

What Are the Different Strategies for EMU Countries?

By Patrick Artus*

The answer to competition from emerging countries with low wage costs must be very different according to the affected sector. We need to draw a distinction between manufacturing industry and services that can be relocated and other sectors: consumer services, retail, construction, most business services and financial services. For the former, no obstacle to restructuring or the modernisation of companies can be efficient, even though this implies further relocations and job losses. For the latter, there is a crucial need to analyse and assess the various experiments that seek to stimulate job creation in said sectors, as this is indispensable if industry is to continue losing jobs. We complete the analysis of the strategy of the various countries in manufacturing by a research of the determinants of exports performance.

1 **The Exchange Rate Is no longer a Useful Instrument against Emerging Countries**

The question consists in determining the “best” response for EMU countries to competition from emerging countries with low wage costs, in Asia and Central Europe, which, moreover, practise tax and welfare competition.

Let us start off from the fact that this response cannot be provided by exchange rates: on the one hand, emerging countries have avoided an appreciation in their currencies, by currency interventions in Asia (central bank reserves in Asia increase by more than 300 bns \$ a year) on the other hand, the size of the required adjustments to equalize the extremely different producer costs between advanced countries and emerging countries, would be so considerable – the Chinese Renminbi would need to appreciate 500% to 700% – that such adjustments are unrealistic.

2 **One Must Differentiate between Sectors Facing International Competition and Sheltered Sectors**

The strategy of EMU countries can be absolutely different with regard to the sectors facing international competition from emerging countries, i.e. manufacturing industry and business services, and the sectors sheltered from international competition: consumer services, retail, construction, etc.

In the sectors facing international competition – for the sake of simplicity, we will say “industry” – the answer has to consist in cost-cutting and product differentiation, in compari-

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son with the goods manufactured by emerging countries. Success then lies, first, in the capacity to lower unit costs as can be seen in Germany, Japan and Sweden, but not at all in the Netherlands, Spain and Italy; while France and the United States are in an intermediate situation (Figures 1 and 2).

In advanced countries, lowering unit costs is achieved to a greater extent by substantial productivity gains, as is the case in Germany, France, the United States (due to IT industry), Sweden and Japan than by reducing wages - although there is downward pressure on wages in Germany and Japan: in Germany, normal wages per head stagnate since 2003, In Japan, since the early 1990s.

Figure 1

Unit Wage in Manufacturing Sector (1996 = 100)

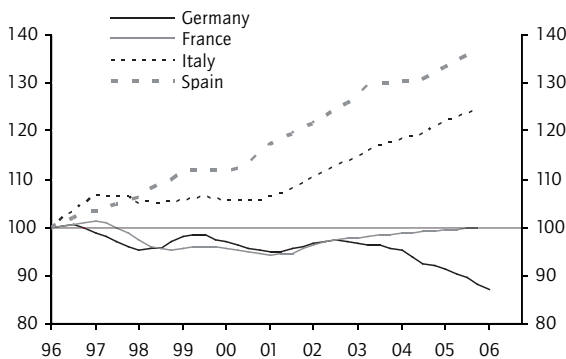
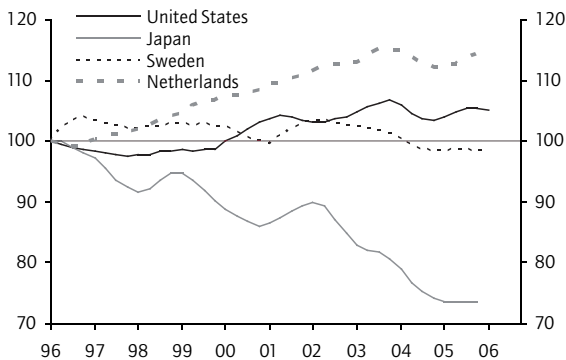


Figure 2

Unit Wage in Manufacturing Sector (1996 = 100)



Source: Datastream IXIS CIB.

It also consists in offshoring, i.e. accelerating subcontracting in countries with low wage costs, as can be seen in the decline in the share of added value in production in most European countries. Moreover, success has to be achieved via the capacity to innovate, and develop different products.

As is well known, corporate R&D expenditure and the efficiency of R&D are high in the United States, Japan, the Nordic countries and Germany; but are low in France and even more in the countries of southern Europe (Tables 1a, 1b and 1c).

