg). Moreover, the Luxembourgish manufacturing sector is relatively concentrated and internationalised: more than 90% of manufacturing output is exported and the 4 biggest industrial employers in the country belong to large international groups([103]), which certainly carry out a lot of research abroad([104]), from which their Luxembourgish subsidiaries or facilities can benefit. Consequently, neither the size and number of exporting firms nor the low amount of R&D expenditure inside the country seems to constitute a significant handicap for the Luxembourgish export performance.

([102]) Banque centrale du Luxembourg, Compétitivité et exportations, in Bulletin 2008 / 1, pp. 82-90.

([103]) Arcelor-Mittal, Goodyear, Guardian Industries and Dupont de Nemours.

([104]) Beside a production unit, Goodyear also has a large research centre in Luxembourg.

9.4. THE NEED FOR ADJUSTMENT ([105])

The cost-competitiveness of Luxembourg has deteriorated since 2000, due to a faster rise in labour costs than in its main trade partners. This has been caused both by a stronger increase in wages, despite their partial de-indexation in 2006, and by a slower rise in productivity, chiefly related to very large labour hoarding during the 2001-2003 slowdown and the current recession. The deterioration in cost competitiveness probably played a role in the decline up to 2007 in the country's share in euro-area goods exports. However, this share rose abruptly in 2008, although the deterioration in cost competitiveness was especially sizeable that year. On the other hand, no similar decrease can be observed in Luxembourg's share in euro-area exports of services, although the rise in ULCs was even stronger in the financial intermediation and insurance sectors than on average in the economy. The Luxembourgish services sector seems to have been able to pass through cost increases into its export prices without resulting losses in market shares, which, on the contrary, significantly increased in recent years.

The combination of the contraction in output and the still strong employment growth recorded in 2008 resulted in another strong increase in labour costs, which rose by more than 7%. Since employment is unlikely to contract as much as output, ULCs are expected to continue to rise by more than in most other EU member states. Moreover, the partial de-indexation of wages is scheduled to last through 2009, after which the "classical" indexation system is supposed to come into force once again. Since this likely worsening in competitiveness will be largely due to developments in productivity that are beyond the control of the authorities and of the social partners, it might be advisable to try to influence the other term of the equation, namely the increase in wages in a favourable way. The rise in real wages since 2000, though not spectacular, has not been negligible either. Moreover, income tax brackets were recently adapted by 15% in two steps in order to compensate for their non-indexation since 2001, leading to a sizeable increase in the after-tax income of many households (the *ex ante* loss of revenues resulting from these tax cuts has been estimated at 0.8 percentage point of GDP in 2008 and 1.2 pps in 2009).

In view of Luxembourg's strong non-price competitiveness and current account positions, adjustment in the context of the euro area would be facilitated by addressing the structural challenges underlying long-term export market performance.

Against this background and in view of the important deterioration in cost-competitiveness which occurred in recent years, efforts should aim at containing the increase in wages and fostering wage behaviour that takes due account of productivity developments. Given that income tax brackets have recently been adapted by 15% in two steps in order to compensate for their non-indexation since 2001, a few years of wage adjustment, where, for instance, the rise in nominal wages exclusively compensates for inflation, could be warranted. The 2008 Spring European Council insisted on the need to invest more in knowledge and innovation. In this respect, the projected increase in public R&D spending related to the development of the University of Luxembourg should be welcomed. Efforts to increase R&D activities in the country need to be pursued further.

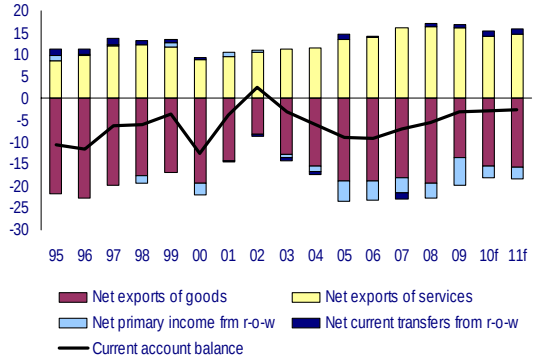
([105]) The text which follows, including policy challenges, draws, *inter alia*, on already issued policy invitations and recommendations under various Community instruments, such as the updated Stability Programme, the EDP recommendations and the strategy for growth and jobs.

10. MALTA

10.1. SETTING THE STAGE: FOREIGN TRADE CHARACTERISTICS

Malta is one of the most open economies in the euro area with exports and imports combined amounting to some 180% of GDP, in volume terms. Malta's small size necessarily implies a narrow range of exports, which gives rise to risks stemming from a lack of diversification. This, coupled with the country's dependence on strategic imports, specifically fuel and industrial supplies, limits the economy's resilience to external shocks. However, as witnessed in the current global crisis, the ongoing transformation of the export sector towards high value-added activities, especially in services, may have improved resilience.

Graph III.10.1: **Developments in Malta's external account, 1995-2011**



Source: Commission services.

Malta has traditionally registered a trade deficit, which nonetheless has declined markedly from 13.2% of GDP in 1995 to around 3% of GDP in 2008, helped mostly by a steady improvement in the services surplus, which almost doubled from 8.7% of GDP in 1995 to 17.3% in 2008. In 2009, the trade balance moved into surplus for the first time since 2002 also thanks to lower energy prices. Looking forward, the external balance of goods and services is expected to narrow further on the back of a notable drop in imports, reflecting the marked slowdown in domestic demand and a lower oil import bill in 2009 followed by a recovery in the services balance thereafter. The share of exports of goods in total exports has declined progressively over the years from almost 69% in 1995 to around 57% in 2009. Conversely, growth in the volume of services exports averaged a notable 4.7% annually in the period 1996-2009. These developments reflect the ever-shrinking role of manufacturing, as traditional sectors like textiles and clothing face stiff competition from low-cost producers, and have occurred despite Malta's recent inroads in attracting new manufacturing activities such as pharmaceuticals and aircraft maintenance. Further success was registered in attracting new services activities, most notably ICT and financial services and online gaming, and in upgrading traditional tourism exports.

A breakdown by product category shows that electronics account for around half of total foreign sales of goods (linked to the dominance of a single firm), while the remainder is spread thinly across other sectors, namely pharmaceuticals (9%), food (3.7%), printed matter (6%), aircraft maintenance (2.5%), textiles and clothing (4.2%) and scientific equipment (2.5%). Malta's merchandise exports appear to enjoy a very strong comparative advantage in the high technology sectors. Around 55% of merchandise exports are concentrated in the high-technology category, reflecting the high share of electronics. For services, the distribution is more even with tourism remaining the main export sector (25% of services exports revenue) followed by ICT and other business services (25%), online gaming (20%) and financial services (6%).

10.2. INDICATORS OF COMPETITIVENESS

In the period 1995-2009, Malta's real effective exchange rate (ULC-based) registered a substantial appreciation against both euro area countries and industrialised countries (IC35).([106]) The pace of appreciation was faster between 1995 and 2001 in relation to the euro area while it depreciated against industrialised countries, reflecting in part nominal effective exchange rate developments in this period. Thereafter, the REER depreciated vis-à-vis the euro area but appreciated further relative to the industrialised countries.([107]) The loss in

([106]) The average annual appreciation during this period varies from a low 1.0% for the private-consumption-deflator-based REER to a high 2.2% for the REER based on the export price deflator.

([107]) This is significant given that some 60% of Malta's total exports are directed to non-euro-area countries.

competitiveness against industrialised countries after 2001 was brought about by unfavourable developments in Malta's ULC relative to the IC35 as well as a weakening dollar.([108]) For Malta, consistently higher unit labour costs, especially in a context of an appreciating exchange rate, may be critical as firms in the exposed sector are "price-takers" on the international market, implying that any adjustment would have to come through a reduction in profit margins, reduced investment or lay-offs.

Malta's share of exports of goods and services declined during the period 1995-2009, albeit marginally. The fall is due to the performance of goods, whose export shares declined appreciably. Conversely, services export shares registered an improvement as Malta progressively diversified into new fast-growth activities. For goods, market share losses were mainly concentrated in electronics and clothing, while gains were recorded in food. On the other hand, Malta's market share improved marginally in pharmaceuticals but declined in scientific and telecoms equipment. In the case of services, market shares increased in financial intermediation and ICT services and substantially for personal, cultural and recreational services, mainly due to the expansion of remote gaming in recent years. The higher export market shares in services led to positive terms-of-trade changes. A look at the export market performance indicator suggests that Malta has not been able to respond fully to the accelerating global demand of its products. The export performance indicator has been declining almost uninterruptedly between 1995 and 2008, with little prospects of a reversal in the near term.

The ratio of gross operating surplus to value added deteriorated during the period 1995-2005 for industry as a whole. For manufacturing, after declining in the second half of the 1990s, the profitability ratio peaked in 2000 mainly on the back of the strong growth registered in the electronics industry. Thereafter, the ratio broadly continued its downward trend due to both restructuring in anticipation of EU accession in 2004 and the global economic downturn. At a sub-sectoral level, the more-than-doubling of the profit ratio in the chemicals sector between 2000 and 2005, reflecting the growth of the high value-added pharmaceutical activities, is worth noting. Conversely, during the same period the profitability of the electronics sector fell markedly. In services, profitability was pushed down by lower gross operating surplus in tourism during the period 1995-2005. This was partly offset by the emerging online gaming and activities related to financial intermediation.

Net FDI inflows were particularly strong during the period 2000-2008 peaking at slightly above 29% of GDP in 2006.([109]) Around 45% of inward investment originated in EU27 Member States in 2007. In services (excluding financial intermediation, which is the sector mostly affected by non-productive flows), the highest FDI inflows in 2007 were registered in the transport, storage and communication sector (60%), while real estate accounted for 22% and recreational, cultural and sporting activities reached 16% of total inflows, reflecting investment in online gaming. Over the years, FDI has proved to be a key aspect supporting Malta's competitiveness since it promotes transfer of technology and expertise, while allowing for the exploitation of new market opportunities.

10.3. SPECIAL FOCUS: DIVERSIFYING THE EXPORT SECTOR TOWARDS FAST-GROWING SECTORS

The small size and openness of the country, together with its narrow productive base have historically provided a challenge to the Maltese economy. Heavy reliance on external trade and a lack of diversification, both in terms of products exported and export markets, make Malta vulnerable to external shocks. Continuing the diversification of the export sector with a focus on more dynamic sectors is key for enhancing Malta's resilience as evidenced by the role played by new service activities in cushioning the impact of the global economic crisis.

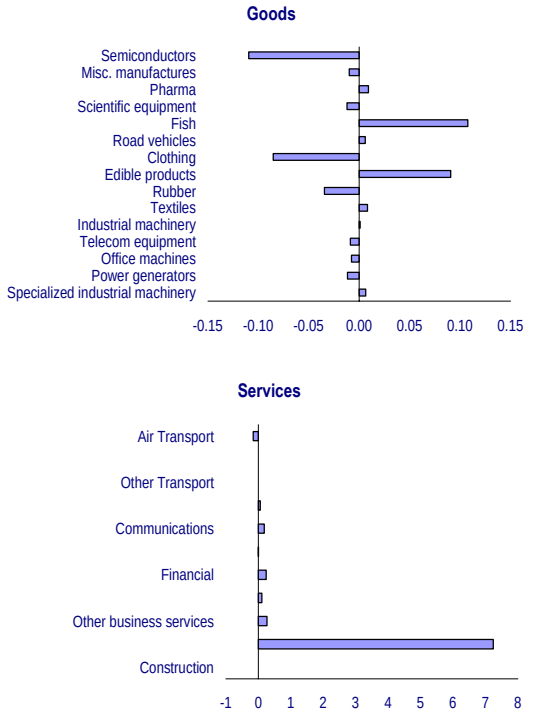
([108]) For Malta, fluctuations in the exchange rate of the dollar are relevant given that it is the currency in which electronic products are traded.

([109]) There are indications that a proportion of inward FDI includes non-productive flows reflecting the activities of "Special Purpose Entities" or SPEs, which are mainly financial holding companies, foreign-owned, and principally engaged in cross-border financial transactions, with little or no local activity in the Member State of residence.

In recent years, Malta has followed an FDI-led diversification strategy relying on improving non-price competitiveness by targeting and attracting high-end niche operations. Manufacturing has seen a shift to high value-added activities such as printing, aircraft maintenance and generic pharmaceuticals. The tourist industry is being transformed from one largely reliant on the declining mass-market tour operators to faster-growing, high value-added individual tourism. In addition, new services-oriented export activities such as remote gaming, call centres, and more importantly financial services and ICT have expanded in recent years. The authorities' strategy to make Malta an ICT cluster in the region has translated into securing 'Smart City', a project that will involve the operation of a technology park for ICT and media companies. There are indications that the expansion in new services activities has improved Malta's economic resilience. Specifically, in 2009, as economy-wide gross value added contracted by 0.3%, gross value added in both financial intermediation and remote gaming posted significant growth suggesting that, in their absence, the decline in output would have been much worse. Malta's strategy of FDI-led export diversification could potentially encounter difficulties in the current economic situation as global liquidity constraints tend to favour saving instead of funding long-term investments.([110]) In this context, the need to press ahead with structural reform, specifically in those aspects that improve the business climate, becomes even more pertinent.

A look at Malta's specialisation shows that it is still highly concentrated in the less internationally dynamic sectors. This seems to be particularly the case in manufacturing due to the dominance of electronics (slightly more than 50% of merchandise exports). However, the expansion of pharmaceuticals, telecommunications and scientific instruments points to the steady, albeit incipient, progress achieved in recent years in shifting manufacturing to high-growth industries. Malta has been losing export market shares mainly in electronics and clothing, both considered to be slow-growth sectors internationally, while gains were recorded in food, also a less dynamic sector (see Graph III.10.1). On the other hand, in high-growth sectors such as pharmaceuticals, scientific instruments and telecoms equipment, Malta's market shares have either improved marginally (pharmaceuticals) or else declined (scientific and telecoms).

Graph III.10.2: **Change in Malta's exports market share, 1995-2007**



Source: IMF.

Malta's degree of specialisation in services has increased significantly over time. Despite a more even distribution across services sectors (compared to that in the goods exports), tourism remains the dominant activity. Improvements in the export performance of total services would thus require strong growth in tourism. This has not been the case: after reaching a peak in 2003, Malta's share in global visitors has declined. However, the underperformance of the tourism industry has been more than compensated for by emerging service activities. In recent years, Malta has become specialised in high-growth sectors, with substantial market share increases in personal, cultural and recreational mainly due to the expansion of remote gaming. Market share increases were also recorded in financial intermediation and ICT, two of the top high-growth sectors at the international level.

([110]) Although they should be treated with caution due to their high degree of volatility, provisional FDI data show that in the first half of 2009, inflows declined by around 10% compared to the corresponding period of 2008.

The structural changes undergone by Malta and the efforts to diversify the export structure in the past few years have started to bear fruit, although so far the size of exports generated by the new activities remains relatively modest in comparison to Malta's traditional exports. It appears that in the case of manufacturing, Malta's export performance would benefit from further shifts in the production base from declining to fast-growth sectors as well as from capturing a bigger share of the growing world demand in those new sectors with significant growth potential. For services, while there remains scope for reducing the dominance of the tourism sector, overall Malta seems to be targeting internationally dynamic sectors and the challenge is to respond more forcefully to the opportunities offered by this trend.

10.4. THE NEED FOR ADJUSTMENT ([111])

Although fiscal policy can play a role in dampening the impact of external shocks, its effectiveness for small and open economies like Malta is limited because of significant import leakages that generally accompany budgetary impulses. Malta has largely avoided such a pitfall by focussing most of its fiscal response to the economic downturn on enhancing public infrastructure, which should result in a high multiplier to the local economy. At the same time, although unpopular, some reforms aimed at enhancing the quality of public finances, namely the reduction of subsidies granted to the water and energy providers and the liquidation of the Malta shipyards (which however had a strongly negative impact on the general government deficit in 2008), have been implemented.

Nevertheless, in the specific case of small and open economies operating within the context of a monetary union, competitiveness as a channel of adjustment to shocks such as the current crisis takes a more prominent role. Against the background of weak productivity gains, Malta's competitiveness remains vulnerable. Real wage restraint was reversed recently following the sustained pay increases in the public sector as provided in the current collective agreement as well as higher salaries awarded to public healthcare employees. As a result, in the first half of 2009, wage inflation exceeded productivity growth. Looking forward, wages are expected to grow at an annual average of slightly more than 2¼% in 2009-2010. Wage increases in the sizeable public sector (which accounts for slightly less than a quarter of total employment in Malta) may have cushioned the initial impact of the economic recession but could act as a signal to the private sector, thus hampering the wage adjustment process. In addition, between October 2008 and mid-2009, Malta displayed a persistent inflation differential with the euro area, most notably as a result of sticky food prices. Trade operators failed to pass on the lower global food prices, suggesting the existence of a dysfunction in the product market, such as restrictive trade practices. This is of further concern for Malta since annual automatic cost-of-living adjustment is mandatory and based on backward-looking price developments. Such a mechanism may give rise to price inertia as past inflation is built into future pay settlements. As a result, wage adjustment is hindered, which could heighten the persistence of the adverse impact of external shocks on output and thereby reduce the economy's resilience. Ensuring competitiveness demands further structural reforms that will enhance productivity and better alignment of wage to productivity developments. It is therefore desirable to promote more price flexibility to help the economy respond swiftly to such shocks.

In view of Malta's competitiveness position in the euro area and its current account balance, adjustment in the context of the euro area would be facilitated by addressing the structural challenges underlying long-term export market performance.

Against this background and considering the importance of the export sector to Malta's growth, policy efforts should aim to ensure that labour market institutions do not unduly hamper the efficiency of the wage-setting process. This may be achieved through, *inter alia*, sustaining wage moderation by promoting wage restraint in the public sector and preventing excessive public sector pay increases from spilling over to the private sector, while ensuring that wage growth reflects productivity developments and reducing inflation persistence. There is also a need to bolster

([111]) The text which follows, including policy challenges, draws, *inter alia*, on already issued policy invitations and recommendations under various Community instruments, such as the updated Stability Programme, the EDP recommendations and the strategy for growth and jobs.

productivity. Looking forward, the near-term prospects for productivity appear weak. Therefore, productivity should be boosted by strengthening competition in product markets, redirecting resources to growth-enhancing areas, investing in human capital development and facilitating further inward FDI, which represents the main source of technology transfer, and further reducing the size of government. In addition, improving non-price competitiveness should continue to be pursued by further reorienting the export sector towards high value-added and fast-growing goods and services. In the area of the labour market, there is a need to improve incentives to work, particularly for women and older workers, *inter alia* by: taking further action on the tax and benefit systems to make declared work more attractive and to enhancing lifelong learning, while stepping up efforts to increase educational levels and reduce the number of early school leavers.

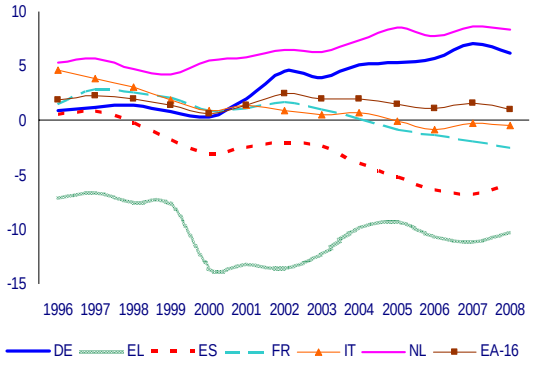
11. NETHERLANDS

11.1. SETTING THE STAGE: FOREIGN TRADE CHARACTERISTICS

The Netherlands is one of the most open economies in the euro area. Trade openness in the Netherlands (measured as the sum of imports and exports relative to GDP) increased steadily from 74% of GDP in 1980 to 161% in 2008 (compared to the euro area average of 89% in 2008). The shares of both exports and imports in GDP have been increasing at a rather similar pace in the last few decades with the former rising from 37.3% in 1980 to 84.1% in 2008 and the latter from 37% in 1980 to 76.8% in 2008. Due to the global economic and financial crises, however, trade openness declined in 2009 for the first time in almost thirty years as both exports and imports fell by more than GDP.

The share of Dutch exports and imports of goods and services in world trade has remained relatively stable over the past few decades. The Dutch market share in world exports and imports amounted to 3.7% and 3.3%, respectively, in 2008.

Graph III.11.1: **Relative export performance of the Netherlands (net exports of goods and services as a percentage of GDP)**



Source: Commission services.

The trade balance recorded a positive 8½% of GDP in 2008, considerably higher than the euro area average (see Graph III.11.1). Dutch exports of goods accounted for 82% of total exports in 2008. A significant part of this consists of re-exports (47% in 2008), which can in large part be explained by the country's strategic geographical position, especially vis-à-vis Germany, which enables the Netherlands to function as a major transit country, particularly through the part of Rotterdam. Most re-exported goods originate in Asia, and are primarily oriented towards the EU. Unsurprisingly, the total share of exported goods going to the EU is relatively high, reaching 78%. The country's main export partners are Germany (24.2%), Belgium (12.6%), United Kingdom (9.1%), France (8.1%) and Italy (4.7%). In contrast, just half of total imports originate from the EU. The relative importance of exports of goods has increased somewhat over the past few decades, while the share of services in total exports has declined from around 23% in 1980 to 18% in 2008, which is slightly below the current euro-area average (20%).

A breakdown of exported goods by category indicates that exports are mainly in the categories "machinery and transport equipment" (30%), "chemicals and related products" (17%), and "mineral fuels and lubricants" (16%). Re-exports account for around two thirds of the total exports of machinery and transport equipment and primarily consist of electrical equipment and electronics. The high share of exports of mineral fuels and lubricants can be explained by the fact that the Netherlands is both a producer and an exporter of gas (total net exports of gas amounted to around 1.6% of GDP in 2008), an importer of oil and an exporter of refined oil products (through the port of Rotterdam).

Net exports of services were negative between 1995 and 2003 before turning positive in 2004 (due to an increase in the balance of licence royalties, transport and tourism). The total share of exported services going to the European Union is 58%, whereas around 9% of exported services are destined for the US. Exports of services therefore seem to be more extra-EU-oriented than goods exports. The main exported services are in the categories "other business services" (33%), including e.g. legal services, accountancy and management advice, commercial services, architect and engineering services, and "transport services" (24%). Financial services amounted to a mere 1½ % of total exported services in 2008.

The Netherlands is a structural net direct investor abroad, as the net Foreign Direct Investment balance was mainly negative in past years. Only in

2007 did the Netherlands record a positive net FDI balance of over 11% of GDP, which can be explained by the take-over of ABN-AMRO by a consortium of Spanish, British and Belgian banks. Due to the subsequent nationalisation in 2008, the total net FDI turned negative once again (-3% of GDP).

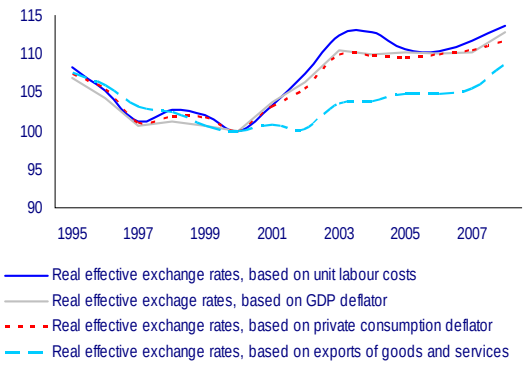
11.2. INDICATORS OF COMPETITIVENESS

Cost and price competitiveness may be assessed by looking at developments in the real effective exchange rate (REER). The REER (based on unit labour costs, the GDP deflator, the deflator of private consumption and the export price deflator) vis-à-vis the euro area appreciated from 1997 to 2002 and has stabilised since then. The REER vis-à-vis a group of 35 industrialised countries (IC35) shows an appreciating trend from 2000 onwards, pointing to decreasing competitiveness, which was only briefly interrupted in 2005. Specifically, the largest competitiveness losses were recorded with the REER based on unit labour costs, which increased by 14% vis-à-vis IC35 over the period 2000-2008 (see also section 3). Competitiveness based on the other REER deflators show a less pronounced deterioration, especially that using the export price deflator, which appreciated by 9% vis-à-vis IC35 in the period 2000-2008. Despite the appreciation of the REER vis-à-vis the IC35 (whichever deflator one takes), the market share of Dutch exports increased from 3.5% in 2000 to 3.7% in 2008. This trend is also apparent in the export market performance indicator, which has been showing gains in market share over several years except for 2006.

The high market share of exports is distorted by the fast growth of re-exports. The latter posted an annual average growth rate during 2000-2008 of 11%, whereas domestically produced exports grew by only 2% on average. The loss of competitiveness of domestically-produced goods and services was thus offset by the dynamism of re-exports, which are scarcely affected by unfavourable domestic unit-labour-cost developments. The added value of domestically produced exports is, however, estimated to be around six times higher than that of re-exports.

Other reasons for the relatively stable performance of Dutch exports in spite of the deterioration of cost competitiveness could stem from an improvement in non-price competitiveness, due for example to quality improvements, or falling profit margins. Starting with the latter, the much more limited deterioration in the REER based on the export price deflator suggests that Dutch exporters may have reduced their profit margins to maintain their competitiveness. Factors other than cost and price developments may also play a role. First, geographical specialisation can play an important role in export performance: if for example exports are primarily oriented towards fast growing markets, this will, ceteris paribus, improve export performance. Second, sectoral specialisation can influence trade performance: if demand is high for certain products (e.g., in highly research-intensive goods) and competition remains low, this can have a positive effect on export performance. Finally, other non-price competitiveness developments such as technological competitiveness can also be important. Technological competitiveness increases export performance, not only by leading to more innovation, but also by increasing efficiency and reducing costs.

Graph III.11.2: **Real effective exchange rates versus IC 35 (2000=100)**



Source: Commission services.

Dutch exports are primarily oriented to other euro area countries, whose import growth has been relatively limited in comparison with growth in world trade. In addition, the share of extra-EU exports directed to fast-growing markets such as Brazil, Russia, India and China (BRIC- countries) is relatively low (around 15%). Thus, geographical specialisation does not seem to have a very positive effect on the relative export performance of the Netherlands.

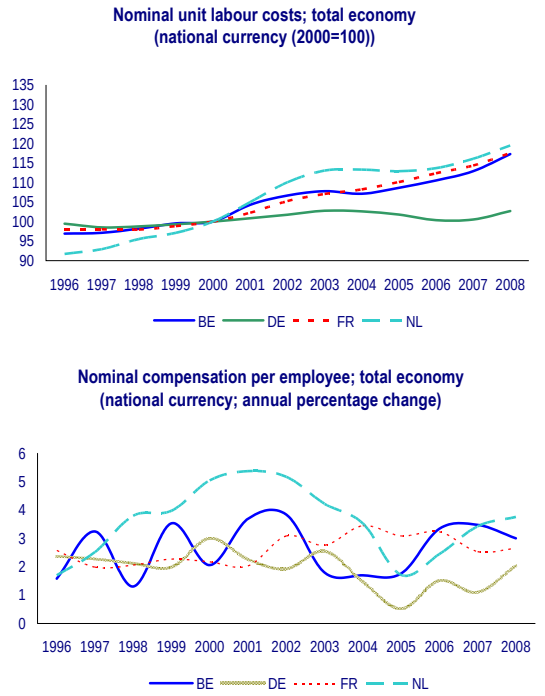
Revealed Comparative Advantage (RCA) provides an indication of the relative advantage or disadvantage of the Netherlands in a certain field. It is measured using the classic Balassa index of revealed comparative advantage, which is calculated as the share of a given goods category in the country's total exports, relative to the export share of that goods category for the world aggregate. If the RCA is higher than 1, this means that the Netherlands has a comparative advantage in this field. The RCA based on factor intensity shows that the Netherlands performs well in "easy to imitate research-intensive" goods and "Raw material intensive" exports, where the latter seems to be explained by exports of domestically-produced gas. Looking at the RCA based on technology intensity of manufactured goods, the Netherlands excelled in all but medium-to-low-technology goods until 2006, but showed a marked deterioration in 2007, especially for high-technology goods. This development might jeopardize competitiveness since high-technology goods are more difficult to imitate than medium-to-low-technology goods.

In the latest EU Innovation scoreboard, the Netherlands is classified as an innovation follower and scores just above the EU average. Overall R&D intensity was 1.7% of GDP in 2007, down slightly from 1.8% of GDP in 2001. Private investment in R&D is relatively modest at around 1% of GDP (well below the Dutch target of 2%) and is mainly concentrated in a few multinational companies. The relatively low private R&D might partly be the result of the strong service focus of the Dutch economy as a whole. However, compared to other countries (DE, BE, SE, FI), R&D investment in services also lags behind in the Netherlands.

11.3. SPECIAL FOCUS: WAGE DEVELOPMENTS AND UNIT LABOUR COSTS

Unit labour costs increased steadily between 1995 and 2003, as shown in Graph III.11.3. This was the result of the strength of the Dutch economy in the second half of the 1990s, which created vigorous labour demand growth. Increasing demand and a tightening labour market exerted upward pressure on wages around the turn of the century. Following an agreement in autumn 2003 between the government and social partners to moderate wages in 2004 and 2005, unit labour costs remained broadly stable until 2006, when they started to rise sharply again, although at a similar pace to the country's main trading partners.

Graph III.11.3: **Relative unit labour costs and wage developments in the Netherlands**



Source: Commission services.

Looking at the period 2000 to 2008, unit labour costs rose by around 20% in the Netherlands, which is somewhat above the 17½ % increases in France and Belgium, but markedly above the 3% increase in Germany over the same period. This widening gap vis-à-vis Germany is particularly important given the fact that Germany is the main trading partner of the Netherlands. Unit labour costs consist of two components: productivity and compensation of employees. Observed differences in unit labour costs result mainly from differences in compensation of employees and far less from differences in productivity. Over the period 2000-2008, nominal compensation per employee rose by 34% in the Netherlands compared to 25% in France and Belgium and only 14% in Germany (see Graph III.11.3). Since it is difficult to increase productivity through the implementation of new policy measures, at least in the short run, policy makers tend to plead for wage moderation when

competitiveness needs to be improved, as experienced in 2003 when the above-mentioned autumn agreement was reached and led to a competiveness gain of the Netherlands in 2005.

Wage behaviour affects not only competitiveness, but also public finances. For the Netherlands, this effect is very important, as social benefits are directly linked to wage developments. Lower wage growth not only has a positive effect on public finances through the government wage bill, but it also automatically leads to lower social benefits. These combined effects dominate the negative effect from lower income tax.

Against this background, wage moderation was presented as one of the pillars of the exit strategy for the high current deficit levels by the Dutch government in their third stimulus package in March 2009. The incidence of wage moderation will depend largely on the social partners([112]), but it can be expected that some wage moderation will take place due to the rapid loosening of the labour market. Since wage agreements tend to be set for one year or more, their effects are expected to hold for 2010 and 2011.

Due to the severe recession, nominal unit labour costs increased in 2009 by around 5%, above the euro area average of around 4%. This is the result of the combined effect of a lagged labour market response to the crisis, resulting in lower productivity, and the still relatively strong wage growth. As unemployment is set to increase sharply in 2010 and the effect of wage moderation is expected to hold notably in 2011, unit labour costs are predicted to stabilise in 2010 and to decrease in 2011. Due to the strong increase in nominal unit labour costs, the high trade surplus in the Netherlands fell by around 1 pp. in 2009, although it still remained in considerable surplus (7¼ % of GDP) partly as a result of the downward pressure on imports from the expected muted domestic demand. In 2010 and 2011, a recovery in the trade balance is foreseen as domestic demand remains weak and the rising trend in unit labour costs is expected to be reversed.

([112]) In The Netherlands, collective wage contracts are negotiated between labour unions and employers' organisations. Collective wage contracts typically refer to a single firm or an industry. Moreover, regular discussions between social partners take place within the framework of the Labour Foundation (STAR) and the Social Economic Council (SER) and between social partners and the government.

11.4. THE NEED FOR ADJUSTMENT ([113])

The openness of the economy made the Netherlands particularly vulnerable to the sharp drop in world trade as a result of the global economic crisis. The significantly positive trade balance in 2008 indicated that the Netherlands had a relatively favourable competitive position. This resulted partly from a stable and even slightly increasing market share in world exports over past years, although this came mainly from a strong growth performance of re-exports, which have a relatively low added value. Looking more closely at competitiveness indicators, it emerges that Dutch cost competitiveness has been deteriorating since 2000. This is also the case, though the deterioration is more limited, for price competitiveness, possibly indicating diminishing profit margins. From a euro area perspective, this loss in competitiveness in past years can be seen as contributing to an adjustment of external imbalances.

Growth of nominal compensation per employee in the Netherlands has been relatively high compared to its main trading partners and is the main reason for the loss in cost competitiveness over the past few years. The policy of wage moderation conducted in 2004 and 2005 largely brought cost competitiveness back in line with the country's main trading partners. The government has announced its intention to pursue a renewed policy of wage moderation. While this may have favourable effects on employment in tradable sectors and public finances, it may result in some downward pressure on real disposable income, which is the main driver behind private consumption. Regarding productivity, a weakness has been identified in the levels of both public and private R&D expenditures. The Dutch government has responded to these challenges by a set of initiatives such as the Innovation Platform and the innovation voucher scheme. Results, however, have remained modest thus far.

([113]) The text which follows, including policy challenges, draws, *inter alia*, on already issued policy invitations and recommendations under various Community instruments, such as the updated Stability Programme, the EDP recommendations and the strategy for growth and jobs.

In view of the Netherland's competitiveness in the euro area and its current account surplus, adjustment in the context of the euro area would be facilitated by a particular focus on strengthening the sources of domestic demand.

Against this background and in view of the relatively high increase in unit labour costs above the euro area average in 2009, policy efforts should aim at maintaining cost competitiveness by attenuating the rise in relative unit labour costs. At the same time, wage moderation alone is not a promising long-term strategy, given its dampening impact on domestic demand. A further increase in R&D spending and innovation should lead to higher productivity growth (and therefore lower unit labour costs) and would help to shift Dutch exports towards more high-technology-intensive products where competition is more limited. It is important that the reform efforts are continued in order to counterbalance possible downward pressure on R&D investment resulting from the difficult economic circumstances. In addition, there is a need to ensure that wages evolve in line with productivity developments. In the area of the labour market, possible structural reforms include: simplifying the dismissal system to make it more predictable as well as increasing labour supply through a reduction of disincentives to take-up work and to work longer, especially with respect to women, the elderly, and disadvantaged groups.

12. AUSTRIA

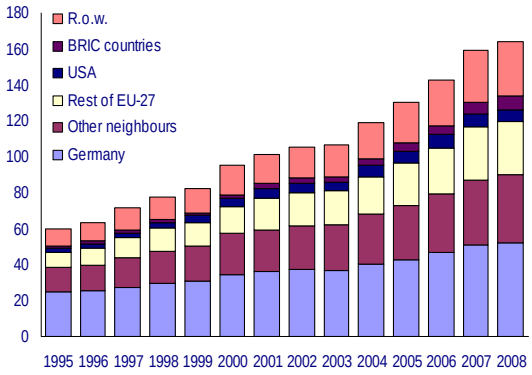
12.1. SETTING THE STAGE: FOREIGN TRADE CHARACTERISTICS

Austria's good overall economic performance during the last one and a half decades was to a large extent due to favourable developments in the country's exports. On average, net exports contributed close to ¾ of a percentage point per year to GDP growth. Austria's foreign trade is characterised by three main features. First, there is a close link with the German economy, which was further reinforced by Austria's accession to the EU in 1995. Second, Austria benefited more than other Western European countries from the opening-up of the markets of Central-Eastern and South-Eastern Europe (CESEE) in the course of the enlargement of the European Union in 2004 and 2007. Third, Austria has traditionally earned a sizable net surplus in cross-border services mainly due to its tourism sector. The surplus in the trade balance is a more recent phenomenon, which has come about as a consequence of dynamic growth in the transition economies in Austria's neighbourhood and improved cost competitiveness, but also due to a relatively restrained domestic demand.

While total exports constituted 35% of GDP in 1995, they reached more than 62% of GDP at the end of 2007, but fell almost 54% in 2009. Between 1995 and 2008, the share of exports of services in GDP increased by 50%, while that of goods exports almost doubled. For imports, a similar but somewhat less dynamic pattern can be observed. As a consequence, the overall trade balance improved steadily over this period, turning to a surplus from 1998 onwards.

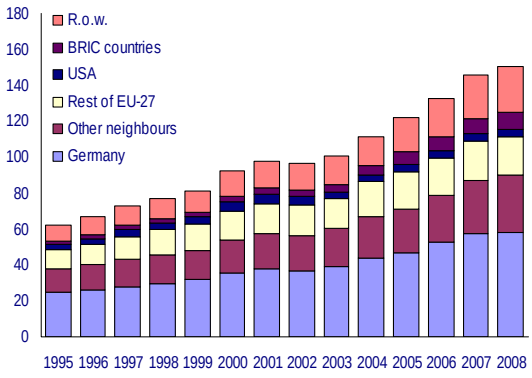
Since 1995, the degree of openness (total exports plus imports in volume terms as a % of GDP) has increased by 45 pps, reaching 118% in 2007 (compared with 93% for Germany and 88% for the euro area average), and Austria managed to increase its market share in world exports. As a consequence of the global financial and economic crisis, international trade collapsed, leading to a decrease in openness in 2009. The value of Austrian goods exports started to decline in the fourth quarter 2008 and dropped dramatically in 2009 (almost -18%). As the drop in imports was less pronounced, the trade balance for goods swung into deficit once again. However due to strong net earnings on services trade, the external balance of goods and services stayed in surplus, albeit substantially reduced.

Graph III.12.1: **Total exports by region (billion €)**



Source: Oesterreichische Nationalbank (OeNB), Balance of Payments Statistics.

Graph III.12.2: **Total imports by region (billion €)**



Source: Oesterreichische Nationalbank (OeNB), Balance of Payments Statistics.

In terms of geographical structure, Austria's foreign trade is largely concentrated on its eight direct neighbouring countries, which absorbed more than 55% of exports and supplied more than 63% of imports in 2008 (Graphs III.12.1 and III.12.2). Germany clearly dominates as a destination for Austrian exports, accounting for 32% of all exports, even if this reliance has diminished somewhat (from 41.6% in 1995). With over 39% in 2008, the imports share of Germany has remained almost unchanged over the last 15 years. The high figures reflect the tight links in the

supply chains of (South) German and Austrian companies, notably in the automotive and electronics industry. With around 40% of overnight stays, German tourists remain dominant in Austrian services exports. The slight diversification of trade away from Germany is due to the dynamic increase in exports to the new EU Member States of Central and South Eastern Europe in recent years. These economies now account for 17.5% of total exports, reflecting a certain revival of Austria's role as a hub for Central and Eastern Europe.([114]) With a share of 7.5%, Italy is Austria's second largest trading partner, followed by the US and Switzerland (both around 4%). Trade with China currently amounts to only 1% of exports suggesting a potential for further development. In this regard, Austria is held back, however, by the preponderance of small and medium-size enterprises and the absence of large multi-national companies. This also explains why Austria's trade is still concentrated on neighbouring countries, as entering overseas markets (like e. g. China or India) generally exceeds the capacity of small companies. Conversely, China has strengthened its position in the Austrian market in recent years. With a share of 4.2%, China (together with Switzerland) is the third most important origin for Austria's goods imports.

In terms of product categories, Austrian goods exports are dominated by machines and vehicles, which make up more than 40% of the total value of exports, followed by processed materials (almost 25%), notably of iron and steel. Taken together, these two categories (SITC 5 – 6) make up 65% of all Austrian goods exports. In 2009, the export value of these product categories declined by 30% (passenger car exports: -45%). This country–product–mix has rendered the Austrian economy more vulnerable to the current crisis, as Austria's major export markets, and the product categories in which Austria is specialised, were affected most by the slump of world trade in 2008 and 2009.

Outward and inward foreign direct investment stocks increased strongly in the last decade (outward stock by 590% and inward stock by 400%) and the excess of inward FDI over outward stocks shrank from 57% to 5%. Compared with the EU average, however, the Austrian economy still appears less open in this regard.

12.2. INDICATORS OF COMPETITIVENESS

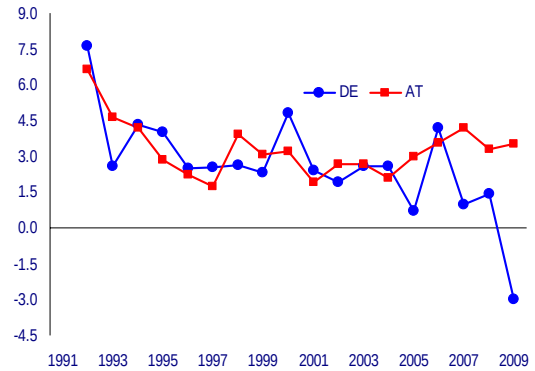
As a small, highly open economy, growth prospects in Austria crucially depend on the external competitiveness of goods and services produced. The close ties to the German economy have led to Austrian wage-setting being closely aligned with developments in its most important trading partner. Therefore, Austria's competitive performance over the last decade and a half has paralleled that of Germany - with the notable difference that Austria's domestic demand proved more robust, as it did not have to bear the costs of reunification.

Graph III.12.3 presents evidence of how Austria's performance shadowed both Germany's high wage agreements in the early nineties and wage moderation since 1995. However, in the last few years, wages grew relatively faster in Austria as productivity growth was stronger and a shortage of skilled labour became an issue for manufacturing firms. Like Germany, Austria also saw a turnaround in its current account balance. From a deficit of around 3% of GDP in the mid-1990s, Austria moved to a current account surplus of over 3½% in 2008 (Graph III.12.4). The surplus then edged down in 2009 in the wake of the crisis.

In relation to the rest of the euro area, four indicators of the real effective exchange rate (those based on the deflator of private consumption, the GDP deflator, the export price deflator and ULC for the total economy) show a partly mixed picture (Graph III.12.5). Until the first few years of the new millennium, an effective depreciation was observed followed by a period of a more or less stable REER up to 2008. The most significant depreciation took place in the REER based on ULC, in line with the subdued growth of wages in Austria and average productivity increases above the euro area level in the last decade. Since 1995, real output per employee has risen by about ½ pp. faster in Austria on average than in the euro area.

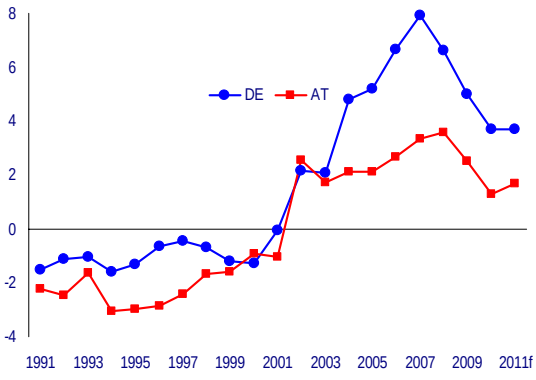
([114]) For further details, see Ragacs C., Vondra K., "Austria's Exports to Eastern Europe: Facts and Forecasts - Likely Impact of Slowing Exports on Growth in Austria", Oesterreichische Nationalbank (OeNB), Monetary Policy and the Economy, Q1/2009, pp 29-43.

Graph III.12.3: **Nominal compensation per employee in manufacturing (annual % change- until 1995 West Germany)**



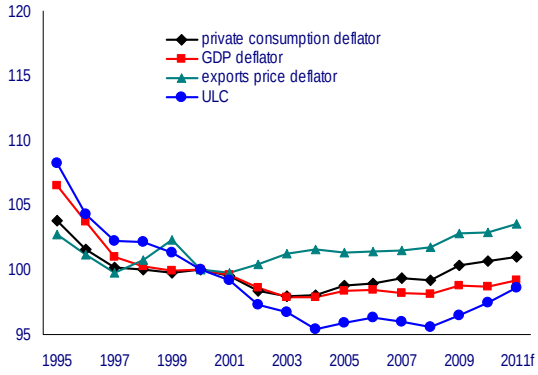
Source: Commission services.

Graph III.12.4: **Current account in % of GDP**



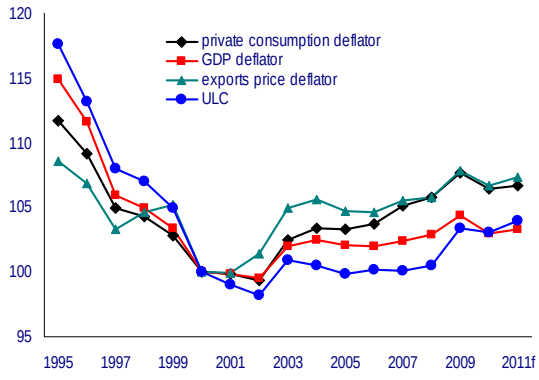
Source: Commission services.

Graph III.12.5: **Real effective exchange rates compared with rest of euro area**



Source: Commission services.

Graph III.12.6:: **Real effective exchange rates compared with 35 trading partners**



Source: Commission services.

Explaining the increase in the REER based on export prices since 2002 is not straightforward. Given that the rise in relative export prices has been accompanied by a minor gain of market shares and an improvement in the relative labour cost position, thus does not point to a loss in competitiveness. However, as terms of trade worsened, the rise in relative export prices may be the result of an increase in intermediate input prices. Whether the rise in relative export prices may also be linked to an increase in exports of higher quality products and/or a rise in Austrian exporters' profit margins is not clear based on the available evidence.([115])

With regard to the IC35 benchmark (Graph III.12.6), the picture is slightly different. Here, three REER indicators, apart from that based on ULC, show a loss in competitiveness, in line with the nominal appreciation of the euro. However, in spite of the strong euro, the REER based on ULC remained more or less unchanged between 2000 and 2008, bearing witness to Austria's much less dynamic wage developments compared with other industrialised countries.

([115]) It should be noted that the reliability of the export price deflator for Austria suffers from (i) the difficulty of measuring quality changes; (ii) Austrian export price indices are partly adapted from German trade data fitted to the Austrian trade basket; and (iii) underreporting is likely to have increased since 2002, which coincides with the significant deviation of the export price deflator from the other deflators.

Table III.12.1: **Austria's outward FDI position in CESEE in 2007**

	(1)	(2)	(3)	(4)		(1)	(2)	(3)	(4)
EU-10 [a]	33. 71	32. 9			**CESEE-9** [b]	17.4	17.0		
Slovenia	2.1	2.1	44.7	1	Croatia	10.5	10.2	34.2	1
Romania	9.2	8.9	21.4	1	Bosnia-Herzegovina	1.6	1.5	34.2	1
Bulgaria	6.6	6.4	20.2	1	Serbia	1.3	1.2	15.6	2
Slovak Republic	4.3	4.2	14.2	3	FYROM	0.2	0.2	9.4	4
Hungary	7.4	7.2	13.0	3	Ukraine	1.7	1.7	6.8	4
Czech Republic	7.6	7.4	10.7	3	Montenegro	0.2	0.2	7.1	5
Poland	3.5	3.4	3.6	9	Albania	0.0	0.0	2.3	6

(1) Austrian outward FDI in Billion € (2) Share in % of Total Austrian FDI stock (3) Share of Global FDI Stock (4) Global Rank a) EU-10: Bulgaria, Estonia, Latvia, Lithuania, Poland, Czech Republic, Rumania, Slovak Republic, Slovenia, Hungary b) CESEE-9: Albania, Belarus, Bosnia Herzegovina, Croatia, FYROM, Moldavia, Russia, Serbia Montenegro, Ukraine
Source: OeNB, FIW, WIFO.

he loss of competiveness based on the ULC indicator for the total economy for the period 2009 onwards is due to two effects. On the one hand, wage settlements negotiated in autumn 2008 for 2009 took into account the higher rate of inflation and the high productivity growth of the previous years. On the other hand, due to the severe recession, economic activity fell sharply in 2009, but as government policy measures were shielding the labour market, the decrease in employment was less pronounced. As a consequence, productivity dropped sharply, while unit labour costs rose. However, the increase in ULC is overstated to some extent as part of wage costs for employees in short-time work is borne by the government.

12.3. SPECIAL FOCUS: AUSTRIAN FDI IN THE CENTRAL AND EASTERN EUROPEAN COUNTRIES

An important element of Austria's trade performance is due to the opening up of Central and Eastern Europe, which affected the Austrian economy more than most other Western European countries. Based on model simulations, the fall of the iron curtain and EU Eastern enlargement had positive effects on exports and growth as well as (but to a lesser extent) on employment, whereas real wages per capita and inflation were held back.([116])

Trade figures as presented in Section 1, however, underestimate the importance of the economic relationship with Central and Eastern European countries, as Austrian firms have developed into major foreign investors in the new EU Member States, as well as in the successor states of former Yugoslavia (Table III.12.1). Almost one-third of the Austrian FDI stock has been invested in the new EU-10 states, with the biggest shares in Romania, the Czech Republic, Hungary and Poland and 17% in CESEE-9 countries (see footnote b in Table III.12.1 for a definition). Of even greater importance (71%) is Central and South Eastern Europe in terms of the number of persons employed by Austrian FDI. Austria's strong position as an investor in this region is also emphasised by the market shares of Austrian FDI (Table III.12.1, column 3 and 4). In five countries, Austrian companies are the most important investors.

As shown in Table III.12.2, Austria's outward foreign direct investment is to a large extent concentrated in the services sector (74%), most notably in the banking and insurance industry and real estate, renting etc. which make up one-third and more than one-fourth of total outward FDI. Although the production sector roughly accounts for only one-fourth of the FDI outward stock, 55% of those persons working for Austrian direct investors abroad are employed in this sector.

While Austria has lost some of its first-mover advantage, Austrian enterprises still benefit strongly from their presence in the CESEE region. The apparent profitability (measured as return on equity) of these investments in the EU-10 and CESEE-9 is quite high, exceeding 15% on invested capital in 2006, compared with only 5.8% for

([116]) For further details see: Bayerl, N., Fritz, O., Hierländer, R., Streicher, G., "Exports, Services and Value Added - A National, International and Regional Analysis for Austria", FIW Studie Nr. 008/2008; Breuss F., "Ostöffnung, EU-Mitgliedschaft, Euro-Teilnahme und EU-Erweiterung, Wirtschaftliche Auswirkungen auf Österreich", WIFO Working Papers 270/2006; Breuss F., "Erfahrungen mit der fünften EU-Erweiterung", WIFO-Monatsberichte, 12/2007, S. 933-950.

Austrian outward FDI in the EU-15.([117]) An international comparison is hampered by the non-availability of a breakdown of data by region. According to an alternative measure of profitability – total income from outward foreign investment according to balance of payment statistics as a percentage of the end-of-the-year outward FDI stocks – outward FDI activities of Austrian firms (8.6%) were more profitable than comparable activities of the EU 15 (6.7%).

The main motive to invest abroad appears to be market entry to increase sales (market seeking), in particular for companies in the services sector. For manufacturing firms the reduction in production costs (efficiency seeking) is also of some importance, but market-seeking motives clearly dominate.([118])

Table III.12.2: **Sector structure of Austrian outward FDI - all countries in 2007**

in € bn	in %	
102.58	100.0	**Services**
26.93	26.2	Trade and repair
4.49	4.4	Banking, Insurance
20.27	19.8	Real estate, renting, IT, R&D
2.17	2.1	Other services

Source: OeNB.

Empirical evidence on the costs and benefits, which the Austrian economy might have drawn from FDI in its Eastern neighbours, is scarce. Falk and Wolfmayr (2009) find that foreign activities do not have a negative impact on the employment and turnover of domestic activities of the parent company. Their analysis of Austrian multinational companies reveals a small positive relation between employment change in the parent company and employment change in all foreign affiliates.([119])

Following the financial and economic crisis, investment projects in CESEE are expected to yield (much) lower returns as well as to bear a higher associated risk. As a result, the strong increase in outward FDI flows, as witnessed by Austrian companies in the region in recent years, lost much of its dynamism in 2008 and almost came to a halt in 2009. Furthermore, as international financial investors' risk aversion to CESEE countries rose sharply, the strong engagement of Austrian banks in this area changed into a critical international reassessment. Austrian banks directly, and via their CESEE subsidiaries as well as in their role as financial intermediaries for Austrian firms investing in CESEE, are (also in absolute terms) the largest foreign lenders to CESEE. Reflecting expectations of an increase in credit defaults and a decrease in the return on equity for the FDI stocks held by Austrian banks, share values of the latter dropped sharply and risk premia on their credit-default swaps went up. However, as indicated by stress tests carried out by Austrian financial market surveillance authorities, the Austrian financial sector is still in a solid position.

12.4. THE NEED FOR ADJUSTMENT ([120])

External competitiveness is of the utmost importance for the growth prospects of a small, highly open economy like Austria. With a depreciating real effective exchange rate and a solid current account surplus for almost ten years, Austria's competitive performance over the last decade and a half has paralleled that of Germany - with the notable difference that Austria's domestic demand proved more robust, as it did not have to bear the cost of reunification. This is unsurprising since close ties to the German economy have led to Austrian wage-setting being closely aligned with developments in its most important trading partner. More recently, the dramatic fall in external demand that took place in 2008 and 2009 had a severe impact on export-led growth in Austria. Being highly concentrated on machines, vehicles and processed materials, Austrian exports were particularly hard hit by the global downturn. In 2009, unit labour costs increased for two reasons. On the one hand, wage settlements negotiated in

([117]) See: Sieber S. "Grenzüberschreitende Direktinvestitionen in und aus Österreich" in: FIW (2008), Österreichs Außenwirtschaft 2008, Vienna December 2008; OeNB, Statistiken, Direct Investment 2007, September 2009.

([118]) OeNB, Statistiken, Direct Investment 2007, September 2009, Table X.

([119]) For further details see: Falk M., Wolfmayr Y., "Home Market Effects of Outward FDI: Evidence Based on Amadeus Firm-Level Data" in: Tondl G., "The EU and Emerging Markets", European Community Studies Association of Austria, ECSA Austria Publication Series Vol. 12, Vienna March 2009.

([120]) The text which follows, including policy challenges, draws, *inter alia*, on already issued policy invitations and recommendations under various Community instruments, such as the updated Stability Programme, the EDP recommendations and the strategy for growth and jobs.

autumn 2008 for 2009 were based on the higher rate of inflation and the high productivity growth of the previous years. On the other hand, due to the severe recession, economic activity fell sharply in 2009, but as government policy measures were shielding the labour market, the decrease in employment was less pronounced. As a consequence, productivity fell sharply. Government policy measures to shield the labour market can only be a temporary strategy which needs to be supplemented by productivity-enhancing reforms. Should Austria succeed in raising productivity and potential growth more strongly, wages would be allowed to show a more dynamic behaviour, thereby helping to sustain domestic demand. Overall, the main medium- to long-term challenges for Austria to maintain competitiveness and growth in global markets will be to keep up with technological progress.

In view of Austria's strong competitiveness in the euro area and its current account surplus, adjustment in the context of the euro area would be facilitated by a particular focus on strengthening the sources of domestic demand.

Against this background Austrian efforts should continue to enhance structural competitiveness by shifting output production to higher value-added goods and services. This may be achieved through, *inter alia*, strengthening the translation of research results into innovation and production of goods and services of the highest quality segments. This involves productive investment in physical and human capital such as supporting R&D expenditures, in particular for small and medium sized enterprises, and improving the education system at all levels, in particular at the tertiary level.

13. PORTUGAL

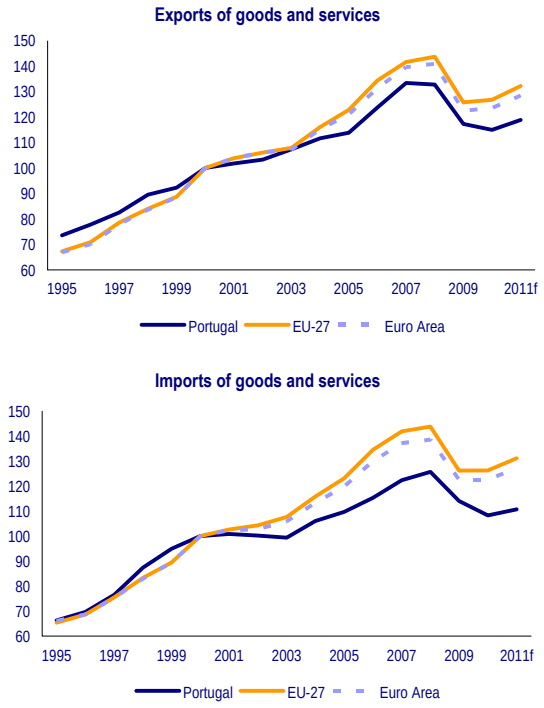
13.1. SETTING THE STAGE: FOREIGN TRADE CHARACTERISTICS

Since the beginning of the current decade, the openness of the Portuguese economy has been on a slight upward trend, yet below the corresponding averages for the euro area (EA) and EU countries. In 2008, the sum of Portuguese exports and imports was 84% of GDP, against around 88% of GDP for the latter two area averages. This contrasts with the patterns observed in the previous decade, when Portugal's trade openness was somewhat above the EA and EU averages and reflects weaker growth of both exports and imports. As regards openness to FDI, the sum of inflows and outflows averaged some 3% of GDP between 2001 and 2007, with inflows roughly balancing outflows over this period.

Growth in Portugal's exports of goods and services has been relatively contained and below the EA and EU averages for most years of the current decade apart from 2006 and 2007. Overall, for the decade up to 2008, exports volumes grew in cumulative terms by less than 33%, compared with 40% for the EA average (Graph III.13.1, left panel). Imports expanded by less than exports over this period: total imports rose by slightly less than 26% up to 2008, against 40% for the EA country average (Graph III.13.1, right panel). This was a consequence of sluggish demand in Portugal in these years after the demand buoyancy of the late nineties.

Exports of goods account for around ¾ of Portugal's total exports. This export structure is marginally tilted more towards services than the average for the EU and, especially, the EA countries. In addition, the weight of exports of services in Portugal's total exports has been increasing in a slow but relatively steady way, while the sluggishness of goods trade seems to underlie Portugal's weaker export performance (Graph III.13.2). Concerning geographical markets, Portugal's trade has been concentrated in a small number of the EU's largest markets; in total, trade with the rest of the EU accounts for almost ¾ of Portugal's exports and imports. Amongst these, Spain has clearly been the most important destination for goods exports (almost 27% of the total in 2008), followed by Germany and France with 14% and 13%, respectively. The geographical distribution of services exports is relatively similar, although the UK has maintained its traditional role as a major client for such exports. An increasing presence in the new markets of the recently-acceded Member States and in countries outside the EU has been observed during this decade.

Graph III.13.1: **Trade performances in Portugal, euro area and EU averages (2000=100)**

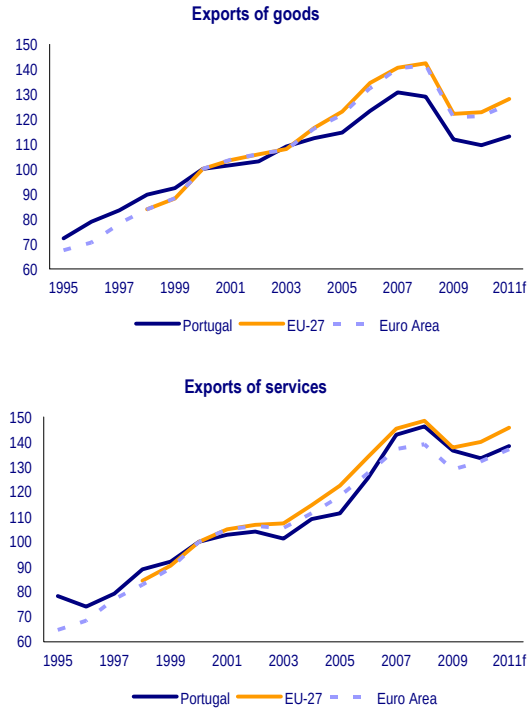


Source: Commission services.

The current international crisis has particularly hurt Portugal's trade activity. In 2008, export volumes diminished by ½% under the effects of the slump in world trade in the final part of the year. However, exports were cooling visibly already since early 2008. At the same time, imports retained some dynamism in 2008, reflecting an upswing in domestic demand, especially in equipment investment. In the first half of 2009, imports and more particularly exports fell sharply. As in many other economies, trade in goods is clearly adjusting more than trade in services. For 2009 as a whole, exports of goods and services fell by around 11½% in volume terms

and imports by over 9%, both slightly lower than the averages for the EA countries.

Graph III.13.2: **Export performances: goods versus services (2000=100)**



Source: Commission services.

The external sector has on average provided a neutral contribution to GDP growth over the current decade, yet with visible differences over time. For instance, contributions were positive in the earlier years of the decade, thanks to import retrenchment and to strong export growth in 2006, whereas the contribution was negative in 2004-2005 and in 2008 as a result of poor export performance and some import resilience. In 2009, the contribution of external trade is estimated to have been essentially neutral to GDP growth.

The balance of goods has recorded deficits averaging some 10% of GDP in the current decade, after 9¼% in the second half of the nineties. In 2008 alone, the deficit reached 12% of GDP reflecting the gap between growth in exports and imports in volume terms and hikes in commodity prices. In 2009, against the backdrop of the crisis, it narrowed only slightly to 10% of GDP. By contrast, the services balance has posted slightly growing surpluses averaging 1¾% of GDP since 2000 and reaching 2½% of GDP in recent years due to a retrenchment of imports in the early 2000s' as well as an expansion of exports after the middle of the decade.

13.2. INDICATORS OF COMPETITIVENESS

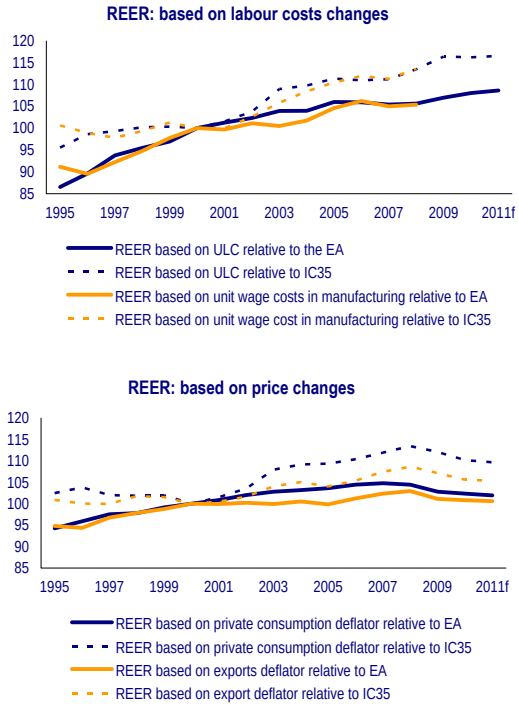
Various indicators of the real effective exchange rate (REER) – namely those based on the deflator for private consumption, the export price deflator and unit labour costs growth (ULC) – have exhibited an upward trend vis-à-vis the rest of the EA and especially against a broader group of 35 industrialised economies (IC35) since at least the mid 1990s (Graph III.13.3). The degree of appreciation is more evident in terms of ULC for the overall economy, which have grown by 20 pps in excess of the EA average since 1995. In the first half of the present decade, the rate of growth of both productivity and wages slowed down considerably, but ULC still continued to grow somewhat more rapidly than in the country's trading partners.

Most indicators point to a possible halt in the trend deterioration in cost competitiveness losses in relation to the EA around 2006, with various measures of the REER being roughly stable thereafter.([121]) Yet this has not been the case relative to IC35 as the real appreciation has continued in the range of 10-15% since the year 2000, mainly due to the euro's appreciation. In addition, the current crisis seems to be leading to the re-emergence of Portugal's labour cost growth differential vis-à-vis the rest of the EA. Furthermore, estimates of the equilibrium exchange rate suggest that Portugal's real effective exchange rate has been overvalued with respect to

([121]) These figures have to treated with some caution to the extent that compensation of employees for the whole economy reflects two different phases of compensation of government employees: up to 2005, compensation of the latter was growing well above the rest of the economy (i.e. essentially, the private sector) whereas the opposite occurred in some later years. Furthermore, over most of this decade, the strong growth in government personnel spending was more related to government deficit-covering payments to the public employees' pension scheme than to public wages and employment – even if they do not affect the wage costs of the private sector. In addition, it is worth bearing in mind that while for most of the EA productivity growth is measured on a full-time-equivalents basis, in the case of Portugal it is based on number of persons.

equilibria benchmarks by one of the largest margins in the EA.

Graph III.13.3: **Real effective exchange rates vs. the euro area and IC35 (2000=100)**



Source: Commission services.

A picture of adverse competitiveness developments is also provided by the evolution of export market shares. Indeed, Portugal's share in global goods exports followed a clear downward path, declining from 0.44% in 1995 to 0.36% in 2008, which is a more pronounced loss than for the average of all EA countries. Portugal's weight in EA exports declined more or less continuously in the nineties and again sharply in 2004 and 2005.

In addition to adverse cost developments vis-à-vis industrialised countries, other aspects appear to have hampered the performance of the external sector in past years. Notably, Portuguese exports of goods have relied to a considerable extent on labour-intensive products ─ well in excess of the euro area average ─ in which emerging economies tend to have a strong comparative advantage thanks to their low labour costs.([122]) Whilst considerable differences vis-à-vis the EA persist, Portugal's goods export sector has undergone considerable restructuring and convergence towards the average EA pattern in recent years, with a marked decline in the importance of labour-intensive exports. Such a fall was closely linked to the dynamics of trade in textiles and clothing, where exports have fallen by an annual average rate of 1% since the early nineties, leading to a decline of their weight in goods exports from almost 30% in 1996 to around 10% in 2008.([123]) In fact, excluding these goods, Portugal's exports performance was comparable to that of the rest of the EA. Nonetheless, during the crisis, this specialisation does not seem to have been an aggravating factor. In fact, there is some evidence that exports of various labour-intensives types of goods declined less than total exports, possibly due to more inelastic demand. At the same time, trade has been concentrated on a small number of EU markets, where growth has been below the world average, thereby limiting the growth in demand.

13.3. SPECIAL FOCUS: THE EXTERNAL BALANCE BEYOND THE BALANCE OF GOODS AND SERVICES ─ THE IMPORTANCE OF TRANSFERS AND PRIMARY INCOME IN PORTUGAL'S EXTERNAL BALANCE

For many years, Portugal has recorded sizeable external deficits. In the present decade, the current account deficit has averaged 9½% of GDP (compared to 6% of GDP in the late nineties) and was at 10½% of GDP in 2009. A striking feature is the recording of large deficits in this decade despite sluggish demand, as economic activity has

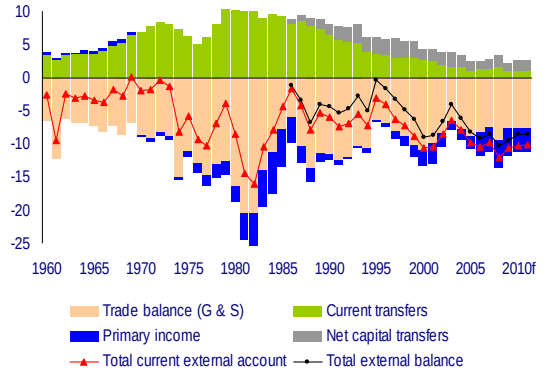
([122]) It can be argued that competition from emerging economies is not fully captured by some standard cost-based competitiveness indicators to the extent that: first, only recently have some of these countries become integrated into world trade; second, real effective exchange rates vis-à-vis industrial economies exclude, by definition, emerging economies; third, standard indicators are based on growth rates rather then levels of wages and prices; and, finally, the structure of trade may differ between trade partners. For a more detailed discussion on this matter see, e.g. di Mauro, F. and Forster, K. (2008), *Globalisation and the competitiveness of the euro-area*. ECB Occasional Paper Series, No. 97.

([123]) In addition, intra-sector adjustments seem to have also taken place as reflected in gains in terms of trade inside some sectors, especially in more labour-intensive sectors such as textiles, clothing and footwear (Cardoso, F. and Soares Esteves, P. (2008), *What is behind the recent evolution of Portuguese terms of trade?* Bank of Portugal, Working paper, No. 5/2008).

been expanding by a meagre ½% per year. The objective of this section is to shed light on some items of Portugal's external balance other than the trade balance (goods and services) – transfers and primary income balances – and their roles in the evolution of the overall external balance.

An analysis of Portugal's external imbalances and its components over the past five decades (Graph III.13.4) gives rise to a number of observations. First, Portugal's external imbalances have been persisting for a long time. Second, for a number of decades, large trade deficits have registered close to double-digit figures. Third, the trade deficits that have been recorded after the creation of the euro area do not differ substantially from earlier ones, e.g. throughout the early and mid nineties. Fourth, still more striking has been the downward trend in the surpluses on current transfers since the early nineties and the rising importance of primary income deficits since the late nineties, both of which have aggravated external borrowing needs.

Graph III.13.4: **A long-term view of Portugal's external account (% of GDP)**



Source: Commission services.

Portugal has historically recorded a large surplus in transfers, which has considerably offset the trade deficits since the late 1960s. Graph III.13.4 shows the importance of current transfers, which reached an average of 7½% of GDP in the 1970s and 1980s, largely owing to migrants' remittances, in a situation that was somewhat unusual among the current EA countries. However, the gradual decline in the importance of remittances has led to a downward trend in the current transfers' surplus, which may have resulted from a change in the differential between asset remuneration in Portugal and abroad, as well as from changes in migration flows in recent decades. In addition, capital transfers – comprising mainly EU transfers – have been significant and the highest in the EA (on average, almost 2% of GDP since mid-1980s). Overall, capital transfers have been more stable than their current counterparts.([124])

Another aspect of the evolution of Portugal's external account over the past 15 years is the growing deficit in the primary income balance, which has become a major component of the overall external deficit. In the current decade, this deficit has averaged 2¾% of GDP, reaching 4% of GDP in 2008. This increase reflects the remuneration paid on the rising (net) stock of external liabilities, which has been growing continuously and surpassed 110% of GDP in 2009 (from 4% of GDP in 1995 and 41% of GDP in 2000). These developments reflect past external deficits which, for more than a decade, have been financed by portfolio and other investments. Roughly ¾ of the primary income outflows constitute remuneration of portfolio and other investments whereas the remaining ¼ is remuneration of FDI.

To sum up, major changes have occurred in the transfers and primary income balances for more than a decade, which have contributed to the high external deficits. Notably, current transfers have offset a gradually smaller share of the chronically large trade deficit, whereas the recourse to external liabilities has become more important. The need to service the stock of external liabilities has led to a certain degree of inertia. Going forward, whereas improving competitiveness, i.e. strengthening the ability to successfully compete in world markets, is necessary to improve the trade balance and to boost GDP, it may not be mapped onto commensurate falls in the external deficit to the extent that the burden of servicing growing liabilities will also rise, thereby offsetting a

([124]) The large capital inflows in the case of Portugal favours use of the broader concept of external deficit, instead of the narrower current account, at least as far as external financing needs are concerned. At the same time, on the basis of the evidence on the historically high trade deficit counterbalanced by large transfers, a more fundamental question could be raised on the appropriateness of the relation between the level of Portuguese and foreign prices – i.e. the exchange rate – at the time of adopting the euro with a view aligning spending and income or savings (excluding transfers from abroad) and investment.

possible correction of the trade balance. In addition, gross national income will fall behind GDP by a growing margin due to the growing external debt service burden.

13.4. THE NEED FOR ADJUSTMENT ([125])

Portugal's external imbalances remain large and the current crisis has led only to a small narrowing of these imbalances. Even if the Portuguese economy has fared slightly better than the EA as a whole in terms of the initial impacts of the crisis, adjustment needs continue to be rather sizeable. The adjustment path will depend on several factors, both external, hence largely exogenous, and internal and consequently reflecting domestic conditions and policy options. Concerning the former, despite the effects of the uncertainty of external demand on export performance, it cannot be ignored that the increase in and the persistence of external deficits have been made possible by rather benign financial conditions. In fact, the near- and medium-term path for the large savings-investment gap will crucially depend also on the financial conditions that prevail from now on. The remainder of this section highlights internal aspects of the current situation and of the needed adjustment.

Portugal's competitiveness position still reflects past adverse developments. Not only have costs and prices grown in excess of those of trading partners, but exports performance has been hampered by a still relatively high dependence on labour-intensive export sectors, where competition is fierce, and have suffered also from a high concentration in EA markets that have grown by less than the world average. More recently, these patterns have been changing somewhat, with costs and prices developments better aligned with the rest of the EA, a further move away from labour-intensive exports, and a stronger presence in fast-growing markets. Yet the gaps that need to be bridged remain large.

Besides chronic high trade deficits, the external deficit has been reflecting a downward trend in the current transfers' surplus and an upward trend in the primary income deficit. At the same time, the continued high external deficits have led to the accumulation of external liabilities that have now reached 110% of GDP. This is a non-negligible element to take into account as the servicing of these liabilities will continue to absorb a large and rising share of income over the medium term, thereby creating considerable friction in the process of narrowing the overall deficit. Whereas the deeper financial markets facilitated by euro area membership have clearly averted the disruptive correction of external imbalances, the economic and financial crises, by highlighting the difficulties that may derive for borrowers from changes in financing conditions, have emphasised the need to address these issues. From a longer-term perspective, the narrowing of the external imbalance will depend upon sustained gains in competitiveness and the subsequent correction of the persistent deficit in the balance on goods and services.

In view of Portugal's weakened competitiveness in the euro area and its persistent current account deficit, adjustment in the context of the euro area would be facilitated by relative price and cost adjustments and a shift of resources from the non-tradable to the tradable sector.

Against this background, efforts should aim at producing sustained gains in competitiveness, leading to a correction of the long-lasting deficit in the balance on goods and services. Given Portugal's differentials in productivity vis-à-vis the euro area, this should be achieved by lifting productivity growth in a sustained way, which will support competitiveness in international markets as well as boost potential GDP growth. Productivity may be enhanced in a sustained manner through, inter alia, fostering further structural change towards higher valued-added activities, and investment in human (e.g. by improving the education system and the lifelong learning system, and enhancing access to training and qualifications, in order to increase the labour force's average skills level) and physical capital. Prices and costs moderation is also needed. Unit labour costs may also be contained by improving labour market functioning, wage moderation and fostering wage behaviour that takes due account of productivity developments. In the area of the labour market, possible structural reforms include:

([125]) The text which follows, including policy challenges, draws, *inter alia*, on already issued policy invitations and recommendations under various Community instruments, such as the updated Stability Programme, the EDP recommendations and the strategy for growth and jobs.

implementing recent reforms on the modernisation of employment protection legislation, in order to avoid increasing duality in the labour market between conditions for permanent versus temporary contracts; improving the effectiveness and efficiency of public employment services and moving ahead with the proposal to reform active labour market policies, including a better link with training programmes. There is also a need to improve product market functioning (e.g. network industries, services, regulated services) and the business environment and reduce administrative burdens with a view to allowing a more active role for competition in the allocation of resources as well as containing price pressures and facilitating structural adjustment. In addition, domestic spending moderation is important for containing external imbalances by dampening imports, as structural changes on the supply side often take time to bear fruit. In this respect, the government sector can help in bridging the gap between domestic savings and investment by reducing its own large borrowing needs, i.e. by pursuing fiscal consolidation over the medium term. Moreover, due attention to aspects such as the impact of government revenue and expenditure patterns on potential GDP and the efficiency and effectiveness of the public sector can strengthen the economy's fundamentals and help boost potential GDP growth.

14. SLOVENIA

14.1. SETTING THE STAGE: FOREIGN TRADE CHARACTERISTICS

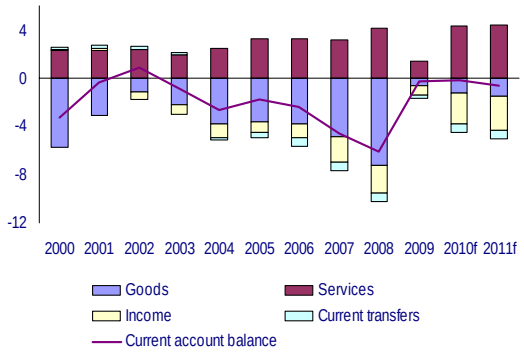
The degree of openness of the Slovenian economy increased significantly over the last few years, with both exports and imports rising in tandem. From almost 100% in 1995, exports and imports combined rose to some 150% of real GDP in 2008, with a marked acceleration since accession to the EU in 2004. Against the backdrop of the global downturn, openness fell steeply in 2009 with imports falling even more significantly than exports.

The trade balance (goods and services) had been on a gradually worsening trajectory since 2002, when a surplus of 1.2% was registered, culminating in a deficit of 3% of GDP in 2008. This reflects different trends in the evolution of trade in goods and services. While the free movement of services within the EU and strong economic growth in Slovenia's main trading partners helped to nearly double the services trade surplus between 2002 and 2008, there was a six-fold increase of the goods trade deficit over the same period.([126]) This pattern has been drastically altered by the economic crisis. Preliminary balance of payments data for 2009 point to an overall trade surplus of 1.5% resulting from both improved terms of trade and a steep fall in imports. According to the Commission services' autumn 2009 forecast, the trade balance is expected to register a surplus again in 2010, reflecting faster export growth this time.

In 2008, machinery and transport equipment accounted for around 41% of total goods exports. Road vehicles represent the most important subcategory, largely driven by a single car manufacturing company owned by a French manufacturer, which is Slovenia's biggest exporter. The relative importance of such products for Slovenia's exports has increased over time. The share of chemicals and related products increased less markedly, to 14%, with medical and pharmaceutical goods - which is the most technology-intensive industry in Slovenia - being the most important product group in this category.

The share of goods in Slovenia's total exports (in constant 2000 prices) has remained broadly stable since 1998 at slightly above the euro area average of 80%. Tourism accounts for the largest share (42% in 2007) of services exports, but has grown less rapidly in recent years than transport services (29% share) and other services (the remaining 29%).([127])

Graph III.14.1: **Evolution of the current account balance (% of GDP)**



Source: Commission services.

Despite the increasing importance of other markets, EU countries continue to absorb the major part of Slovenian exports, accounting for over two thirds of all goods exports in 2008. However, within the EU there has been a marked shift in the importance of different markets. In particular, the share of Slovenian merchandise exports going to the euro area fell from 61% in 2000 to 53% in 2008. Over the same period, the importance of the recently-acceded Member States (RAMS) as a destination for Slovenian exports increased from 8% to 14%. The major export markets in the EU are Germany (almost 19%) and Italy (12%). Outside the EU, the Western Balkan region, especially Croatia, and some other Eastern European countries are also important export markets for Slovenia.

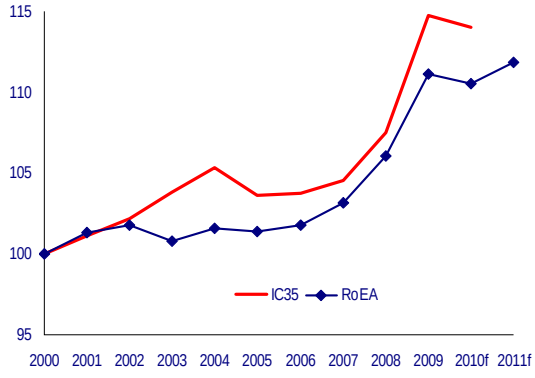
([126]) This was caused by a slightly higher average growth rate of imports than exports, in conjunction with a somewhat higher initial level of imports.

([127]) The weight of transport services is also due to Slovenia's favourable geographical location and role in transit trade ("Rotterdam effect").

14.2. INDICATORS OF COMPETITIVENESS

Over the period 2000-2008, Slovenia's real effective exchange rate (for all four deflators) saw some appreciation vis-à-vis both the euro area and 35 main trading partners (IC35). Vis-à-vis the euro area, the appreciation was most marked when deflating by the GDP deflator or by nominal unit labour costs for the total economy, whereas vis-à-vis the IC35, the measure based on the private consumption deflator showed the strongest appreciation. The loss in competitiveness vis-à-vis the IC35 cannot be explained by developments in the nominal effective exchange rate, which depreciated by almost 9% between 2000 and 2004. Slovenia's nominal unit labour costs increased by 22% over the 2000-2008 period, faster than in the EU and the euro area.([128]) For 2009, the picture regarding the real effective exchange rate is less uniform, with most deflators continuing to indicate modest appreciation, except those for private consumption and exports with respect to the euro area.

Graph III.14.2: **Real effective exchange rate (based on ULC in the total economy)**



Source: Commission services.

In contrast to the overall economy, the manufacturing sector's competitive situation saw an improvement over the years 2000-2008, as reflected in a depreciation vis-à-vis the euro area of around 5.5% of the real effective exchange rate based on nominal unit labour costs. This was partly driven by improved productivity. Indeed, the 4 pp difference between average productivity growth recorded in the tradables sector (mainly manufacturing) and the non-tradables sector (mainly services) in 1998-2007 was not proportionately reflected in wage developments as the average differential in nominal wage growth only amounted to 0.8 pp. over the same period. This typical Balassa-Samuelson catching-up effect is estimated to have contributed 0.6 pp. on average to the inflation differential with the euro area over the last decade and points to the importance of aligning sectoral wage and productivity developments for preserving competitiveness.([129]) Against the background of the pick-up in inflation in Slovenia in 2007 and 2008, almost all measures of the real exchange rate registered a marked appreciation in 2008.

From 2000 to 2008, Slovenian export market shares increased in all but one year, leading to a cumulative 30% gain in shares. Market shares received a particular boost in 2007, the year of euro area accession. The terms of trade for Slovenia's external trade in both goods and services deteriorated slightly over the period 2000-2008 but appear to have rebounded by around 4% in 2009, helped by falling commodity prices.

Calculations of the revealed comparative advantage (RCA) index – broken down according to the technology intensity of manufacturing trade – indicate that over the last decade Slovenia developed a comparative advantage in exporting medium-technology products, namely road vehicles. By contrast, Slovenia continues to have a marked comparative disadvantage in the high-technology sector, despite the recent buoyant performance of the pharmaceutical sector. At the same time, Slovenia's formerly pronounced comparative advantage in low-tech manufacturing has almost been eliminated over the last decade. This may partly be explained by labour cost developments. This picture is broadly confirmed by the RCA for merchandise trade broken down according to factor intensity, where Slovenia's comparative advantage in manufactured labour-intensive goods, although still marked, has been on the decrease.

([128]) Most other RAMS (Poland and Malta are exceptions) registered faster wage growth than Slovenia over this period. Most also experienced a more pronounced appreciation of their real effective exchange rate.

([129]) See Bank of Slovenia, Price Stability Report, October 2008, p. 20.

Despite its advanced economic development, good transport system and strategic geographical position, foreign direct investment inflows to the economy have been rather limited when compared to the other RAMS. Inward FDI flows to Slovenia averaged around 3% of GDP over the period 2002-2008, compared to 6.5% of GDP on average for the RAMS. Net FDI over the same period averaged less than 1% of GDP, compared to around 4.5% for the RAMS. Recent surveys indicate that, in addition to the small size of the domestic market and high labour costs, structural and policy weaknesses (such as high taxes, payment delays, an inefficient judicial system, lack of properly skilled labour force, rigid firing restrictions and insufficient competition) are the main factors discouraging FDI inflows.([130])

14.3. SPECIAL FOCUS: PRESERVING COMPETITIVENESS IN THE EURO AREA

In 2007, Slovenia became the first of the RAMS to adopt the euro. While the country had been living with a stable exchange rate since June 2004, membership of the euro area represented a regime change. This section analyses some of the factors which are crucial for enhancing the resilience of the Slovenian economy in this new environment with a special focus on safeguarding competitiveness in the euro area.

The structure of the economy is a key factor for competitiveness developments. Slovenia's economy continues to rely heavily on its industrial base. Industry represented almost 30% of gross value added (GVA) in 2009 and is therefore of much higher importance than in the euro area, where this share was below 22%. Within the group of the RAMS, the weight of the manufacturing sector in GVA is higher only in the Czech Republic and Slovakia.

At the same time, Slovenia's comparative advantage is not in the production of high-tech goods, which accounted for 17% of goods exports in 2007, well below the corresponding share in the EU.([131]) The country's comparative advantage, not only vis-à-vis the euro area but also compared to about half of the other RAMS is clearly in producing labour-intensive goods.([132]) This underlines the importance of wage and price developments if this comparative advantage is to be maintained.

After improvements in the run-up to euro area entry, recent developments have eroded Slovenia's cost advantage. From a low of 2.5% in 2006, HICP rose to a high of 5.5% in 2008. External shocks to energy and food prices combined with domestic demand pressures and limited competition in parts of the retail sector were such that price increases propagated rapidly through the entire economy. As oil and food prices moderated after their 2008 peaks and the economy moved into recession, inflation fell back to 0.9% in 2009, while remaining above the euro area average.([133])

Average wage growth also displayed a decreasing trend before euro area entry, followed by an acceleration in 2007 and 2008 when wage negotiations resulted in nearly full indexation of both public and private sector wages to previous year inflation. Wage restraint in the public sector has been followed by a period of accelerated growth.([134]) In 2009, average wage growth was still rather dynamic, at 3.3%. The Commission services' autumn forecast predicts a slowing down in 2010, to 1.3%, before rebounding again in 2011 to 3.5%.

Recent wage developments have led to a misalignment of wage and productivity growth. While real unit labour costs had been falling

([130]) See IMAD Development Report 2009, p. 20.
([131]) See IMAD Development Report 2009, p. 79.
([132]) In 2007, such goods accounted for 12.6% of Slovenian merchandise exports, compared to the RAMS' average of 11.4%. See IMAD Development Report 2009, p. 79.
([133]) Since 2004 HICP inflation in Slovenia has exceeded that in the euro area, with the differential increasing from 0.5 pp on average in the period before the introduction of the euro to more than 2 pps afterwards. This differential has decreased since the start of the economic crisis.
([134]) This has resulted from the agreement in July 2007 of a new pay system aiming to eliminate existing pay differences among the various professions in the public sector by 2010. Public sector employees were scheduled to receive four wage increments, amounting to a total increase of 13% in average pay or 1.1% of 2008 GDP (IMAD, Slovenian Economic Mirror, June 2008, p. 18). The most significant pay increases were planned for workers in sectors such as culture, social security and healthcare, while it is expected that workers in education will experience the lowest wage increase given their more generous wage rises in the past. The first two instalments were paid out in September 2008 (backdated to May 2008) and January 2009. The third and fourth instalments should be paid out in October 2010 and October 2011.

between 2001 and 2007 (on average by almost 1% per year), this trend was reversed by a small rise in 2008 followed by a more substantial rise in 2009. The initial improvements partly reflected strong productivity growth. As might be expected given the different starting levels, real productivity per hour worked increased much faster in Slovenia than in the euro area but slower than in most other RAMS. The recent deterioration in real unit labour costs is due to wage growth in excess of labour productivity growth. Since future productivity increases depend on current investment, it is important to note that gross fixed capital formation growth has been very high in recent years in Slovenia with an average annual growth rate of more than 8% over the period 2005-2008, 5 pps. above that in the euro area. In contrast to some other Member States, the increase was broad-based, with a marked rise in equipment and non-housing construction investment rather than just in residential investment.

Graph III.14.3: **Wage and productivity developments**

Source: Commission services.

These productivity trends underline the importance of non-price competitiveness factors. R&D and innovation is one such factor, as is the ability of the business sector to capitalise on new market opportunities afforded by changes in competitive advantage and relative prices. The absorption capacity of EU funds is a further important element. The capacity of the economy to successfully make such adjustments, e.g. in the form of a technological upgrading of the Slovenian production structure leading to a new export pattern, therefore appears central to raising competitiveness over the longer term. As FDI inflows to Slovenia continue to be low, there is scope for increasing their role in the productivity-increasing transfer of knowledge by further improving the conditions for attracting investment from foreign enterprises.

14.4. THE NEED FOR ADJUSTMENT ([135])

Up to 2007, Slovenia's macroeconomic performance was robust and did not point to emerging imbalances. Soon after, however, a significant inflation differential with the euro area opened up, also reflecting emerging overheating pressures. With wages adjusting to inflation and productivity growth slowing, the trade deficit peaked at 3% of GDP in 2008. Cost competitiveness deteriorated against both other euro area countries and a wider group of industrialised trading partners. The acceleration in prices was also reflected in deterioration of price-based competitiveness indicators. The global crisis has been hitting the very open Slovenian economy quite hard. Real GDP shrank by around 10% between 2008Q4 and 2009Q1 before returning to modest positive growth in (quarter-on-quarter) in the second quarter of last year. In 2009, Slovenia is estimated to have posted one of the worst falls in real GDP in the euro area. In addition, some of the recent stimulus measures focused on safeguarding employment could delay the needed structural changes in the labour market and hamper the reallocation of workers to more competitive sectors, if not phased-out in a timely way and if not accompanied, where necessary, by activation and training policies that favour job reallocation and the re-skilling of the labour force.

The surplus on the trade balance in 2009 (from a deficit position in the past 6 years) is driven by an improvement in the terms of trade and a more significant contraction of imports than of exports (due to falling domestic demand). However, if domestic demand regains strength as the economy recovers, the current improvement in the trade balance could prove to be unsustainable. If left unchecked, recent wage and productivity developments could entail a serious deterioration of Slovenia's competitive position in the euro area.

([135]) The text which follows, including policy challenges, draws, *inter alia*, on already issued policy invitations and recommendations under various Community instruments, such as the updated Stability Programme, the EDP recommendations and the strategy for growth and jobs.

Other countries' experiences show that a lengthy and painful adjustment process may then be necessary to regain competitiveness. If, however, the risks to competitiveness are adequately and promptly addressed, the country could rely on its outward orientation and underutilised productive capacity to benefit from the global upswing and complete the catching-up process with the euro area.

In view of Slovenia's competitiveness position within the euro area and its past significant current account deficit, adjustment in the context of the euro area would be facilitated by addressing the structural features underlying these challenges.

Against this background and since the country's comparative advantage vis-à-vis the euro area lies in the production of labour-intensive goods, Slovenian competitiveness could be improved through a wage-setting mechanism that prevents wage growth from exceeding productivity growth.

Structural reforms should be implemented to counter labour market segmentation and encourage investment in human capital. Possible reforms include: reviewing the employment protection legislation to reduce asymmetries between non-standard and standard employment in particular for student workers; increasing the coverage of unemployment benefits, while also further increasing financial incentives to work; enhancing the efficiency and effectiveness of the public employment services; extending the coverage of activation strategies and improving their targeting, especially concerning older workers and the long-term unemployed; strengthening the link between the educational system and labour market to support employability of the young; revising the pension system and increasing the labour supply and employment of older workers.

There is also a need to foster a higher technology-intensity of manufacturing, via efforts to attract FDI and stimulate R&D activities, which would help support the development of new comparative advantages and a more favourable external trading pattern. Furthermore, in view of the widening government deficit and rising debt level (albeit from a low starting point), in conjunction with the long-term sustainability challenge, structural reforms in public finances (aimed at curbing the inherent dynamics of social transfers and the public sector wage bill on a permanent basis) could make room for more productive spending (such as public investment) and raise potential growth.

15. SLOVAKIA

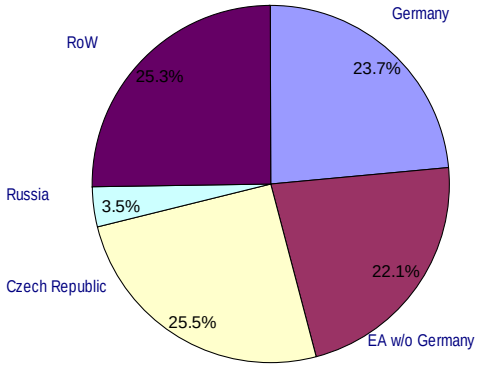
15.1. SETTING THE STAGE: FOREIGN TRADE CHARACTERISTICS

The Slovak economy is one of the most open economies in the EU. The share of exports and imports in GDP has been increasing markedly since the mid-nineties reaching 188% of GDP in 2008 in volume terms. The main drivers have been closer economic integration with the EU, an initial important cost-competitiveness advantage, gradual improvements in the quality of Slovak products and, up to 2008, the rapid expansion of world trade and external demand addressed to Slovakia. The trade balance has improved markedly since the end of the nineties, from a deficit of around 10% of GDP in 1998 to 2% of GDP in 2008.

With an average share of services in total exports and imports of about 10% in 2008 – down from 21% in 1995 – Slovakia is the country with the lowest intensity of trade in services in the EU. This reflects the very large expansion of trade in goods over the last decade. The structure of merchandise trade has changed significantly over time, with a strong concentration in the car and transport industry that now accounts for almost a quarter of Slovak exports. The import structure is dominated by machinery and electric equipment goods used in the car and energy sectors (43 percent of total imports), and energy products (13 percent of total imports). Turning to the characteristics of trade linkages, the importance of intra-industry trade is high relative to other recently-acceded Member States (RAMS) – with the standard Grubel-Lloyd index standing at 60 percent in 2008 – especially in trade relationships with other EU countries.

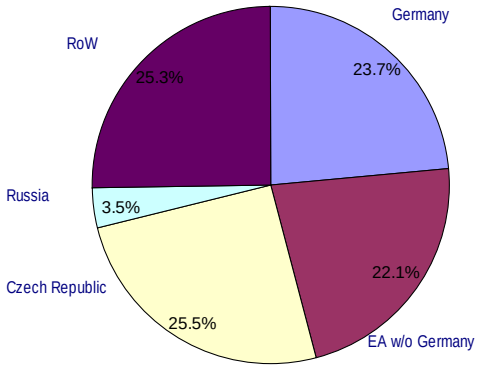
The geographic distribution of Slovakia's external trade has experienced significant changes over the last 10 years. In the late nineties, the Czech Republic was still the main trading partner of Slovakia (in 1997 about a quarter of Slovakia's exports were directed to the Czech Republic). This share has gradually diminished, to less than 15% in 2008, with a corresponding increase of exports to the euro area countries. As for many other countries in the region, the geographical structure of imports is more diversified than that of exports: while over 85% of Slovak exports are directed to the EU countries, which is the largest proportion across the RAMS, only 67% of imports are from other EU countries (nearly 20% of imports are from Asian countries).

Graph III.15.1: **Regional composition of exports in 1997**



Source: Slovstat.

Graph III.15.2: **Regional composition of exports in 2008**



Source: Commission services.

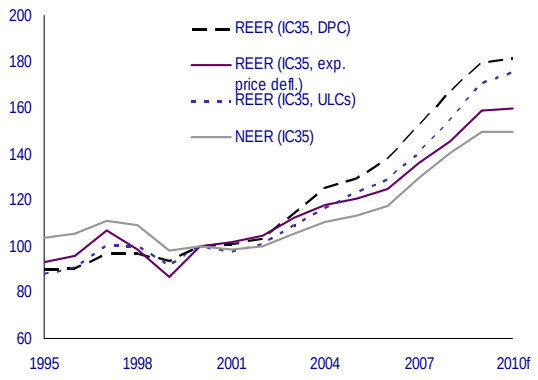
15.2. INDICATORS OF COMPETITIVENESS

After participating in the ERM II between November 2005 and December 2008, Slovakia joined the euro area on January 1, 2009. Prior to ERM II membership, a managed float regime had been in operation since October 1998.

Slovakia has had one of the fastest appreciating currencies in the EU over the recent period. This reflects a sizeable appreciation of the nominal effective exchange rate (43% over the ten years to 2008) and a positive inflation differential between Slovakia and most of its neighbouring countries.

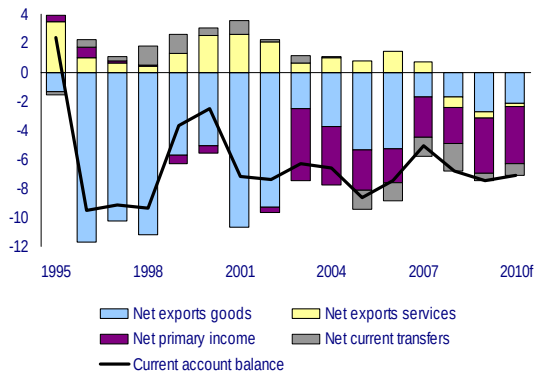
The size of the REER appreciation between 2000 and 2008 varies from 45% (based on the export price deflator) to 67% (based on the deflator of private consumption), the difference reflecting developments in terms of trade, including exports mark-ups. At the same time, since the second half of the nineties, the current account has been constantly in deficit, in part reflecting negative primary income flows due to the repatriation of profits. Taking these elements into account these elements, estimates of Slovakia's equilibrium REER based on a benchmark "equilibrium" current account point to an overvaluation of the order of 5% in 2008 (see special focus below).

Graph III.15.3: **Effective exchange rates (2000=100)**



Source: Commission services.

Graph III.15.4: **Current account balance (% of GDP)**



Source: Commission services.

Slovakia's export market share in world trade has more than doubled since 1995, reaching 0.4% in 2008. The export market share in euro area countries has also increased significantly, from 0.2% in 1995 to almost 0.8% in 2008. The key drivers of these increases have been similar to those mentioned above regarding the rapid expansion of Slovakia's external trade, i.e. a greater economic integration, an initial significant cost-competitiveness advantage, and continuous improvements in the quality of exported products (see below). However, the pace of gains in market shares has slowed down over time, suggesting an erosion of Slovakia's competitiveness, consistent with developments in the real effective exchange rate.

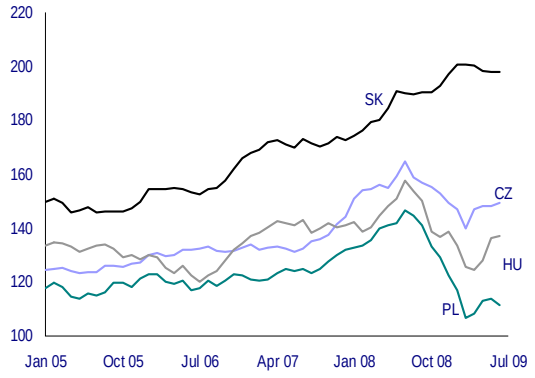
The revealed comparative advantage (RCA) index, broken down according to technology intensity of goods exports, indicates that Slovakia has developed a comparative advantage in medium-to-high technology goods and ICT industries. This picture is broadly in line with an analysis of RCA based on factor intensity, which indicates that Slovakia has a comparative advantage in capital-intensive goods and a disadvantage in raw-material-intensive goods. With respect to R&D intensive goods, Slovakia is relatively strong in the easy-to-imitate category of research-intensive goods and less competitive in the difficult-to-imitate category. These indicators are consistent with changes in the exports composition discussed in the previous section and point to a gradual shift in the structure of Slovakia's export to higher value-added products.

The large FDI inflows to Slovakia have been an important source of technology transfer for its economy, which has supported a rapid increase in labour productivity (the third strongest in the EU over the five years up to 2008). After a period of slow increase in the 1990s, FDI inflows boomed over 2000-2008 and represented almost 50% of annual GDP in cumulative terms in 2008. A favourable geographical location, relatively low labour costs and taxes, the existence of various schemes in support of FDI, important improvements in the overall economic and business climate over the period and, after 2004, EU accession, largely explain the attractiveness of Slovakia for foreign investors. FDI inflows are concentrated in the energy (production and distribution), car manufacturing and financial sectors, and come mostly from other EU countries, notably the Netherlands and Austria.

15.3. SPECIAL FOCUS: HAS SLOVAKIA LOST ITS EDGE DURING THE CRISIS?

In January 2009, Slovakia was the first of the Visegrád Four countries – the Czech Republic, Hungary, Poland and Slovakia – to adopt the euro. The exchange rate was thus fixed after a prolonged period of appreciation of the Slovak koruna. The acquired stability of the currency has had important benefits in the midst of the crisis, as it protected Slovakia against potential pressures on its exchange rate. It will also have important benefits in the longer run, including through lower transaction costs, better price transparency and the elimination of exchange rate uncertainty, which will all support potential growth. However, following the substantial depreciation in a number of Slovakia's competitors, the question arises as to whether recent exchange rate developments will affect Slovakia's external competitiveness and external position.

Graph III.15.5: **Monthly REER vs. IC35 (HICP,1999=100)**



Source: Commission services.

Since the summer of 2008, the currencies of Slovakia's neighbouring countries have experienced sizeable nominal depreciations, both in nominal and in real effective terms. The Polish, Czech and Hungarian currencies, respectively lost 18, 3 and 13 percent against the euro over the year to September 2009. As a result, and despite the growing importance of euro area countries in Slovakia's external trade, the real effective exchange rate of Slovakia has continued to appreciate during the crisis – broadly following the same trend as before – in contrast with developments in the neighbouring countries with floating exchange rates.

It is relevant to assess how these developments have affected external flows over the recent period. In the first half of 2009, Slovakia's exports plummeted by more than 25 percent compared to the same period a year earlier, which is similar to developments in other countries. At the same time, the severe contraction of investment and inventories – driven, for the largest part, by a sharp increase in private sector savings – resulted in an even larger contraction of imports, and the current account balance swung from a non-negligible deficit to a small surplus in the second quarter of 2009. Even if this improvement was accompanied by a sharp fall in net FDI, which was negative in the first half of 2009, and a decline of other capital inflows, the external position of Slovakia does not seem to have suffered excessively from nominal exchange rate developments.

It will, however, be important to carefully monitor developments in external flows and the real exchange rate. The overvaluation of the Slovak REER relative to equilibrium, if sustained, may translate into a sizeable deterioration in Slovakia's external position. On the other hand, it is possible that the nominal depreciation in the neighbouring countries will be partly or even fully reversed in the months ahead, limiting the REER appreciation in Slovakia (such a movement is already under way). In this scenario, the current account balance may well remain in surplus, or in deficit but at readily financeable levels.

15.4. THE NEED FOR ADJUSTMENT ([136])

Slovakia's economy has been strongly affected by the current global downturn. The economy contracted by over 5% yoy in the first half of 2009 and exports have plunged by over 25% on a year on year basis. Following Slovakia's entry in the euro area in January 2009, the large nominal depreciations in the neighbouring countries vis-à-vis the euro have implied a further significant appreciation of Slovakia's REER in the first half of 2009. The very fluid environment and large margins of uncertainties surrounding equilibrium REER estimates make it difficult to conclude that a

([136]) The text which follows, including policy challenges, draws, *inter alia*, on already issued policy invitations and recommendations under various Community instruments, such as the updated Stability Programme, the EDP recommendations and the strategy for growth and jobs.

significant weakening of Slovakia's external competitiveness has taken place during the crisis, but this possibility cannot be excluded.

While in the past policies to restore competitiveness and rebalance external accounts could rely on the exchange rate instrument, in the context of monetary union, in which the exchange rate reflects the economic circumstances of the euro area as a whole, Slovakia's external imbalances will have to be tackled through domestic control of relative prices and costs vis-à-vis competitors and improvements in non-price competitiveness.

In view of Slovakia's competitiveness position in the euro area and its current account deficit, adjustment in the context of the euro area would be facilitated by addressing the structural features underlying these challenges.

Against the background of Slovakia's potential further deterioration of competitiveness due to appreciation of the real exchange rate, addressing external imbalances and competitiveness problems will require wage moderation and careful design and implementation of macroeconomic and structural policies. Regarding structural policies, it is crucial that Slovakia gives a further impulse to its reform program to support productivity gains and improvements in the non-price competitiveness of its products. Reform priorities include enhancement of the business environment and market functioning, and reduction of administrative burdens. Labour market functioning would benefit from improved public employment services and development of an active ageing strategy. Increasing the employment rate, especially for younger and older workers, would also require stronger efforts to develop lifelong learning, address persisting skill mismatches, promote sufficient wage differentiation, and safeguard income security. These measures ought to be accompanied by reforms that enhance the quality and efficiency of public finances. For instance, reallocation of resources towards education and R&D and increasing the quality of public procurements would enhance the growth prospects of the economy, while facilitating the transition to new types of economic activities. The project-oriented support to R&D activities, which Slovakia has undertaken during the crisis, is a step in the right direction and should be continued after the crisis. Regarding macroeconomic policies, it is important that fiscal and incomes policies avoid fuelling imbalances and support moderate developments in unit labour costs relative to the country's trading partners.

16. FINLAND

16.1. SETTING THE STAGE: FOREIGN TRADE CHARACTERISTICS

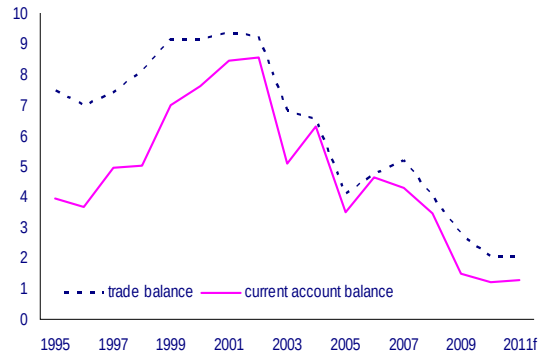
While Finland is a small and open economy with a highly specialised manufacturing structure and a strong export base, its openness to trade (exports plus imports as a share of GDP) is only slightly higher than the euro area average. Import penetration in particular is lower than the average. It appears that the peripheral and remote geographical location of the country might be weighing on trade potential to some extent. Nonetheless, among the euro area countries, Finland had built up one of the highest surpluses in trade in goods in the first decade of euro-area membership. A considerable surplus in trade had been achieved ever since the export-led recovery from the deep slump of the 1990s recession. The current account turned promptly into a sizeable surplus, peaking at over 8% of GDP at the beginning of the 2000s, but diminishing steadily over the following years to reach 3½ % of GDP in 2008([137]) (Graph III.16.1). The current global crisis has hit Finnish exports particularly heavily. Over 2009, the decline in Finnish exports was the sharpest among the euro area countries (-24% y-o-y in Finland in volume terms vs -13% for the euro area average). Nevertheless, while the current account surplus will shrink substantially, it is not forecast to turn into a deficit over the current crisis given its strong starting position.

Finnish exports are specialised to a high degree, reflecting the concentrated industry structure of the country. The dominant sectors of metal engineering, electronics, and wood and paper industries account for 70% of total exports. In the second half of the 1990s, Finnish export performance was boosted by the rapid rise of the ICT manufacturing sector, led by the so-called Nokia cluster (Graph III.16.2). Correspondingly, the breakdown of trade by technology and factor intensity shows a marked shift over the past decade towards higher technology and thereby less labour-intensive manufacturing. Over the last few years, the pick-up of growth in the metal engineering industry (i.e. machine building, shipyards) has compensated for the more subdued growth in ICT.

([137]) The sizeable discrepancy between the current account and trade balances before the year 2000 reflects net income transfers.

The wood and paper industry has been steadily losing its prominence in exports. Finnish trade links with the rapidly emerging economies in Asia and with Russia are among the strongest within the EU. About 10 % of Finnish exports go to Russia (to some degree transit trade to Russia enters Finnish statistics due to various storage arrangements) and about 10% to Asia. Amongst the euro area countries, Finland has the highest share of trade with countries outside the euro area. In 2007([138]) about 70% of Finnish exports went outside the euro area, whereas the average among the euro area countries was about 50%. While this allows the country to benefit from the growth of global markets, it has also rendered Finland more vulnerable to the recent sudden appreciation of the euro against other major currencies.

Graph III.16.1: **Trade balance and current account balance (% of GDP)**



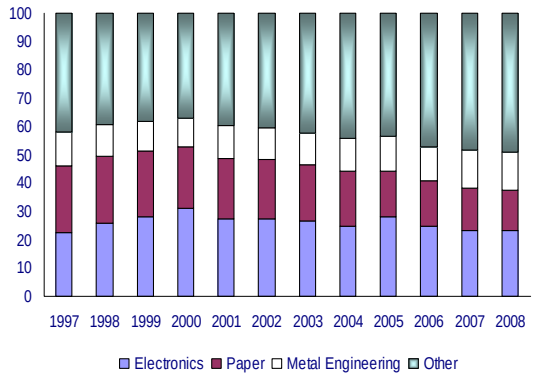
Source: Commission services.

The Finnish economy is more heavily reliant on industrial production than most of the other euro area countries. In 2008, manufacturing industry accounted for 33% of gross value added, while the euro area average was 22%. Conversely, the service sector is smaller in Finland. The strong manufacturing base also explains the high surplus in trade in goods, while the balance of trade in services has been in deficit over the past decade. Whereas the surplus in goods has started to weaken in recent years, the deficit in services trade has decreased and turned into surplus in 2007, reflecting the pick up in service exports. The share of services in exports has risen from 14% in 2000 to 21% in 2008. This is partly related to the

([138]) Data for 2008 not available.

internationalisation of Finnish companies, whereby the manufacturing component is increasingly relocated to lower-cost locations while other, more sophisticated, business functions usually remain in Finland. In effect, the internationalisation of companies has resulted in weaker exports of goods which are, however, partly compensated for by stronger exports of services (for example in the form of business-to-business services). Nevertheless, compared with the EU average, Finnish companies appear to be less globalised to date, as measured by both inward and outward FDI stock as a percentage of GDP. Even though FDI inflows have slightly surpassed outflows in recent years, the outward FDI stock is about one quarter higher than the inward stock.

Graph III.16.2: **Change in export structure (% share of total)**

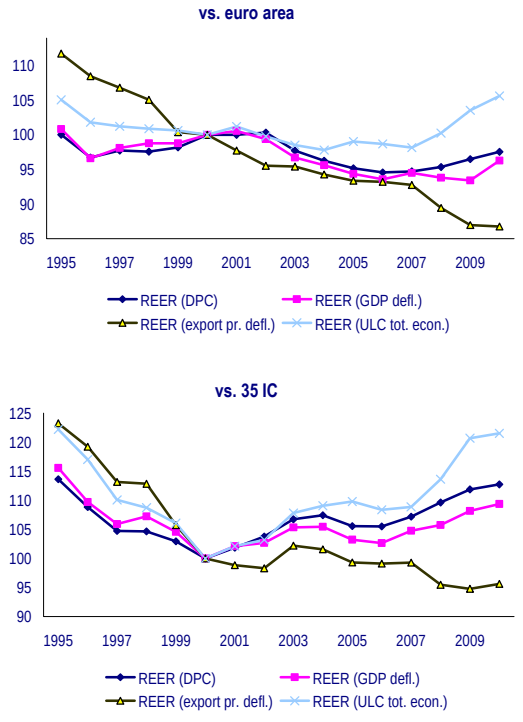


Source: Statistics Finland.

16.2. INDICATORS OF COMPETITIVENESS

From a historical perspective, the exceptionally severe economic recession at the beginning of the 1990s proved to be a dividing line for the structural performance of the Finnish economy. The Finnish economy was characterised in the 1980s by a credit and asset price boom, high inflation, deteriorating competitiveness and several periods of mounting current account deficits, followed by currency devaluation cycles. It ended with the bursting of a housing bubble and a financial crisis, coinciding with the collapse of the Soviet Union, which was one of Finland's principal export markets. This was followed by a complete turnaround in the economy in the subsequent two decades. Estimates of deviations from equilibrium exchange rates imply that the Finnish real effective exchange rate (REER) is somewhat undervalued in relation to the other euro area countries, but this difference is narrowing. The commonly used competitiveness indicators for the REER (Graph III.16.3, also presented in the statistical annex) support this result, indicating that Finland has gained in cost competitiveness vis-à-vis the euro area over the past decade, but lost competitiveness relative to the other major world economies, especially during the current global crisis, mainly reflecting the euro's appreciation.

Graph III.16.3: **Real effective exchange rates (2000 = 100)**



Source: Commission services.

The export-price-based real effective exchange rate (REER export price deflator) indicates the strongest gain in competitiveness. This is heavily influenced by the export structure of Finland, where the dominant ICT manufacturing sector is facing a continuous decline in prices on the world market. In effect, the rapid productivity gains in the ICT sector are passed on to consumers in the form of lower prices. These trends in the ICT sector also largely explain the strongly negative terms-of-trade indicator.

The inflation-based REER measures (DPC, GDP deflator) also show a gain in competitiveness vis-à-vis the euro area, which is however reversed from 2007 onwards. This reflects the relatively subdued inflation developments over the past decade and the recent pick-up of inflation to above the euro area average due to a sudden jump in wage growth. However, while the average inflation rate is low, Finnish price levels are nevertheless among the highest in the euro area. Finland entered the EU with comparative price levels about a quarter higher than the EU-27 average, surpassed only by Denmark and Sweden. The increase of competition from the EU Single Market played an important role in the subsequent downward convergence of Finnish prices. However, a sizeable price gap with the euro area average still remains, possibly indicating a lack of competitive pressures.

After a decade of broadly stable developments, the unit-labour-cost-based REER shows a loss of competitiveness over 2008-2009 in relation to the euro area average. This stems primarily from the outcome of the most recent wage settlement round. Over the past decade, the centralised wage agreements maintained wage growth in line with aggregate productivity advances. However, the multi-annual wage agreements concluded in 2007 provided for exceptionally high wage growth over the next 2-3 years, reaching 5½% in 2008 and slightly less in 2009 and 2010. This is 1½ percentage points higher than on average over recent years. Short-term statistics indicate that nominal wage growth amounted to 4½% in the first half of 2009. Downward wage flexibility appears to be limited in Finland even during a major recession. Since the jump in wages is coinciding with a sudden loss in output, the rate of growth in unit labour costs appears exceptionally high and also adds to domestic inflationary pressures.

16.3. SPECIAL FOCUS: FACTORS BEHIND THE VULNERABILITY OF EXPORTS

In spite of balanced macroeconomic growth over the past years and the seemingly good aggregate competitiveness position of the Finnish economy at the onset of the global crisis, Finnish exports have been highly vulnerable to the crisis. This can be explained by both short-term direct effects of the crisis and also some underlying long-term structural factors that are not directly linked to the collapse in global demand.

Short-term transitory factors

The heavy specialisation of Finnish industry in investment goods is proving to be an unfavourable feature during a major global crisis. Due to global manufacturing overcapacity, it can be expected that demand for investment goods will revive only after demand for consumer goods has recovered. Major segments of Finnish industry are therefore not directly responsive to stimulus measures. A minor part of the total decline in exports can be explained by the reduction of transit-like trade to Russia. Transit goods occasionally enter Finnish trade statistics due to some transport and storage arrangements. Over the first half of 2009, the value of Finnish exports to Russia dropped by 50% and imports by 45%, the steepest decline amongst Finland's main trading partners.

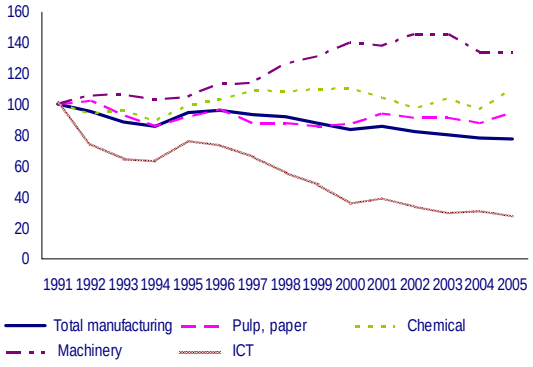
The values of the currencies of some of Finland's major trading partners and competitor countries, most notably Sweden, have depreciated sharply over the past year. While this hardly can be a major factor in explaining the 2009 difference in export performance, the weakening of the Swedish krona is putting Finnish exports at a disadvantage on the Swedish domestic market and is also putting pressure on the international price competitiveness of major industry branches in Finland. The industrial specialisation of Swedish and Finnish companies is often similar and production can be substituted between the two countries. It appears that, for example, the globalised Nordic forest companies have reacted to production cost differences between the two countries by reducing their overall production share in Finland and retaining it in Sweden. Over the first half of 2009, forest industry exports declined by over 30% in Finland compared with less than 10% in Sweden.

Structural long-term factors

The aggregate ULC measures may hide sectoral divergences in competitiveness in the highly specialised and concentrated Finnish export industries. In Finland, wage developments are not strongly linked with productivity developments

across industries.([139]) Therefore, ULC developments do not properly reflect productivity differences, showing large discrepancies between the high- and low- growth industries. Especially in the late 1990s, the good aggregate performance was driven notably by the boom in the ICT industry, while in the other major industry branches ULC growth exceeded the average growth rate (Graph III.16.4). In effect, these wage developments have provided cost advantages for industries with high productivity growth while imposing a heavier cost burden on branches with low productivity growth.

Graph III.16.4: **Nominal unit labour costs, industry breakdown**



Source: Commission services.

However, even industry branches that have benefited from notable reductions in unit labour costs, like the ICT industry, are vulnerable to global production shifts. It appears that many other competitiveness factors are often important underlying determinants of industry branch performance. In recent years, the slowing growth in the Finnish ICT sector can be explained by the maturation and globalisation of the telecommunications equipment production, as emerging economies increasingly enter this sector. Overall, the more labour-intensive production has been relocated to cheaper locations. On the other hand, high value-added industry functions, like R&D, and capital and skill intensive manufacturing have been largely maintained in the country. Finland benefits in this respect from its excellent education system, which provides for highly-skilled labour.

The export potential of the important Finnish wood and paper industry has also weakened over an extended period of time. Nevertheless, even if this sector's share in exports has declined substantially over the past 15 years, it still is very important for net exports, as the import content of the production is low. Besides the more immediate competitiveness loss vis-à-vis Sweden, fundamentally cheaper forestry production technology is developing in areas with warmer climates in Asia and South America. Additionally, the Finnish forest industry has been suffering from disturbances to wood supply caused by the introduction of round-wood export duties in Russia.

16.4. THE NEED FOR ADJUSTMENT ([140])

Over the past decade, Finland built up significant current account surpluses, which provide a buffer against a temporary loss of competitiveness. However, the recent exceptionally sharp drop in export production has coincided with an acceleration in wage growth, mirrored in a rapid rise in unit labour costs in 2008-2009. Moreover, due to its industry structure, Finnish exports are likely to rebound later than in many other euro area countries after the expected recovery of global demand takes hold.

In view of Finland's competitiveness position in the euro area and its current account balance, adjustment in the context of the euro area would be facilitated by addressing the structural challenges underlying long-term export market performance.

Against the background of a rapid rise in unit labour costs in 2008-2009 and the heterogeneity in sectoral productivity developments and prospects, policy efforts should aim at bringing wage growth back in line with productivity advances in the upcoming wage agreements. The current wage

([139]) For a more thorough analysis of the Finish wage setting system, see Maiväli, M. and Lubenets, N. (2007), "Managed vs free wage-setting in Finland and Estonia", European Commission, Country Focus No. 10, October 2007.

([140]) The text which follows, including policy challenges, draws, *inter alia*, on already issued policy invitations and recommendations under various Community instruments, such as the updated Stability Programme, the EDP recommendations and the strategy for growth and jobs.

formation system implies that those industry branches, which show below-average productivity growth (possibly affected by adverse global factors), have come under additional pressure due to relatively higher growth in unit labour costs and various non-price factors. It would therefore be important to increase the responsiveness of the wage formation system to sectoral productivity developments, a tendency that has already started to materialise in the more recent wage rounds.

It would be important to take measures to increase labour supply in the longer term, including measures to make work pay, in order to counter the negative effects on the labour market from the ageing of the population and a related decline in the working age population. Given its structure, Finnish industry is relatively energy intensive. Its growth and productivity potential will therefore also depend on meeting the climate change challenges and improving energy efficiency.

Annexes

ANNEX
Statistical Appendix

Table A.1: **BELGIUM - Indicators related to competitiveness (% of GDP unless otherwise indicated)**

Indicator	1995	2000	2005	2007	2008	2009	2010f
Current account balance	4.8	4.2	3.3	3.7	0.2	2.0	0.9
Trade balance - goods & services	3.9	2.9	3.9	3.9	0.9	2.8	1.5
Trade balance - goods	3.8	2.1	2.1	1.6	-1.6	-1.1	-0.7
Trade balance - services	0.1	0.8	1.8	2.3	2.4	3.8	2.2
Net foreign assets	20.9	73.2	25.6	33.3	48.6	#N/A	#N/A
Export market perf. G & S (% change)	-2.6	0.0	-1.5	-0.5	0.3	0.7	-0.4
REER (DPC) index 2000=100							
vs 35 industrial countries	114.0	100.0	106.9	110.3	113.4	114.1	113.0
vs rest of euro area	103.9	100.0	99.7	101.5	102.6	102.6	102.9
REER (GDP deflator) index 2000=100							
vs 35 industrial countries	115.3	100.0	106.7	108.1	109.6	110.4	109.5
vs rest of euro area	104.7	100.0	100.2	100.7	100.4	100.3	100.6
REER (exp. price defl.) index 2000=100							
vs 35 industrial countries	110.5	100.0	109.1	111.0	113.4	112.0	110.9
vs rest of euro area	103.1	100.0	103.7	104.6	106.4	104.2	104.3
REER (ULC tot. econ.) index 2000=100							
vs 35 industrial countries	115.9	100.0	106.8	109.1	112.0	114.9	114.0
vs rest of euro area	104.2	100.0	99.8	101.5	102.2	103.0	103.5
Terms of trade (index 2000=100)***:***							
Goods & services	103.6	100.0	99.8	99.4	97.2	99.6	99.5
Goods	104.6	100.0	99.3	99.3	96.8	98.7	98.4
Services	99.6	100.0	102.2	99.9	98.7	99.9	99.9
Openness:							
a1. Exports (constant prices)	64.5	78.2	84.3	87.5	87.9	80.9	81.5
a2. Imports (constant prices)	62.8	75.3	80.0	82.9	84.5	77.6	77.7
a3. Exports and imports (constant prices)	127.3	153.6	164.4	170.3	172.4	158.4	159.3
b. Net foreign direct investment (FDI)	#N/A	#N/A	0.5	2.7	-3.5	#N/A	#N/A
c. FDI intensity	#N/A	#N/A	8.9	13.4	#N/A	#N/A	#N/A
d. Net portfolio investment	#N/A	#N/A	-11.7	-8.9	10.0	#N/A	#N/A
Profitability:							
a. 1/RULC (index 2000=100):	98.2	100.0	102.2	102.7	100.8	97.3	98.8
b. Gross operating surplus as a % of GVA	41.8	41.5	42.7	43.4	42.5	40.7	41.6
c. Employee wage bill as a % of GVA	56.9	57.2	56.5	56.3	57.2	59.2	58.3
d. (NDP - TCE) as a % of NKS	12.7	13.0	12.9	13.0	12.3	10.6	10.8
Economic structure (% of GVA)***:***							
Agriculture (ISIC A_B)	1.4	1.4	1.1	1.1	1.1	1.1	#N/A
Industry (ISIC C_E)	21.4	22.1	20.7	20.5	20.2	18.9	#N/A
Building (ISIC F)	5.1	5.0	5.0	5.2	5.1	5.1	#N/A
Market Services (ISIC G_K)	49.1	49.1	51.3	52.0	52.3	52.4	#N/A
Other Services (ISIC L_P)	23.1	22.5	21.9	21.2	21.2	22.3	#N/A
Share of services in total trade							
Exports	17.7	19.6	18.8	19.5	20.1	19.8	19.6
Imports	17.9	19.2	17.9	17.8	17.8	17.7	17.7
1. RCA for all exports (vs World):							
raw-material-intensive	0.9	0.8	0.8	0.8	#N/A	#N/A	#N/A
labour-intensive	1.2	1.3	1.1	1.1	#N/A	#N/A	#N/A
capital-intensive	1.6	1.4	1.3	1.3	#N/A	#N/A	#N/A
difficult-to-imitate research-intensive	0.6	0.6	0.6	0.6	#N/A	#N/A	#N/A
easy-to-imitate research-intensive	0.9	1.1	1.4	1.4	#N/A	#N/A	#N/A
2. RCA for exports of goods (vs World):							
low-technology goods	1.0	1.2	1.0	1.0	#N/A	#N/A	#N/A
medium-to-low-technology goods	1.4	1.1	1.2	0.9	#N/A	#N/A	#N/A
medium-to-high-technology goods	1.2	1.3	1.3	1.3	#N/A	#N/A	#N/A
high-technology goods	0.3	0.4	0.3	0.3	#N/A	#N/A	#N/A
- ICT	0.3	0.4	0.3	0.3	#N/A	#N/A	#N/A

Footnotes: f = Commission autumn 2009 forecast; REER = real effective exchange rate; DPC = deflator of private consumption; FDI intensity = average of inward and outward FDI flows as a % of GDP; 1/RULC = Nominal GDP/employee wage bill; GVA = gross value added; NDP = Net domestic product; TCE = total compensation of employees; NKS =net capital stock; RCA = revealed comparative advantage: 1 based on factor intensity of total exports; and 2 based on technology intensity of exports of manufactured goods.
Source: Commission services.

Table A.2: **GERMANY - Indicators related to competitiveness (% of GDP unless otherwise indicated)**

Indicator	1995	2000	2005	2007	2008	2009	2010f
Current account balance	-1.2	-1.6	5.2	7.9	6.6	5.0	3.8
Trade balance - goods & services	0.5	0.4	5.3	7.1	6.2	4.6	3.7
Trade balance - goods	2.5	3.0	7.1	8.2	7.3	5.6	4.7
Trade balance - services	-2.0	-2.7	-1.8	-1.1	-1.0	-1.0	-1.0
Net foreign assets	2.1	0.3	13.5	19.3	20.9	#N/A	#N/A
Export market perf. G & S (% change)	-1.7	1.2	1.3	1.6	2.3	-1.3	0.7
REER (DPC) index 2000=100							
vs 35 industrial countries	122.7	100.0	105.6	105.9	106.7	107.5	104.9
vs rest of euro area	110.6	100.0	95.8	93.8	92.8	93.0	92.4
REER (GDP deflator) index 2000=100							
vs 35 industrial countries	126.1	100.0	102.1	101.5	102.1	103.4	101.2
vs rest of euro area	113.8	100.0	93.0	90.8	90.0	90.4	89.9
REER (exp. price defl.) index 2000=100							
vs 35 industrial countries	117.7	100.0	102.6	101.0	99.1	100.1	98.2
vs rest of euro area	109.1	100.0	95.4	92.2	89.6	89.6	89.1
REER (ULC tot. econ.) index 2000=100							
vs 35 industrial countries	124.9	100.0	100.7	97.3	97.7	101.4	98.3
vs rest of euro area	110.4	100.0	90.6	86.0	84.5	85.9	84.5
Terms of trade (index 2000=100)***:***							
Goods & services	105.9	100.0	101.1	100.2	99.4	103.1	103.0
Goods	104.0	100.0	102.6	101.4	100.3	106.1	105.7
Services	113.9	100.0	96.8	97.2	98.0	93.4	94.5
Openness:							
a1. Exports (constant prices)	24.0	33.4	43.8	50.3	51.1	46.1	46.8
a2. Imports (constant prices)	24.9	33.0	38.6	42.8	44.1	42.2	42.6
a3. Exports and imports (constant prices)	48.8	66.4	82.3	93.1	95.1	88.4	89.4
b. Net foreign direct investment (FDI)	-1.1	7.5	-1.0	-3.7	-3.7	#N/A	#N/A
c. FDI intensity	1.9	6.7	2.0	3.3	#N/A	#N/A	#N/A
d. Net portfolio investment	1.4	-7.4	-1.3	6.3	1.8	#N/A	#N/A
Profitability:							
a. 1/RULC (index 2000=100):	99.6	100.0	103.7	107.5	106.8	102.9	105.5
b. Gross operating surplus as a % of GVA	40.3	40.1	43.1	44.5	44.0	42.5	43.8
c. Employee wage bill as a % of GVA	59.7	59.4	55.9	54.2	54.7	56.9	55.6
d. (NDP - TCE) as a % of NKS	10.3	10.3	11.0	12.0	11.8	10.4	10.8
Economic structure (% of GVA)***:***							
Agriculture (ISIC A_B)	1.2	1.3	1.3	1.1	1.2	1.2	#N/A
Industry (ISIC C_E)	25.2	25.1	25.6	25.9	25.6	22.4	#N/A
Building (ISIC F)	6.7	5.2	3.9	3.7	3.8	4.0	#N/A
Market Services (ISIC G_K)	43.8	45.7	46.7	47.3	47.4	48.8	#N/A
Other Services (ISIC L_P)	23.2	22.8	22.6	22.0	22.1	23.6	#N/A
Share of services in total trade							
Exports	12.9	13.4	13.5	13.6	13.5	15.7	15.5
Imports	23.2	21.7	19.5	18.3	17.7	18.5	18.0
1. RCA for all exports (vs World):							
raw-material-intensive	0.4	0.4	0.4	0.4	#N/A	#N/A	#N/A
labour-intensive	0.8	0.8	0.8	0.8	#N/A	#N/A	#N/A
capital-intensive	1.4	1.6	1.5	1.5	#N/A	#N/A	#N/A
difficult-to-imitate research-intensive	1.3	1.3	1.3	1.3	#N/A	#N/A	#N/A
easy-to-imitate research-intensive	0.9	0.9	0.9	0.9	#N/A	#N/A	#N/A
2. RCA for exports of goods (vs World):							
low-technology goods	0.6	0.6	0.6	0.6	#N/A	#N/A	#N/A
medium-to-low-technology goods	1.1	1.2	1.0	0.9	#N/A	#N/A	#N/A
medium-to-high-technology goods	1.4	1.4	1.4	1.3	#N/A	#N/A	#N/A
high-technology goods	0.6	0.6	0.7	0.7	#N/A	#N/A	#N/A
- ICT	0.5	0.5	0.5	0.5	#N/A	#N/A	#N/A

Footnotes: f = Commission autumn 2009 forecast; REER = real effective exchange rate; DPC = deflator of private consumption; FDI intensity = average of inward and outward FDI flows as a % of GDP; 1/RULC = Nominal GDP/employee wage bill; GVA = gross value added; NDP = Net domestic product; TCE = total compensation of employees; NKS =net capital stock; RCA = revealed comparative advantage: 1 based on factor intensity of total exports; and 2 based on technology intensity of exports of manufactured goods.

Source: Commission services.

Table A.3: **IRELAND - Indicators related to competitiveness (% of GDP unless otherwise indicated)**

Indicator	1995	2000	2005	2007	2008	2009	2010f
Current account balance	2.8	-0.4	-3.3	-5.3	-5.1	-3.1	-1.8
Trade balance - goods & services	11.7	13.5	11.9	10.2	10.4	15.8	18.0
Trade balance - goods	17.8	26.2	17.2	10.4	13.1	20.5	22.5
Trade balance - services	-6.1	-12.8	-5.3	-0.2	-2.7	-4.8	-4.5
Net foreign assets	-28.0	-8.1	-21.5	-17.8	#N/A	#N/A	#N/A
Export market perf. G & S (% change)	12.0	8.3	-1.0	4.9	-1.3	10.4	-1.1
REER (DPC) index 2000=100							
vs 35 industrial countries	101.1	100.0	121.4	122.8	127.9	126.0	121.9
vs rest of euro area	86.2	100.0	107.6	105.7	106.1	104.1	102.3
REER (GDP deflator) index 2000=100							
vs 35 industrial countries	95.8	100.0	119.7	123.3	123.6	120.0	116.3
vs rest of euro area	81.0	100.0	107.2	108.0	104.4	100.7	98.8
REER (exp. price defl.) index 2000=100							
vs 35 industrial countries	98.5	100.0	106.5	105.9	104.7	110.1	106.9
vs rest of euro area	87.5	100.0	96.8	94.1	91.7	95.8	94.3
REER (ULC tot. econ.) index 2000=100							
vs 35 industrial countries	109.8	100.0	122.6	130.6	142.4	137.1	130.3
vs rest of euro area	91.7	100.0	109.1	114.5	119.8	112.7	108.6
Terms of trade (index 2000=100)***:***							
Goods & services	100.4	100.0	99.0	95.5	94.3	94.7	94.7
Goods	101.0	100.0	101.1	94.3	91.7	92.3	90.8
Services	99.6	100.0	107.8	109.0	109.9	109.6	111.4
Openness:							
a1. Exports (constant prices)	68.8	98.3	97.9	100.0	102.0	106.6	109.4
a2. Imports (constant prices)	58.5	84.8	82.8	83.5	84.2	83.3	83.6
a3. Exports and imports (constant prices)	127.3	183.1	180.7	183.4	186.3	190.0	193.0
b. Net foreign direct investment (FDI)	0.9	22.6	-22.8	1.4	-12.6	#N/A	#N/A
c. FDI intensity	#N/A	16.1	-4.3	9.8	#N/A	#N/A	#N/A
d. Net portfolio investment	-0.4	-5.1	32.5	-3.8	-21.6	#N/A	#N/A
Profitability:							
a. 1/RULC (index 2000=100):	86.6	100.0	100.2	97.9	89.6	89.2	92.3
b. Gross operating surplus as a % of GVA	49.0	55.2	54.1	53.7	52.5	53.6	55.6
c. Employee wage bill as a % of GVA	50.4	44.7	46.2	46.7	50.4	49.9	48.1
d. (NDP - TCE) as a % of NKS	14.3	19.9	19.6	19.4	16.6	14.8	14.9
Economic structure (% of GVA)***:***							
Agriculture (ISIC A_B)	4.7	3.2	2.2	1.8	1.8	#N/A	#N/A
Industry (ISIC C_E)	29.8	34.3	34.0	35.3	35.8	#N/A	#N/A
Building (ISIC F)	6.7	7.5	7.8	7.5	6.7	#N/A	#N/A
Market Services (ISIC G_K)	36.0	39.2	42.0	42.4	43.1	#N/A	#N/A
Other Services (ISIC L_P)	23.3	15.9	13.8	13.3	13.3	#N/A	#N/A
Share of services in total trade							
Exports	13.2	21.9	30.5	35.1	35.0	35.2	35.1
Imports	24.9	40.4	45.7	46.1	49.9	55.1	56.5
1. RCA for all exports (vs World):							
raw-material-intensive	1.2	0.5	0.4	0.5	#N/A	#N/A	#N/A
labour-intensive	0.8	0.6	0.5	0.5	#N/A	#N/A	#N/A
capital-intensive	0.3	0.3	0.5	0.4	#N/A	#N/A	#N/A
difficult-to-imitate research-intensive	0.5	0.5	0.6	0.5	#N/A	#N/A	#N/A
easy-to-imitate research-intensive	2.6	3.3	3.3	3.5	#N/A	#N/A	#N/A
2. RCA for exports of goods (vs World):							
low-technology goods	1.3	0.7	0.6	0.7	#N/A	#N/A	#N/A
medium-to-low-technology goods	0.6	0.4	0.3	0.4	#N/A	#N/A	#N/A
medium-to-high-technology goods	0.7	1.1	1.3	1.4	#N/A	#N/A	#N/A
high-technology goods	1.5	1.5	1.4	1.4	#N/A	#N/A	#N/A
- ICT	1.8	1.8	1.6	1.8	#N/A	#N/A	#N/A

Footnotes: f = Commission autumn 2009 forecast; REER = real effective exchange rate; DPC = deflator of private consumption; FDI intensity = average of inward and outward FDI flows as a % of GDP; 1/RULC = Nominal GDP/employee wage bill; GVA = gross value added; NDP = Net domestic product; TCE = total compensation of employees; NKS =net capital stock; RCA = revealed comparative advantage: 1 based on factor intensity of total exports; and 2 based on technology intensity of exports of manufactured goods.
Source: Commission services.

Table A.4: **GREECE - Indicators related to competitiveness (% of GDP unless otherwise indicated)**

Indicator	1995	2000	2005	2007	2008	2009	2010f
Current account balance	-0.8	-12.0	-11.0	-14.7	-13.8	-8.8	-8.0
Trade balance - goods & services	-6.5	-13.5	-9.2	-11.1	-10.2	-4.8	-3.6
Trade balance - goods	-10.9	-19.4	-16.3	-17.7	-16.6	-11.0	-10.3
Trade balance - services	4.3	5.9	7.1	6.6	6.4	6.2	6.8
Net foreign assets	-0.3	-44.5	-82.1	-100.5	-88.4	#N/A	#N/A
Export market perf. G & S (% change)	-4.8	1.8	-4.4	-1.3	2.8	3.0	1.2
REER (DPC) index 2000=100							
vs 35 industrial countries	101.0	100.0	109.4	111.9	114.6	117.3	115.6
vs rest of euro area	91.5	100.0	103.3	105.4	106.6	107.9	108.2
REER (GDP deflator) index 2000=100							
vs 35 industrial countries	102.9	100.0	109.3	110.7	113.0	115.1	113.5
vs rest of euro area	92.7	100.0	104.4	106.3	107.7	108.0	108.3
REER (exp. price defl.) index 2000=100							
vs 35 industrial countries	99.2	100.0	113.6	114.6	115.5	120.2	118.9
vs rest of euro area	92.4	100.0	109.4	110.6	111.9	114.6	114.9
REER (ULC tot. econ.) index 2000=100							
vs 35 industrial countries	102.1	100.0	111.9	112.6	114.6	115.6	115.2
vs rest of euro area	90.8	100.0	105.3	107.3	107.8	106.2	107.8
Terms of trade (index 2000=100)***:***							
Goods & services	101.2	100.0	104.0	103.4	103.0	108.3	108.0
Goods	98.7	100.0	97.7	98.9	96.7	103.0	102.1
Services	105.6	100.0	116.3	113.4	116.7	116.7	117.4
Openness:							
a1. Exports (constant prices)	16.7	24.9	23.1	23.5	24.0	21.4	22.1
a2. Imports (constant prices)	25.7	38.4	33.9	36.2	35.6	28.7	27.9
a3. Exports and imports (constant prices)	42.4	63.2	57.0	59.8	59.6	50.1	49.9
b. Net foreign direct investment (FDI)	0.8	-0.8	-0.3	-1.1	0.6	#N/A	#N/A
c. FDI intensity	#N/A	1.3	0.4	1.2	#N/A	#N/A	#N/A
d. Net portfolio investment	#N/A	#N/A	3.7	7.9	7.1	#N/A	#N/A
Profitability:							
a. 1/RULC (index 2000=100):	99.4	100.0	100.7	102.6	102.2	101.2	101.7
b. Gross operating surplus as a % of GVA	63.8	62.0	61.4	61.8	61.3	61.4	61.6
c. Employee wage bill as a % of GVA	35.9	37.6	38.7	39.1	39.3	39.2	38.9
d. (NDP - TCE) as a % of NKS	14.5	15.0	15.2	15.7	15.6	15.1	14.9
Economic structure (% of GVA)***:***							
Agriculture (ISIC A_B)	7.8	6.6	4.9	3.9	3.9	#N/A	#N/A
Industry (ISIC C_E)	14.3	13.9	13.4	13.0	13.6	#N/A	#N/A
Building (ISIC F)	6.6	7.0	6.8	7.3	4.7	#N/A	#N/A
Market Services (ISIC G_K)	47.8	50.7	54.1	54.4	55.1	#N/A	#N/A
Other Services (ISIC L_P)	23.5	21.7	20.8	21.3	22.0	#N/A	#N/A
Share of services in total trade							
Exports	40.2	57.9	57.8	57.2	57.3	58.8	58.9
Imports	10.6	22.1	21.3	21.2	24.1	25.4	25.6
1. RCA for all exports (vs World):							
raw-material-intensive	2.0	1.9	1.5	1.6	#N/A	#N/A	#N/A
labour-intensive	1.8	1.7	1.5	1.3	#N/A	#N/A	#N/A
capital-intensive	1.0	1.0	1.1	1.1	#N/A	#N/A	#N/A
difficult-to-imitate research-intensive	0.3	0.3	0.5	0.5	#N/A	#N/A	#N/A
easy-to-imitate research-intensive	0.2	0.5	0.7	0.7	#N/A	#N/A	#N/A
2. RCA for exports of goods (vs World):							
low-technology goods	2.2	1.9	2.0	1.6	#N/A	#N/A	#N/A
medium-to-low-technology goods	1.6	2.1	1.5	1.6	#N/A	#N/A	#N/A
medium-to-high-technology goods	0.3	0.5	0.7	0.6	#N/A	#N/A	#N/A
high-technology goods	0.2	0.3	0.3	0.2	#N/A	#N/A	#N/A
- ICT	0.2	0.3	0.3	0.3	#N/A	#N/A	#N/A

Footnotes: f = Commission autumn 2009 forecast; REER = real effective exchange rate; DPC = deflator of private consumption; FDI intensity = average of inward and outward FDI flows as a % of GDP; 1/RULC = Nominal GDP/employee wage bill; GVA = gross value added; NDP = Net domestic product; TCE = total compensation of employees; NKS =net capital stock; RCA = revealed comparative advantage: 1 based on factor intensity of total exports; and 2 based on technology intensity of exports of manufactured goods.

Source: Commission services.

Table A.5: **SPAIN - Indicators related to competitiveness (% of GDP unless otherwise indicated)**

Indicator	1995	2000	2005	2007	2008	2009	2010f
Current account balance	-0.2	-4.0	-7.5	-10.0	-9.5	-5.1	-4.6
Trade balance - goods & services	0.0	-3.1	-5.3	-6.8	-5.9	-2.1	-0.4
Trade balance - goods	-3.1	-6.3	-7.5	-8.6	-7.9	-4.2	-3.2
Trade balance - services	3.1	3.2	2.2	1.8	2.1	2.1	2.8
Net foreign assets	-21.7	-31.6	-56.0	-77.9	-78.9	#N/A	#N/A
Export market perf. G & S (% change)	2.0	-1.0	-3.0	1.5	-1.9	0.2	-0.6
REER (DPC) index 2000=100							
vs 35 industrial countries	105.0	100.0	113.3	117.6	120.8	121.1	119.1
vs rest of euro area	95.5	100.0	106.3	109.0	110.0	109.5	109.2
REER (GDP deflator) index 2000=100							
vs 35 industrial countries	104.1	100.0	117.1	121.8	124.2	124.1	122.0
vs rest of euro area	94.4	100.0	110.8	114.4	114.8	113.5	112.9
REER (exp. price defl.) index 2000=100							
vs 35 industrial countries	100.3	100.0	111.2	114.5	115.4	116.9	115.6
vs rest of euro area	93.6	100.0	106.2	108.4	108.8	109.1	109.2
REER (ULC tot. econ.) index 2000=100							
vs 35 industrial countries	105.9	100.0	112.3	118.0	121.9	119.9	119.7
vs rest of euro area	95.1	100.0	105.6	110.6	112.0	108.0	109.3
Terms of trade (index 2000=100)***:***							
Goods & services	100.9	100.0	106.2	107.0	105.2	109.7	110.0
Goods	101.0	100.0	104.1	104.8	102.4	106.9	106.3
Services	102.9	100.0	107.4	108.1	108.0	108.2	110.7
Openness:							
a1. Exports (constant prices)	21.9	29.0	29.1	30.7	30.2	27.7	28.3
a2. Imports (constant prices)	22.1	32.2	37.3	41.2	38.8	33.0	32.4
a3. Exports and imports (constant prices)	43.9	61.2	66.3	71.9	69.0	60.8	60.7
b. Net foreign direct investment (FDI)	0.6	-3.2	-1.5	-4.8	-0.6	#N/A	#N/A
c. FDI intensity	0.9	8.4	3.0	6.4	#N/A	#N/A	#N/A
d. Net portfolio investment	3.4	-0.2	4.6	8.6	0.3	#N/A	#N/A
Profitability:							
a. 1/RULC (index 2000=100):	97.2	100.0	106.2	106.5	104.4	104.2	104.1
b. Gross operating surplus as a % of GVA	46.2	44.8	46.6	46.9	47.0	47.4	46.5
c. Employee wage bill as a % of GVA	53.0	54.7	52.9	53.1	52.9	52.4	53.2
d. (NDP - TCE) as a % of NKS	12.9	12.7	12.2	11.7	11.0	11.1	10.5
Economic structure (% of GVA)***:***							
Agriculture (ISIC A_B)	3.8	4.4	3.3	3.3	3.2	#N/A	#N/A
Industry (ISIC C_E)	20.4	20.9	19.2	18.3	17.8	#N/A	#N/A
Building (ISIC F)	8.1	8.3	9.5	9.4	9.2	#N/A	#N/A
Market Services (ISIC G_K)	46.0	45.6	46.5	47.3	47.9	#N/A	#N/A
Other Services (ISIC L_P)	21.8	20.8	21.3	21.2	21.9	#N/A	#N/A
Share of services in total trade							
Exports	30.8	31.5	29.9	29.5	30.0	30.1	29.9
Imports	17.1	18.4	18.5	18.7	19.3	20.1	20.2
1. RCA for all exports (vs World):							
raw-material-intensive	1.0	1.0	0.9	0.9	#N/A	#N/A	#N/A
labour-intensive	0.9	1.0	1.0	1.0	#N/A	#N/A	#N/A
capital-intensive	2.0	2.1	1.9	1.8	#N/A	#N/A	#N/A
difficult-to-imitate research-intensive	0.6	0.7	0.8	0.7	#N/A	#N/A	#N/A
easy-to-imitate research-intensive	0.5	0.5	0.6	0.6	#N/A	#N/A	#N/A
2. RCA for exports of goods (vs World):							
low-technology goods	1.0	1.0	1.1	1.1	#N/A	#N/A	#N/A
medium-to-low-technology goods	1.1	1.2	1.1	0.9	#N/A	#N/A	#N/A
medium-to-high-technology goods	1.3	1.3	1.3	1.2	#N/A	#N/A	#N/A
high-technology goods	0.4	0.3	0.3	0.4	#N/A	#N/A	#N/A
- ICT	0.4	0.3	0.3	0.3	#N/A	#N/A	#N/A

Footnotes: f = Commission autumn 2009 forecast; REER = real effective exchange rate; DPC = deflator of private consumption; FDI intensity = average of inward and outward FDI flows as a % of GDP; 1/RULC = Nominal GDP/employee wage bill; GVA = gross value added; NDP = Net domestic product; TCE = total compensation of employees; NKS =net capital stock; RCA = revealed comparative advantage: 1 based on factor intensity of total exports; and 2 based on technology intensity of exports of manufactured goods.
Source: Commission services.

Table A.6: **FRANCE - Indicators related to competitiveness (% of GDP unless otherwise indicated)**

Indicator	1995	2000	2005	2007	2008	2009	2010f
Current account balance	0.5	1.1	-1.8	-2.3	-3.3	-2.3	-2.2
Trade balance - goods & services	1.1	0.9	-0.9	-1.9	-2.5	-1.2	-1.1
Trade balance - goods	0.8	-0.2	-1.3	-2.0	-2.7	-1.5	-1.4
Trade balance - services	0.4	1.1	0.4	0.2	0.2	0.3	0.3
Net foreign assets	7.1	9.6	8.0	14.3	-4.2	#N/A	#N/A
Export market perf. G & S (% change)	0.7	1.3	-2.9	-2.4	-0.6	2.3	1.3
REER (DPC) index 2000=100							
vs 35 industrial countries	116.0	100.0	106.1	108.0	110.0	110.7	109.1
vs rest of euro area	103.9	100.0	97.3	97.1	97.1	97.3	97.4
REER (GDP deflator) index 2000=100							
vs 35 industrial countries	114.6	100.0	106.6	109.0	111.3	112.8	111.7
vs rest of euro area	102.1	100.0	98.6	99.4	99.8	100.6	100.9
REER (exp. price defl.) index 2000=100							
vs 35 industrial countries	111.5	100.0	102.3	103.1	103.9	104.5	103.6
vs rest of euro area	102.8	100.0	95.7	95.2	95.5	95.2	95.7
REER (ULC tot. econ.) index 2000=100							
vs 35 industrial countries	115.0	100.0	109.5	112.1	113.8	113.0	111.4
vs rest of euro area	101.1	100.0	100.8	102.3	101.6	98.9	98.9
Terms of trade (index 2000=100)***:***							
Goods & services	100.7	100.0	101.4	101.4	100.3	105.8	105.8
Goods	102.4	100.0	100.5	101.3	99.5	106.2	106.2
Services	94.3	100.0	103.8	99.9	101.9	101.3	101.5
Openness:							
a1. Exports (constant prices)	22.0	28.6	29.0	29.8	29.6	27.0	27.4
a2. Imports (constant prices)	21.1	27.7	30.4	32.3	32.5	30.0	30.3
a3. Exports and imports (constant prices)	43.1	56.2	59.4	62.1	62.1	57.0	57.7
b. Net foreign direct investment (FDI)	0.5	-10.0	-1.4	-2.5	-3.6	#N/A	#N/A
c. FDI intensity	1.3	8.2	4.7	7.4	#N/A	#N/A	#N/A
d. Net portfolio investment	0.4	2.8	-0.8	-6.4	4.6	#N/A	#N/A
Profitability:							
a. 1/RULC (index 2000=100):	98.4	100.0	100.1	101.2	100.9	101.2	103.0
b. Gross operating surplus as a % of GVA	38.5	38.5	38.2	39.2	39.2	39.4	40.4
c. Employee wage bill as a % of GVA	58.0	57.9	58.0	57.5	57.5	57.3	56.6
d. (NDP - TCE) as a % of NKS	11.6	12.0	11.5	11.5	11.0	10.5	10.6
Economic structure (% of GVA)***:***							
Agriculture (ISIC A_B)	2.9	2.8	2.6	2.4	2.4	#N/A	#N/A
Industry (ISIC C_E)	17.4	17.7	17.6	16.9	16.4	#N/A	#N/A
Building (ISIC F)	6.0	5.2	5.0	5.1	5.1	#N/A	#N/A
Market Services (ISIC G_K)	47.6	50.1	51.1	52.3	52.6	#N/A	#N/A
Other Services (ISIC L_P)	26.3	24.2	23.7	23.1	23.2	#N/A	#N/A
Share of services in total trade							
Exports	20.0	20.5	18.3	18.2	17.9	19.6	19.7
Imports	18.2	17.2	16.8	16.1	15.8	16.7	16.9
1. RCA for all exports (vs World):							
raw-material-intensive	0.8	0.6	0.6	0.7	#N/A	#N/A	#N/A
labour-intensive	0.8	0.8	0.9	0.9	#N/A	#N/A	#N/A
capital-intensive	1.4	1.5	1.6	1.4	#N/A	#N/A	#N/A
difficult-to-imitate research-intensive	1.0	1.0	1.1	1.2	#N/A	#N/A	#N/A
easy-to-imitate research-intensive	0.9	1.0	0.9	0.8	#N/A	#N/A	#N/A
2. RCA for exports of goods (vs World):							
low-technology goods	1.0	0.9	1.0	1.0	#N/A	#N/A	#N/A
medium-to-low-technology goods	0.9	0.9	0.9	0.8	#N/A	#N/A	#N/A
medium-to-high-technology goods	1.1	1.2	1.2	1.2	#N/A	#N/A	#N/A
high-technology goods	0.9	0.9	0.8	0.9	#N/A	#N/A	#N/A
- ICT	0.6	0.6	0.5	0.4	#N/A	#N/A	#N/A

Footnotes: f = Commission autumn 2009 forecast; REER = real effective exchange rate; DPC = deflator of private consumption; FDI intensity = average of inward and outward FDI flows as a % of GDP; 1/RULC = Nominal GDP/employee wage bill; GVA = gross value added; NDP = Net domestic product; TCE = total compensation of employees; NKS =net capital stock; RCA = revealed comparative advantage: 1 based on factor intensity of total exports; and 2 based on technology intensity of exports of manufactured goods.

Source: Commission services.

Table A.7: **ITALY - Indicators related to competitiveness (% of GDP unless otherwise indicated)**

Indicator	1995	2000	2005	2007	2008	2009	2010f
Current account balance	2.1	-0.1	-1.2	-1.8	-3.1	-3.2	-2.4
Trade balance - goods & services	3.8	0.9	-0.1	-0.2	-0.6	-0.4	-0.2
Trade balance - goods	3.4	0.9	0.0	0.2	-0.1	0.1	0.3
Trade balance - services	0.4	0.1	-0.1	-0.4	-0.4	-0.5	-0.5
Net foreign assets	-4.8	11.0	-2.3	1.2	#N/A	#N/A	#N/A
Export market perf. G & S (% change)	4.2	0.0	-5.3	-1.4	-4.8	-7.3	-0.2
REER (DPC) index 2000=100							
vs 35 industrial countries	94.0	100.0	112.1	114.9	117.1	117.4	116.4
vs rest of euro area	83.1	100.0	103.3	104.1	104.5	104.3	105.2
REER (GDP deflator) index 2000=100							
vs 35 industrial countries	93.0	100.0	111.6	113.1	115.4	117.2	116.6
vs rest of euro area	81.8	100.0	103.9	104.1	104.8	105.9	106.9
REER (exp. price defl.) index 2000=100							
vs 35 industrial countries	92.7	100.0	116.1	122.9	126.4	131.0	130.6
vs rest of euro area	84.4	100.0	109.7	115.2	118.5	121.9	123.3
REER (ULC tot. econ.) index 2000=100							
vs 35 industrial countries	97.8	100.0	117.2	120.0	123.6	126.9	126.4
vs rest of euro area	85.0	100.0	108.3	110.2	111.6	112.4	113.9
Terms of trade (index 2000=100)***:***							
Goods & services	100.8	100.0	102.0	100.5	98.9	104.8	105.6
Goods	99.9	100.0	101.0	99.1	96.3	103.5	104.0
Services	103.2	100.0	106.6	106.3	109.8	110.4	112.5
Openness:							
a1. Exports (constant prices)	24.4	27.1	26.8	28.8	28.0	23.9	24.1
a2. Imports (constant prices)	20.9	26.1	27.4	29.1	28.2	25.4	25.7
a3. Exports and imports (constant prices)	45.3	53.2	54.2	57.9	56.2	49.3	49.8
b. Net foreign direct investment (FDI)	-0.2	0.1	-1.2	-2.4	-1.2	#N/A	#N/A
c. FDI intensity	0.5	1.2	1.7	3.1	#N/A	#N/A	#N/A
d. Net portfolio investment	3.1	-2.2	3.0	1.2	7.6	#N/A	#N/A
Profitability:							
a. 1/RULC (index 2000=100):	94.5	100.0	98.3	98.7	97.0	94.7	96.0
b. Gross operating surplus as a % of GVA	53.4	52.8	51.3	50.8	50.4	49.7	50.3
c. Employee wage bill as a % of GVA	45.8	43.9	45.3	45.7	46.6	47.7	47.2
d. (NDP - TCE) as a % of NKS	15.3	16.1	14.5	14.4	13.5	12.2	12.4
Economic structure (% of GVA)***:***							
Agriculture (ISIC A_B)	2.8	2.8	2.6	2.5	2.5	2.6	#N/A
Industry (ISIC C_E)	24.2	23.4	21.8	22.1	21.6	19.4	#N/A
Building (ISIC F)	5.2	5.0	5.5	5.4	5.3	5.3	#N/A
Market Services (ISIC G_K)	47.0	48.7	49.7	49.9	50.2	51.1	#N/A
Other Services (ISIC L_P)	20.9	20.1	20.4	20.1	20.3	21.5	#N/A
Share of services in total trade							
Exports	19.8	19.1	18.8	19.0	19.1	20.4	20.4
Imports	21.9	19.5	20.0	21.5	22.5	23.6	23.5
1. RCA for all exports (vs World):							
raw-material-intensive	0.4	0.4	0.5	0.5	#N/A	#N/A	#N/A
labour-intensive	1.8	1.9	1.8	1.7	#N/A	#N/A	#N/A
capital-intensive	0.9	1.0	1.0	1.0	#N/A	#N/A	#N/A
difficult-to-imitate research-intensive	1.1	1.1	1.3	1.3	#N/A	#N/A	#N/A
easy-to-imitate research-intensive	0.6	0.6	0.6	0.5	#N/A	#N/A	#N/A
2. RCA for exports of goods (vs World):							
low-technology goods	1.3	1.4	1.3	1.4	#N/A	#N/A	#N/A
medium-to-low-technology goods	1.1	1.1	1.3	1.0	#N/A	#N/A	#N/A
medium-to-high-technology goods	1.1	1.1	1.1	1.1	#N/A	#N/A	#N/A
high-technology goods	0.4	0.3	0.3	0.3	#N/A	#N/A	#N/A
- ICT	0.4	0.3	0.2	0.2	#N/A	#N/A	#N/A

Footnotes: f = Commission autumn 2009 forecast; REER = real effective exchange rate; DPC = deflator of private consumption; FDI intensity = average of inward and outward FDI flows as a % of GDP; 1/RULC = Nominal GDP/employee wage bill; GVA = gross value added; NDP = Net domestic product; TCE = total compensation of employees; NKS =net capital stock; RCA = revealed comparative advantage: 1 based on factor intensity of total exports; and 2 based on technology intensity of exports of manufactured goods.
Source: Commission services.

Table A.8: **CYPRUS - Indicators related to competitiveness (% of GDP unless otherwise indicated)**

Indicator	1995	2000	2005	2007	2008	2009	2010f
Current account balance	-1.7	-4.9	-5.9	-11.7	-17.7	-11.4	-8.8
Trade balance - goods & services	-0.1	0.8	-2.6	-6.3	-11.5	-6.2	-5.1
Trade balance - goods	-22.5	-26.9	-25.0	-29.7	-32.2	-23.8	-23.2
Trade balance - services	22.5	27.7	22.5	23.4	20.7	17.5	18.1
Net foreign assets	-32.9	-44.3	3.7	15.8	#N/A	#N/A	#N/A
Export market perf. G & S (% change)	8.2	-1.6	-0.8	1.4	-2.6	-1.0	0.5
REER (DPC) index 2000=100							
vs 35 industrial countries	106.7	100.0	110.1	111.4	116.0	118.8	119.7
vs rest of euro area	92.2	100.0	101.4	101.7	102.9	103.8	106.1
REER (GDP deflator) index 2000=100							
vs 35 industrial countries	104.8	100.0	111.2	114.0	119.2	122.8	123.8
vs rest of euro area	89.9	100.0	103.6	105.8	107.9	109.1	111.4
REER (exp. price defl.) index 2000=100							
vs 35 industrial countries	94.6	100.0	109.8	111.6	112.7	117.8	119.1
vs rest of euro area	85.7	100.0	103.1	104.1	104.3	107.7	110.1
REER (ULC tot. econ.) index 2000=100							
vs 35 industrial countries	106.3	100.0	118.0	115.6	117.6	118.8	119.5
vs rest of euro area	90.3	100.0	109.4	107.2	105.9	104.3	106.4
Terms of trade (index 2000=100)***:***							
Goods & services	99.7	100.0	100.8	103.4	102.6	108.5	108.9
Goods	100.3	100.0	92.8	97.5	95.1	100.3	100.0
Services	101.0	100.0	106.2	109.3	108.2	108.4	109.9
Openness:							
a1. Exports (constant prices)	51.0	55.4	52.5	52.6	49.8	42.6	42.9
a2. Imports (constant prices)	50.9	54.5	55.7	61.6	64.1	54.3	53.5
a3. Exports and imports (constant prices)	101.9	109.9	108.2	114.2	113.9	96.9	96.3
b. Net foreign direct investment (FDI)	#N/A	#N/A	3.7	4.5	0.5	#N/A	#N/A
c. FDI intensity	#N/A	5.5	5.1	7.9	#N/A	#N/A	#N/A
d. Net portfolio investment	#N/A	#N/A	-0.9	-2.0	-73.7	#N/A	#N/A
Profitability:							
a. 1/RULC (index 2000=100):	97.1	100.0	96.4	102.1	104.2	104.4	106.1
b. Gross operating surplus as a % of GVA	50.3	50.7	44.1	43.3	44.2	46.2	46.2
c. Employee wage bill as a % of GVA	47.4	46.1	50.0	49.2	49.7	49.9	49.3
d. (NDP - TCE) as a % of NKS	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A
Economic structure (% of GVA)***:***							
Agriculture (ISIC A_B)	4.6	3.6	2.9	2.3	2.2	#N/A	#N/A
Industry (ISIC C_E)	14.2	12.2	11.2	10.2	10.2	#N/A	#N/A
Building (ISIC F)	8.8	6.8	7.5	7.8	7.9	#N/A	#N/A
Market Services (ISIC G_K)	49.6	55.0	56.0	58.2	58.2	#N/A	#N/A
Other Services (ISIC L_P)	22.5	22.3	22.2	21.4	21.5	#N/A	#N/A
Share of services in total trade							
Exports	74.6	81.5	80.0	84.9	84.0	83.5	83.6
Imports	29.3	31.9	34.1	34.2	32.3	32.6	32.9
1. RCA for all exports (vs World):							
raw-material-intensive	1.3	1.2	1.4	1.8	#N/A	#N/A	#N/A
labour-intensive	1.2	1.0	0.6	0.7	#N/A	#N/A	#N/A
capital-intensive	2.0	2.7	1.0	1.0	#N/A	#N/A	#N/A
difficult-to-imitate research-intensive	0.3	0.2	0.3	0.5	#N/A	#N/A	#N/A
easy-to-imitate research-intensive	0.5	0.4	1.8	0.9	#N/A	#N/A	#N/A
2. RCA for exports of goods (vs World):							
low-technology goods	2.7	2.8	1.1	1.1	#N/A	#N/A	#N/A
medium-to-low-technology goods	0.5	0.6	0.4	1.0	#N/A	#N/A	#N/A
medium-to-high-technology goods	0.5	0.7	0.8	1.0	#N/A	#N/A	#N/A
high-technology goods	0.3	0.1	1.7	0.9	#N/A	#N/A	#N/A
- ICT	0.3	0.1	1.9	1.2	#N/A	#N/A	#N/A

Footnotes: f = Commission autumn 2009 forecast; REER = real effective exchange rate; DPC = deflator of private consumption; FDI intensity = average of inward and outward FDI flows as a % of GDP; 1/RULC = Nominal GDP/employee wage bill; GVA = gross value added; NDP = Net domestic product; TCE = total compensation of employees; NKS =net capital stock; RCA = revealed comparative advantage: 1 based on factor intensity of total exports; and 2 based on technology intensity of exports of manufactured goods.

Source: Commission services.

Table A.9: **LUXEMBOURG - Indicators related to competitiveness (% of GDP unless otherwise indicated)**

Indicator	1995	2000	2005	2007	2008	2009	2010f
Current account balance	12.1	13.2	11.0	9.7	5.5	9.4	11.2
Trade balance - goods & services	21.2	21.0	25.4	33.5	32.5	31.1	32.1
Trade balance - goods	-8.9	-12.5	-11.9	-8.6	-10.5	-8.4	-8.6
Trade balance - services	30.1	33.5	37.3	42.1	43.0	39.6	40.6
Net foreign assets	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A
Export market perf. G & S (% change)	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A
REER (DPC) index 2000=100							
vs 35 industrial countries	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A
vs rest of euro area	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A
REER (GDP deflator) index 2000=100							
vs 35 industrial countries	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A
vs rest of euro area	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A
REER (exp. price defl.) index 2000=100							
vs 35 industrial countries	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A
vs rest of euro area	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A
REER (ULC tot. econ.) index 2000=100							
vs 35 industrial countries	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A
vs rest of euro area	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A
Terms of trade (index 2000=100)***:***							
Goods & services	103.9	100.0	103.5	105.8	107.6	107.6	108.0
Goods	109.4	100.0	101.8	107.6	107.8	108.4	108.4
Services	110.2	100.0	104.4	103.4	107.0	107.7	107.7
Openness:							
a1. Exports (constant prices)	124.0	150.0	166.2	182.3	185.0	172.7	174.0
a2. Imports (constant prices)	103.2	129.0	143.9	156.4	161.6	148.4	149.6
a3. Exports and imports (constant prices)	227.2	279.0	310.0	338.7	346.6	321.1	323.6
b. Net foreign direct investment (FDI)	#N/A	#N/A	-22.4	-127.4	-54.5	#N/A	#N/A
c. FDI intensity	#N/A	#N/A	320.2	435.5	#N/A	#N/A	#N/A
d. Net portfolio investment	#N/A	#N/A	129.6	261.2	59.5	#N/A	#N/A
Profitability:							
a. 1/RULC (index 2000=100):	97.1	100.0	101.2	108.1	106.3	99.1	102.9
b. Gross operating surplus as a % of GVA	47.3	46.5	47.3	50.5	50.2	46.0	48.2
c. Employee wage bill as a % of GVA	52.0	51.8	51.5	48.1	48.9	52.4	50.5
d. (NDP - TCE) as a % of NKS	21.0	23.3	22.1	24.0	22.4	18.8	19.2
Economic structure (% of GVA)***:***							
Agriculture (ISIC A_B)	1.0	0.7	0.4	0.3	0.3	#N/A	#N/A
Industry (ISIC C_E)	13.1	12.6	11.4	10.5	10.0	#N/A	#N/A
Building (ISIC F)	6.3	5.7	6.1	5.7	5.8	#N/A	#N/A
Market Services (ISIC G_K)	62.6	65.5	66.6	69.0	69.1	#N/A	#N/A
Other Services (ISIC L_P)	16.9	15.4	15.5	14.5	14.8	#N/A	#N/A
Share of services in total trade							
Exports	68.4	72.6	75.0	77.8	77.8	79.6	79.8
Imports	49.2	58.5	61.7	65.8	65.2	67.8	67.8
1. RCA for all exports (vs World):							
raw-material-intensive	0.3	0.3	0.3	0.3	#N/A	#N/A	#N/A
labour-intensive	1.3	1.2	1.5	1.4	#N/A	#N/A	#N/A
capital-intensive	2.4	2.4	2.3	2.5	#N/A	#N/A	#N/A
difficult-to-imitate research-intensive	0.7	0.7	0.6	0.6	#N/A	#N/A	#N/A
easy-to-imitate research-intensive	0.4	0.7	0.6	0.5	#N/A	#N/A	#N/A
2. RCA for exports of goods (vs World):							
low-technology goods	0.6	0.8	1.0	0.9	#N/A	#N/A	#N/A
medium-to-low-technology goods	3.0	2.5	2.4	2.0	#N/A	#N/A	#N/A
medium-to-high-technology goods	0.5	0.6	0.7	0.6	#N/A	#N/A	#N/A
high-technology goods	0.4	0.6	0.4	0.5	#N/A	#N/A	#N/A
- ICT	0.4	0.6	0.4	0.5	#N/A	#N/A	#N/A

Footnotes: f = Commission autumn 2009 forecast; REER = real effective exchange rate; DPC = deflator of private consumption; FDI intensity = average of inward and outward FDI flows as a % of GDP; 1/RULC = Nominal GDP/employee wage bill; GVA = gross value added; NDP = Net domestic product; TCE = total compensation of employees; NKS =net capital stock; RCA = revealed comparative advantage: 1 based on factor intensity of total exports; and 2 based on technology intensity of exports of manufactured goods.
Source: Commission services.

Table A.10: **MALTA - Indicators related to competitiveness (% of GDP unless otherwise indicated)**

Indicator	1995	2000	2005	2007	2008	2009	2010f
Current account balance	-10.6	-12.5	-8.8	-6.9	-5.6	-2.5	-2.8
Trade balance - goods & services	-13.2	-10.7	-5.4	-2.0	-3.0	2.6	-1.2
Trade balance - goods	-21.9	-19.4	-18.9	-18.0	-19.4	-13.5	-15.3
Trade balance - services	8.7	8.8	13.5	16.0	16.5	16.1	14.1
Net foreign assets	21.1	-1.2	22.9	-16.3	#N/A	#N/A	#N/A
Export market perf. G & S (% change)	#N/A	-5.7	-5.3	-1.1	-7.8	10.7	-1.2
REER (DPC) index 2000=100							
vs 35 industrial countries	103.6	100.0	107.1	111.4	114.3	113.2	112.1
vs rest of euro area	89.2	100.0	94.0	94.0	94.3	94.7	95.3
REER (GDP deflator) index 2000=100							
vs 35 industrial countries	102.7	100.0	109.9	116.3	119.0	118.5	118.6
vs rest of euro area	88.2	100.0	97.1	99.2	99.3	100.2	101.5
REER (exp. price defl.) index 2000=100							
vs 35 industrial countries	83.4	100.0	100.1	115.6	115.7	110.6	109.2
vs rest of euro area	74.4	100.0	90.3	101.4	100.5	96.2	96.2
REER (ULC tot. econ.) index 2000=100							
vs 35 industrial countries	104.7	100.0	115.3	119.2	123.6	122.2	123.4
vs rest of euro area	88.6	100.0	100.7	101.0	101.9	100.5	103.1
Terms of trade (index 2000=100)***:***							
Goods & services	101.0	100.0	101.8	103.3	101.6	103.0	103.5
Goods	97.2	100.0	82.5	81.7	82.2	78.8	79.2
Services	108.8	100.0	143.1	139.3	127.7	129.0	130.1
Openness:							
a1. Exports (constant prices)	95.1	92.1	90.1	95.0	86.3	85.3	86.0
a2. Imports (constant prices)	111.2	102.7	98.1	100.3	91.0	84.7	85.7
a3. Exports and imports (constant prices)	206.3	194.8	188.2	195.3	177.3	169.9	171.8
b. Net foreign direct investment (FDI)	3.5	15.5	11.7	12.1	7.2	#N/A	#N/A
c. FDI intensity	#N/A	8.4	5.5	6.5	#N/A	#N/A	#N/A
d. Net portfolio investment	-12.8	-19.4	-44.7	6.8	6.5	#N/A	#N/A
Profitability:							
a. 1/RULC (index 2000=100):	97.5	100.0	98.2	101.8	99.8	99.4	100.0
b. Gross operating surplus as a % of GVA	50.2	50.8	48.9	50.7	49.8	49.4	49.8
c. Employee wage bill as a % of GVA	50.4	49.5	51.9	49.8	50.4	50.7	50.3
d. (NDP - TCE) as a % of NKS	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A
Economic structure (% of GVA)***:***							
Agriculture (ISIC A_B)	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A
Industry (ISIC C_E)	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A
Building (ISIC F)	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A
Market Services (ISIC G_K)	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A
Other Services (ISIC L_P)	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A
Share of services in total trade							
Exports	31.0	30.7	29.0	38.6	43.1	43.4	43.2
Imports	19.5	19.0	22.8	33.0	32.5	34.9	34.9
1. RCA for all exports (vs World):							
raw-material-intensive	0.2	0.3	0.3	0.4	#N/A	#N/A	#N/A
labour-intensive	1.0	0.8	1.2	1.0	#N/A	#N/A	#N/A
capital-intensive	0.2	0.3	0.4	0.4	#N/A	#N/A	#N/A
difficult-to-imitate research-intensive	2.4	2.5	2.3	2.2	#N/A	#N/A	#N/A
easy-to-imitate research-intensive	0.3	0.2	0.4	0.6	#N/A	#N/A	#N/A
2. RCA for exports of goods (vs World):							
low-technology goods	0.8	0.7	1.1	0.8	#N/A	#N/A	#N/A
medium-to-low-technology goods	0.3	0.5	0.4	0.3	#N/A	#N/A	#N/A
medium-to-high-technology goods	0.2	0.2	0.5	0.6	#N/A	#N/A	#N/A
high-technology goods	3.2	2.7	2.3	3.4	#N/A	#N/A	#N/A
- ICT	3.7	3.2	2.7	4.7	#N/A	#N/A	#N/A

Footnotes: f = Commission autumn 2009 forecast; REER = real effective exchange rate; DPC = deflator of private consumption; FDI intensity = average of inward and outward FDI flows as a % of GDP; 1/RULC = Nominal GDP/employee wage bill; GVA = gross value added; NDP = Net domestic product; TCE = total compensation of employees; NKS =net capital stock; RCA = revealed comparative advantage: 1 based on factor intensity of total exports; and 2 based on technology intensity of exports of manufactured goods.

Source: Commission services.

Table A.11: **NETHERLANDS - Indicators related to competitiveness (% of GDP unless otherwise indicated)**

Indicator	1995	2000	2005	2007	2008	2009	2010f
Current account balance	6.2	6.4	7.5	8.6	4.4	2.7	3.1
Trade balance - goods & services	5.7	5.5	8.5	8.6	8.3	7.2	8.4
Trade balance - goods	5.7	5.7	7.9	8.0	7.4	6.6	6.3
Trade balance - services	-0.1	-0.1	0.6	0.6	0.9	0.6	2.1
Net foreign assets	3.7	-14.8	27.4	44.4	42.8	#N/A	#N/A
Export market perf. G & S (% change)	2.0	1.9	-0.3	1.6	1.1	3.8	0.3
REER (DPC) index 2000=100							
vs 35 industrial countries	107.4	100.0	109.5	110.4	111.7	112.2	110.9
vs rest of euro area	98.3	100.0	103.3	102.9	102.2	101.7	101.9
REER (GDP deflator) index 2000=100							
vs 35 industrial countries	106.9	100.0	110.1	110.2	112.8	112.2	110.8
vs rest of euro area	97.3	100.0	104.7	104.0	104.8	102.9	102.9
REER (exp. price defl.) index 2000=100							
vs 35 industrial countries	107.6	100.0	104.8	105.5	108.6	106.3	104.5
vs rest of euro area	100.7	100.0	100.2	100.3	102.9	99.5	99.0
REER (ULC tot. econ.) index 2000=100							
vs 35 industrial countries	108.2	100.0	110.6	111.7	113.5	117.5	117.2
vs rest of euro area	97.6	100.0	104.7	105.6	105.3	106.7	107.8
Terms of trade (index 2000=100)***:***							
Goods & services	98.5	100.0	102.4	101.6	101.8	100.7	100.3
Goods	97.6	100.0	104.0	103.3	103.3	102.2	101.7
Services	101.3	100.0	98.8	97.2	98.5	98.0	98.0
Openness:							
a1. Exports (constant prices)	56.1	70.1	78.4	83.7	84.3	80.4	81.8
a2. Imports (constant prices)	50.0	64.5	70.4	75.2	76.5	72.6	72.7
a3. Exports and imports (constant prices)	106.1	134.6	148.8	158.9	160.8	153.0	154.5
b. Net foreign direct investment (FDI)	-1.8	-3.1	-13.2	11.2	-3.2	#N/A	#N/A
c. FDI intensity	3.7	18.1	14.1	9.5	#N/A	#N/A	#N/A
d. Net portfolio investment	-2.3	-2.3	12.0	-11.7	14.1	#N/A	#N/A
Profitability:							
a. 1/RULC (index 2000=100):	97.7	100.0	101.9	102.5	102.3	96.5	97.3
b. Gross operating surplus as a % of GVA	42.9	43.2	43.9	44.0	44.1	41.7	42.3
c. Employee wage bill as a % of GVA	56.5	56.7	55.8	55.6	55.8	58.9	58.3
d. (NDP - TCE) as a % of NKS	11.7	12.6	12.7	13.3	13.2	11.0	11.0
Economic structure (% of GVA)***:***							
Agriculture (ISIC A_B)	3.0	2.6	2.5	2.4	2.4	2.5	#N/A
Industry (ISIC C_E)	20.8	19.3	19.0	18.4	18.3	17.5	#N/A
Building (ISIC F)	6.0	5.6	4.9	4.9	5.1	5.1	#N/A
Market Services (ISIC G_K)	45.5	50.3	51.1	52.7	52.8	52.3	#N/A
Other Services (ISIC L_P)	24.8	22.1	22.5	21.7	21.6	22.7	#N/A
Share of services in total trade							
Exports	20.9	20.7	19.2	18.0	18.3	19.1	19.1
Imports	23.8	22.7	20.2	18.6	18.6	20.0	19.5
1. RCA for all exports (vs World):							
raw-material-intensive	1.8	1.4	1.3	1.3	#N/A	#N/A	#N/A
labour-intensive	0.7	0.6	0.6	0.6	#N/A	#N/A	#N/A
capital-intensive	0.8	0.8	0.7	0.7	#N/A	#N/A	#N/A
difficult-to-imitate research-intensive	0.7	0.8	0.8	0.8	#N/A	#N/A	#N/A
easy-to-imitate research-intensive	1.3	1.5	1.5	1.6	#N/A	#N/A	#N/A
2. RCA for exports of goods (vs World):							
low-technology goods	1.2	1.1	1.1	0.9	#N/A	#N/A	#N/A
medium-to-low-technology goods	1.2	1.0	0.6	1.4	#N/A	#N/A	#N/A
medium-to-high-technology goods	0.9	0.8	0.9	0.8	#N/A	#N/A	#N/A
high-technology goods	0.9	1.2	1.3	1.0	#N/A	#N/A	#N/A
- ICT	0.9	1.3	1.4	1.2	#N/A	#N/A	#N/A

Footnotes: f = Commission autumn 2009 forecast; REER = real effective exchange rate; DPC = deflator of private consumption; FDI intensity = average of inward and outward FDI flows as a % of GDP; 1/RULC = Nominal GDP/employee wage bill; GVA = gross value added; NDP = Net domestic product; TCE = total compensation of employees; NKS =net capital stock; RCA = revealed comparative advantage: 1 based on factor intensity of total exports; and 2 based on technology intensity of exports of manufactured goods.
Source: Commission services.

Table A.12: **AUSTRIA - Indicators related to competitiveness (% of GDP unless otherwise indicated)**

Indicator	1995	2000	2005	2007	2008	2009	2010f
Current account balance	-2.9	-0.7	2.2	3.4	3.6	2.5	1.4
Trade balance - goods & services	-1.0	1.8	4.0	5.9	5.8	4.2	3.3
Trade balance - goods	-3.4	-2.1	-0.4	0.7	0.1	-0.9	-2.3
Trade balance - services	2.5	3.8	4.4	5.1	5.7	5.1	5.7
Net foreign assets	-13.3	-17.9	-12.9	-9.1	-6.9	#N/A	#N/A
Export market perf. G & S (% change)	-1.2	1.7	0.9	2.9	-1.1	-3.9	0.1
REER (DPC) index 2000=100							
vs 35 industrial countries	111.7	100.0	103.3	105.1	105.8	107.7	106.4
vs rest of euro area	103.8	100.0	98.7	99.4	99.2	100.4	100.7
REER (GDP deflator) index 2000=100							
vs 35 industrial countries	114.9	100.0	102.1	102.4	102.9	104.4	103.0
vs rest of euro area	106.5	100.0	98.4	98.2	98.1	98.7	98.7
REER (exp. price defl.) index 2000=100							
vs 35 industrial countries	108.5	100.0	104.7	105.5	105.8	107.8	106.7
vs rest of euro area	102.8	100.0	101.3	101.5	101.7	102.9	102.9
REER (ULC tot. econ.) index 2000=100							
vs 35 industrial countries	117.6	100.0	99.8	100.1	100.5	103.4	103.0
vs rest of euro area	108.2	100.0	95.9	96.0	95.6	96.5	97.5
Terms of trade (index 2000=100)***:***							
Goods & services	104.2	100.0	100.9	99.6	98.0	98.7	98.1
Goods	102.8	100.0	101.3	100.1	97.9	98.8	98.1
Services	109.9	100.0	97.1	95.5	95.6	94.8	94.8
Openness:							
a1. Exports (constant prices)	35.3	46.4	56.7	62.3	61.5	53.9	54.5
a2. Imports (constant prices)	37.8	44.7	53.0	55.9	54.4	48.8	49.1
a3. Exports and imports (constant prices)	73.0	91.1	109.8	118.2	115.9	102.7	103.5
b. Net foreign direct investment (FDI)	0.3	1.6	-0.1	-2.0	-3.8	#N/A	#N/A
c. FDI intensity	0.6	3.8	3.7	8.6	#N/A	#N/A	#N/A
d. Net portfolio investment	4.2	1.6	-4.5	8.4	9.3	#N/A	#N/A
Profitability:							
a. 1/RULC (index 2000=100):	96.4	100.0	104.7	106.5	105.6	102.1	102.9
b. Gross operating surplus as a % of GVA	38.6	41.0	44.4	45.1	44.5	43.0	43.5
c. Employee wage bill as a % of GVA	59.6	57.3	54.5	53.7	54.2	56.1	55.7
d. (NDP - TCE) as a % of NKS	9.6	10.3	10.7	11.2	11.0	9.7	9.8
Economic structure (% of GVA)***:***							
Agriculture (ISIC A_B)	2.5	2.0	1.8	1.8	1.8	1.9	#N/A
Industry (ISIC C_E)	22.5	23.3	23.7	25.2	25.7	24.1	#N/A
Building (ISIC F)	8.4	7.5	7.2	7.1	7.0	6.9	#N/A
Market Services (ISIC G_K)	43.8	46.1	47.4	46.9	46.6	46.8	#N/A
Other Services (ISIC L_P)	23.0	21.1	20.1	19.2	19.1	20.3	#N/A
Share of services in total trade							
Exports	30.8	27.1	25.8	25.2	25.6	27.4	27.3
Imports	24.3	19.6	18.7	18.1	17.9	18.8	18.7
1. RCA for all exports (vs World):							
raw-material-intensive	0.5	0.4	0.4	0.5	#N/A	#N/A	#N/A
labour-intensive	1.4	1.4	1.3	1.3	#N/A	#N/A	#N/A
capital-intensive	1.1	1.3	1.6	1.3	#N/A	#N/A	#N/A
difficult-to-imitate research-intensive	1.1	1.2	1.2	1.3	#N/A	#N/A	#N/A
easy-to-imitate research-intensive	0.7	0.6	0.6	0.6	#N/A	#N/A	#N/A
2. RCA for exports of goods (vs World):							
low-technology goods	1.1	1.1	1.1	1.1	#N/A	#N/A	#N/A
medium-to-low-technology goods	1.2	1.5	1.3	1.0	#N/A	#N/A	#N/A
medium-to-high-technology goods	1.1	1.1	1.1	1.2	#N/A	#N/A	#N/A
high-technology goods	0.4	0.4	0.4	0.5	#N/A	#N/A	#N/A
- ICT	0.4	0.4	0.4	0.5	#N/A	#N/A	#N/A

Footnotes: f = Commission autumn 2009 forecast; REER = real effective exchange rate; DPC = deflator of private consumption; FDI intensity = average of inward and outward FDI flows as a % of GDP; 1/RULC = Nominal GDP/employee wage bill; GVA = gross value added; NDP = Net domestic product; TCE = total compensation of employees; NKS =net capital stock; RCA = revealed comparative advantage: 1 based on factor intensity of total exports; and 2 based on technology intensity of exports of manufactured goods.

Source: Commission services.

Table A.13: **PORTUGAL - Indicators related to competitiveness (% of GDP unless otherwise indicated)**

Indicator	1995	2000	2005	2007	2008	2009	2010f
Current account balance	-3.0	-10.7	-9.8	-9.8	-12.1	-10.6	-10.1
Trade balance - goods & services	-6.4	-10.9	-8.9	-7.5	-9.6	-7.6	-7.6
Trade balance - goods	-7.1	-12.0	-10.3	-10.1	-12.1	-10.0	-9.6
Trade balance - services	0.7	1.1	1.5	2.5	2.6	2.4	2.0
Net foreign assets	-3.7	-40.9	-69.1	-89.6	-94.9	#N/A	#N/A
Export market perf. G & S (% change)	5.5	-2.7	-4.4	2.1	0.3	2.3	0.0
REER (DPC) index 2000=100							
vs 35 industrial countries	102.5	100.0	109.4	111.9	113.5	112.2	111.1
vs rest of euro area	94.3	100.0	103.7	104.8	104.5	102.7	102.9
REER (GDP deflator) index 2000=100							
vs 35 industrial countries	99.4	100.0	109.0	111.1	112.6	113.3	112.2
vs rest of euro area	91.0	100.0	103.9	105.0	104.8	104.8	104.7
REER (exp. price defl.) index 2000=100							
vs 35 industrial countries	100.9	100.0	104.1	107.5	108.6	107.4	106.5
vs rest of euro area	94.8	100.0	99.8	102.2	102.8	100.9	101.0
REER (ULC tot. econ.) index 2000=100							
vs 35 industrial countries	95.5	100.0	111.3	111.2	113.5	117.3	118.1
vs rest of euro area	86.6	100.0	105.9	105.3	105.4	107.4	109.2
Terms of trade (index 2000=100)***:***							
Goods & services	100.6	100.0	100.5	102.0	100.3	104.6	103.6
Goods	103.6	100.0	99.8	101.8	99.4	104.2	102.8
Services	91.4	100.0	97.5	96.0	95.9	96.7	97.3
Openness:							
a1. Exports (constant prices)	26.8	29.8	32.4	36.8	36.6	33.3	33.4
a2. Imports (constant prices)	32.9	40.6	42.7	46.1	47.3	44.1	43.9
a3. Exports and imports (constant prices)	59.7	70.4	75.1	82.9	83.9	77.4	77.3
b. Net foreign direct investment (FDI)	0.0	-1.3	1.0	-1.1	0.6	#N/A	#N/A
c. FDI intensity	0.6	6.6	1.6	2.7	#N/A	#N/A	#N/A
d. Net portfolio investment	-1.0	-1.7	-0.8	6.2	8.3	#N/A	#N/A
Profitability:							
a. 1/RULC (index 2000=100):	102.7	100.0	100.5	103.6	102.0	97.9	97.5
b. Gross operating surplus as a % of GVA	45.5	43.2	42.3	43.3	42.6	39.4	38.5
c. Employee wage bill as a % of GVA	55.0	57.3	58.7	57.2	58.0	59.7	60.2
d. (NDP - TCE) as a % of NKS	14.6	13.7	11.8	12.2	11.5	10.2	10.1
Economic structure (% of GVA)***:***							
Agriculture (ISIC A_B)	4.9	3.8	3.5	3.3	3.4	3.5	#N/A
Industry (ISIC C_E)	19.4	20.0	19.1	19.5	19.0	18.0	#N/A
Building (ISIC F)	7.2	7.6	6.3	5.9	5.6	5.1	#N/A
Market Services (ISIC G_K)	42.9	44.7	46.5	47.4	47.9	48.4	#N/A
Other Services (ISIC L_P)	25.6	24.0	24.6	23.9	24.0	25.0	#N/A
Share of services in total trade							
Exports	23.7	22.3	21.8	23.8	24.5	25.9	25.8
Imports	15.6	13.5	12.6	12.7	12.9	13.2	13.2
1. RCA for all exports (vs World):							
raw-material-intensive	0.8	0.6	0.6	0.7	#N/A	#N/A	#N/A
labour-intensive	2.4	2.3	2.2	2.1	#N/A	#N/A	#N/A
capital-intensive	0.8	1.2	1.4	1.3	#N/A	#N/A	#N/A
difficult-to-imitate research-intensive	0.6	0.7	0.6	0.7	#N/A	#N/A	#N/A
easy-to-imitate research-intensive	0.4	0.5	0.6	0.6	#N/A	#N/A	#N/A
2. RCA for exports of goods (vs World):							
low-technology goods	2.2	2.1	1.7	1.8	#N/A	#N/A	#N/A
medium-to-low-technology goods	0.6	0.7	1.4	1.1	#N/A	#N/A	#N/A
medium-to-high-technology goods	0.7	0.9	0.8	0.8	#N/A	#N/A	#N/A
high-technology goods	0.4	0.4	0.5	0.4	#N/A	#N/A	#N/A
- ICT	0.5	0.4	0.6	0.5	#N/A	#N/A	#N/A

Footnotes: f = Commission autumn 2009 forecast; REER = real effective exchange rate; DPC = deflator of private consumption; FDI intensity = average of inward and outward FDI flows as a % of GDP; 1/RULC = Nominal GDP/employee wage bill; GVA = gross value added; NDP = Net domestic product; TCE = total compensation of employees; NKS =net capital stock; RCA = revealed comparative advantage: 1 based on factor intensity of total exports; and 2 based on technology intensity of exports of manufactured goods.
Source: Commission services.

Table A.14: **SLOVENIA - Indicators related to competitiveness (% of GDP unless otherwise indicated)**

Indicator	1995	2000	2005	2007	2008	2009	2010f
Current account balance	-0.8	-3.2	-1.8	-4.5	-6.1	-0.5	-0.2
Trade balance - goods & services	-2.0	-3.5	-0.4	-1.7	-3.0	1.5	3.1
Trade balance - goods	-4.7	-5.8	-3.6	-4.9	-7.2	-1.6	-1.3
Trade balance - services	2.7	2.3	3.2	3.2	4.2	3.1	4.4
Net foreign assets	#N/A	#N/A	-12.0	-21.5	-32.8	#N/A	#N/A
Export market perf. G & S (% change)	-6.4	1.6	4.2	6.8	1.6	-3.4	0.4
REER (DPC) index 2000=100							
vs 35 industrial countries	103.7	100.0	103.0	105.2	108.1	108.3	107.6
vs rest of euro area	96.9	100.0	100.3	102.3	104.8	103.7	104.4
REER (GDP deflator) index 2000=100							
vs 35 industrial countries	103.7	100.0	103.5	105.5	107.2	109.4	108.2
vs rest of euro area	96.7	100.0	101.5	103.8	105.5	106.0	106.2
REER (exp. price defl.) index 2000=100							
vs 35 industrial countries	104.5	100.0	105.0	105.7	104.5	105.3	104.1
vs rest of euro area	99.6	100.0	103.4	104.2	103.3	102.8	102.6
REER (ULC tot. econ.) index 2000=100							
vs 35 industrial countries	111.5	100.0	103.8	104.7	107.6	115.4	112.9
vs rest of euro area	103.3	100.0	101.1	102.7	105.4	110.5	109.4
Terms of trade (index 2000=100)***:***							
Goods & services	100.6	100.0	101.3	101.4	99.5	103.8	103.4
Goods	101.8	100.0	100.9	100.7	98.9	103.5	102.9
Services	97.4	100.0	99.7	101.9	98.2	98.1	98.1
Openness:							
a1. Exports (constant prices)	47.3	53.9	65.5	74.2	73.7	67.5	68.3
a2. Imports (constant prices)	49.5	57.4	66.8	77.1	76.6	68.3	67.8
a3. Exports and imports (constant prices)	96.8	111.4	132.3	151.3	150.4	135.8	136.1
b. Net foreign direct investment (FDI)	0.8	0.4	-0.1	-0.6	1.0	#N/A	#N/A
c. FDI intensity	#N/A	#N/A	2.1	3.7	#N/A	#N/A	#N/A
d. Net portfolio investment	-0.1	0.9	-4.6	-6.5	1.5	#N/A	#N/A
Profitability:							
a. 1/RULC (index 2000=100):	91.4	100.0	102.3	105.0	102.8	95.7	98.4
b. Gross operating surplus as a % of GVA	36.2	39.7	40.3	42.7	41.9	38.6	40.2
c. Employee wage bill as a % of GVA	65.2	59.1	58.1	56.7	58.1	62.5	60.8
d. (NDP - TCE) as a % of NKS	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A
Economic structure (% of GVA)***:***							
Agriculture (ISIC A_B)	3.9	3.3	2.8	2.4	2.3	#N/A	#N/A
Industry (ISIC C_E)	28.1	29.1	30.3	30.5	29.7	#N/A	#N/A
Building (ISIC F)	6.3	6.7	6.2	7.4	7.5	#N/A	#N/A
Market Services (ISIC G_K)	41.3	40.8	41.1	42.0	42.7	#N/A	#N/A
Other Services (ISIC L_P)	20.4	20.1	19.6	17.7	17.6	#N/A	#N/A
Share of services in total trade							
Exports	21.7	17.7	16.5	15.9	17.9	17.6	17.7
Imports	14.6	12.7	11.5	11.5	11.8	12.9	12.9
1. RCA for all exports (vs World):							
raw-material-intensive	0.3	0.2	0.2	0.3	#N/A	#N/A	#N/A
labour-intensive	1.8	1.8	1.6	1.4	#N/A	#N/A	#N/A
capital-intensive	1.4	1.7	1.8	1.7	#N/A	#N/A	#N/A
difficult-to-imitate research-intensive	0.8	0.9	1.1	1.0	#N/A	#N/A	#N/A
easy-to-imitate research-intensive	0.6	0.5	0.6	0.6	#N/A	#N/A	#N/A
2. RCA for exports of goods (vs World):							
low-technology goods	1.4	1.4	1.1	1.0	#N/A	#N/A	#N/A
medium-to-low-technology goods	1.1	1.2	1.2	0.9	#N/A	#N/A	#N/A
medium-to-high-technology goods	1.1	1.2	1.3	1.4	#N/A	#N/A	#N/A
high-technology goods	0.3	0.2	0.2	0.2	#N/A	#N/A	#N/A
- ICT	0.2	0.2	0.1	0.2	#N/A	#N/A	#N/A

Footnotes: f = Commission autumn 2009 forecast; REER = real effective exchange rate; DPC = deflator of private consumption; FDI intensity = average of inward and outward FDI flows as a % of GDP; 1/RULC = Nominal GDP/employee wage bill; GVA = gross value added; NDP = Net domestic product; TCE = total compensation of employees; NKS =net capital stock; RCA = revealed comparative advantage: 1 based on factor intensity of total exports; and 2 based on technology intensity of exports of manufactured goods.

Source: Commission services.

Table A.15: **SLOVAKIA - Indicators related to competitiveness (% of GDP unless otherwise indicated)**

Indicator	1995	2000	2005	2007	2008	2009	2010f
Current account balance	2.5	-2.5	-8.5	-5.1	-6.7	-3.1	-5.5
Trade balance - goods & services	2.3	-2.5	-4.6	-1.0	-2.3	-0.2	-0.6
Trade balance - goods	-1.2	-5.0	-5.4	-1.8	-1.5	1.6	-0.5
Trade balance - services	3.5	2.5	0.8	0.7	-0.7	-1.9	-0.2
Net foreign assets	5.8	-21.1	-43.4	-45.2	-43.2	#N/A	#N/A
Export market perf. G & S (% change)	-8.7	-3.3	3.6	6.0	0.6	-4.8	0.5
REER (DPC) index 2000=100							
vs 35 industrial countries	89.9	100.0	129.2	152.4	167.4	178.8	178.3
vs rest of euro area	82.1	100.0	128.1	151.5	166.8	174.7	177.0
REER (GDP deflator) index 2000=100							
vs 35 industrial countries	92.4	100.0	125.3	142.5	155.0	160.2	161.1
vs rest of euro area	83.7	100.0	125.3	143.7	156.7	158.6	161.8
REER (exp. price defl.) index 2000=100							
vs 35 industrial countries	93.1	100.0	120.7	136.1	145.4	150.2	148.9
vs rest of euro area	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A
REER (ULC tot. econ.) index 2000=100							
vs 35 industrial countries	87.9	100.0	123.7	139.7	149.8	164.6	166.9
vs rest of euro area	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A
Terms of trade (index 2000=100)***:***							
Goods & services	101.6	100.0	98.2	95.7	94.2	95.2	96.1
Goods	103.6	100.0	99.1	96.2	94.4	95.1	95.8
Services	103.4	100.0	92.2	93.0	94.1	98.0	100.1
Openness:							
a1. Exports (constant prices)	54.0	70.5	85.5	98.5	95.7	83.8	84.3
a2. Imports (constant prices)	52.7	73.0	89.0	95.4	92.6	80.1	80.5
a3. Exports and imports (constant prices)	106.7	143.5	174.4	193.9	188.4	163.9	164.8
b. Net foreign direct investment (FDI)	1.2	10.0	4.1	3.6	3.4	#N/A	#N/A
c. FDI intensity	#N/A	5.3	2.7	2.4	#N/A	#N/A	#N/A
d. Net portfolio investment	1.1	3.9	-1.7	-0.6	2.5	#N/A	#N/A
Profitability:							
a. 1/RULC (index 2000=100):	103.9	100.0	103.9	106.4	106.8	98.4	99.4
b. Gross operating surplus as a % of GVA	56.1	55.2	58.5	60.0	61.2	58.8	59.5
c. Employee wage bill as a % of GVA	44.6	45.7	41.9	40.2	39.5	42.0	41.3
d. (NDP - TCE) as a % of NKS	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A	#N/A
Economic structure (% of GVA)***:***							
Agriculture (ISIC A_B)	5.3	4.5	4.8	4.8	4.3	5.0	#N/A
Industry (ISIC C_E)	29.9	29.2	37.8	40.7	40.7	39.1	#N/A
Building (ISIC F)	6.7	7.1	6.2	6.5	6.4	6.6	#N/A
Market Services (ISIC G_K)	44.2	42.3	38.1	36.9	38.8	38.2	#N/A
Other Services (ISIC L_P)	13.5	17.0	14.4	13.3	11.8	12.8	#N/A
Share of services in total trade							
Exports	21.7	15.9	12.6	11.1	10.7	9.6	9.6
Imports	16.7	11.9	10.2	9.9	11.2	12.4	12.4
1. RCA for all exports (vs World):							
raw-material-intensive	0.9	0.7	0.6	0.5	#N/A	#N/A	#N/A
labour-intensive	1.3	1.3	1.2	1.0	#N/A	#N/A	#N/A
capital-intensive	1.7	2.2	1.9	1.9	#N/A	#N/A	#N/A
difficult-to-imitate research-intensive	0.7	0.7	0.8	0.7	#N/A	#N/A	#N/A
easy-to-imitate research-intensive	0.6	0.4	0.7	1.0	#N/A	#N/A	#N/A
2. RCA for exports of goods (vs World):							
low-technology goods	1.0	1.1	1.0	0.8	#N/A	#N/A	#N/A
medium-to-low-technology goods	2.1	1.1	1.1	1.0	#N/A	#N/A	#N/A
medium-to-high-technology goods	0.9	1.4	1.2	1.2	#N/A	#N/A	#N/A
high-technology goods	0.2	0.2	0.5	1.0	#N/A	#N/A	#N/A
- ICT	0.2	0.2	0.7	1.3	#N/A	#N/A	#N/A

Footnotes: f = Commission autumn 2009 forecast; REER = real effective exchange rate; DPC = deflator of private consumption; FDI intensity = average of inward and outward FDI flows as a % of GDP; 1/RULC = Nominal GDP/employee wage bill; GVA = gross value added; NDP = Net domestic product; TCE = total compensation of employees; NKS =net capital stock; RCA = revealed comparative advantage: 1 based on factor intensity of total exports; and 2 based on technology intensity of exports of manufactured goods.
Source: Commission services.

Table A.16: **FINLAND - Indicators related to competitiveness (% of GDP unless otherwise indicated)**

Indicator	1995	2000	2005	2007	2008	2009	2010f
Current account balance	4.0	7.6	3.5	4.3	3.5	1.5	1.2
Trade balance - goods & services	7.5	9.1	4.1	5.2	4.0	2.8	2.1
Trade balance - goods	9.4	11.1	4.7	5.1	3.7	2.3	2.0
Trade balance - services	-2.0	-1.9	-0.6	0.1	0.3	0.5	0.1
Net foreign assets	-42.8	-152.4	-16.7	-30.0	-3.4	#N/A	#N/A
Export market perf. G & S (% change)	0.7	5.1	-0.1	2.1	5.5	-12.6	2.8
REER (DPC) index 2000=100							
vs 35 industrial countries	113.8	100.0	104.8	106.3	108.7	110.9	108.9
vs rest of euro area	100.0	100.0	95.2	94.7	95.4	96.4	96.8
REER (GDP deflator) index 2000=100							
vs 35 industrial countries	115.6	100.0	102.9	103.9	104.5	105.4	103.9
vs rest of euro area	100.8	100.0	94.4	94.5	93.8	93.3	93.8
REER (exp. price defl.) index 2000=100							
vs 35 industrial countries	123.6	100.0	99.6	99.6	96.2	95.2	93.6
vs rest of euro area	111.8	100.0	93.4	92.8	89.4	86.9	87.0
REER (ULC tot. econ.) index 2000=100							
vs 35 industrial countries	122.2	100.0	108.7	107.7	112.0	118.7	116.5
vs rest of euro area	105.1	100.0	99.0	98.2	100.3	103.6	103.7
Terms of trade (index 2000=100)***:***							
Goods & services	107.6	100.0	94.8	91.1	88.4	89.9	89.3
Goods	106.9	100.0	94.8	90.5	87.5	88.9	88.0
Services	102.3	100.0	97.9	96.6	95.2	97.3	97.6
Openness:							
a1. Exports (constant prices)	32.1	43.6	45.7	50.5	53.2	43.6	45.2
a2. Imports (constant prices)	27.5	34.5	39.1	40.8	43.0	36.2	37.3
a3. Exports and imports (constant prices)	59.6	78.1	84.8	91.3	96.1	79.9	82.5
b. Net foreign direct investment (FDI)	-0.3	-12.5	0.3	2.1	-3.9	#N/A	#N/A
c. FDI intensity	1.0	13.5	2.3	3.7	#N/A	#N/A	#N/A
d. Net portfolio investment	-1.2	-1.4	-3.5	-2.1	2.5	#N/A	#N/A
Profitability:							
a. 1/RULC (index 2000=100):	93.8	100.0	97.3	100.1	96.2	89.9	91.8
b. Gross operating surplus as a % of GVA	45.3	47.0	44.6	46.8	44.7	41.1	42.7
c. Employee wage bill as a % of GVA	56.7	54.2	56.4	54.5	56.6	60.3	58.6
d. (NDP - TCE) as a % of NKS	11.1	14.5	14.4	15.9	14.7	11.8	12.3
Economic structure (% of GVA)***:***							
Agriculture (ISIC A_B)	4.5	3.5	3.1	3.3	3.4	3.5	#N/A
Industry (ISIC C_E)	24.5	28.4	30.6	33.6	33.3	29.1	#N/A
Building (ISIC F)	6.3	6.2	6.1	6.0	5.9	5.6	#N/A
Market Services (ISIC G_K)	41.3	41.2	41.7	41.1	41.3	42.9	#N/A
Other Services (ISIC L_P)	23.7	20.7	18.8	17.2	17.2	18.6	#N/A
Share of services in total trade							
Exports	17.9	13.7	17.7	17.6	19.9	21.1	20.9
Imports	29.0	22.9	21.6	20.7	22.9	23.5	23.3
1. RCA for all exports (vs World):							
raw-material-intensive	0.7	0.6	0.6	0.6	#N/A	#N/A	#N/A
labour-intensive	1.7	1.5	1.4	1.3	#N/A	#N/A	#N/A
capital-intensive	0.7	0.7	0.9	1.0	#N/A	#N/A	#N/A
difficult-to-imitate research-intensive	0.9	0.8	0.9	1.0	#N/A	#N/A	#N/A
easy-to-imitate research-intensive	0.9	1.5	1.4	1.2	#N/A	#N/A	#N/A
2. RCA for exports of goods (vs World):							
low-technology goods	1.6	1.5	1.1	1.3	#N/A	#N/A	#N/A
medium-to-low-technology goods	1.1	1.0	1.0	1.1	#N/A	#N/A	#N/A
medium-to-high-technology goods	0.7	0.7	0.8	0.8	#N/A	#N/A	#N/A
high-technology goods	0.7	1.0	1.2	1.0	#N/A	#N/A	#N/A
- ICT	0.8	1.2	1.4	1.3	#N/A	#N/A	#N/A

Footnotes: f = Commission autumn 2009 forecast; REER = real effective exchange rate; DPC = deflator of private consumption; FDI intensity = average of inward and outward FDI flows as a % of GDP; 1/RULC = Nominal GDP/employee wage bill; GVA = gross value added; NDP = Net domestic product; TCE = total compensation of employees; NKS =net capital stock; RCA = revealed comparative advantage: 1 based on factor intensity of total exports; and 2 based on technology intensity of exports of manufactured goods.

Source: Commission services.