Among the major countries, the winners from this “industrial” point of view are, for example, Germany, Japan and the Nordic countries in Europe, as is seen in trends in foreign trade (Figures 3 and 4) and its contribution to growth; the losers, for instance, include the United States, France, Italy and Spain. In real terms, the United States, France and Italy post more or less the same level of exports in 2005 as in late 2000.

Table 1a

Corporate R&D (in % of GDP)

	Germany	France	Spain	Italy	United States	Sweden	Japan
2000	1.75	1.36	0.50	0.53	2.04	3.70	2.12
2001	1.75	1.41	0.50	0.55	2.00	3.32	2.26
2002	1.75	1.43	0.56	0.54	1.87	3.35	2.32
2003	1.73	1.36	0.58	0.55	1.79	3.42	2.38

Sources: OECD, Eurostat.

Table 1b

Number of Corporate Researchers (per 10,000)

	Germany	France	Spain	Italy	United States	Sweden	Japan
2000	39.52	33.55	13.58	12.5	75.78	n/a	65.37
2001	40.55	36.12	11.89	12.46	72.00	65.78	67.17
2002	40.17	38.64	15.15	11.32	71.00	n/a	68.11

Sources: Science, technology and industry: OECD Outlook 2002–2004.

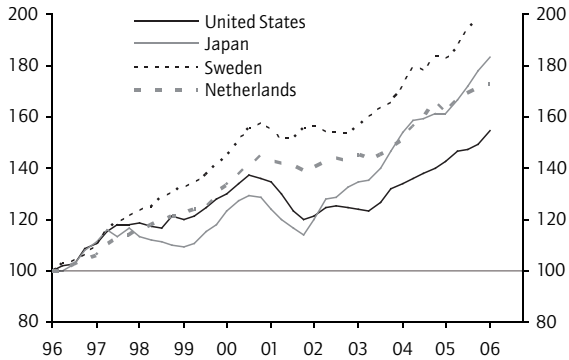
Table 1c

Number of Triadic Patents (per million inhabitants)

	Germany	France	Spain	Italy	United States	Sweden	Japan
2000	71.21	36.69	2.88	13.48	53.98	94.79	91.92
2001	69.42	37.08	2.78	13.71	52.62	92.29	92.25

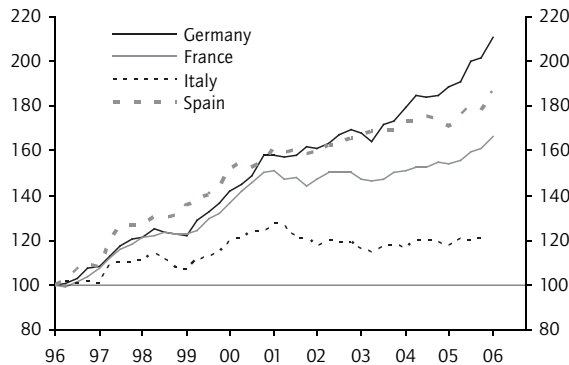
Source: Table n° 65 – Main Science and Technology Indicators 2004, OECD.

Figure 3

Exports (in volume terms, 1996 = 100)

Source: Datastream IXIS CIB.

Figure 4

Exports (in volume terms, 1996 = 100)

Source: Datastream IXIS CIB.

We will return later to the analysis of the causes of the divergence between the export performances of Germany, France and Italy.

Industrial success inevitably implies job losses in manufacturing, if there are substantial productivity gains in industry, and outsourcing. The countries that are winning export market shares, i.e. Germany, Sweden and Japan, however, are countries where industrial employment is contracting by 10% in Sweden, 12% in Japan and in Germany since the start of this decade. Industrial success can therefore generate income, if exports enjoy ro-

bust growth, for instance, but it cannot provide full employment. The unemployment rate is not lower in Sweden or Germany (9%) than in other countries where export market shares are contracting (Italy: 7%, Spain: 8%, for instance). Full employment, by consequence, can only result from job creation in the sheltered sectors – we will say “services” for the sake of simplicity.

3 How to Create Jobs in Services?

Potentially, there are two possible reasons why job creation is weakened in services in many Continental European countries: Germany, France and Italy, for example. One is found in the excessive low-skill labour costs, either in terms of direct wage or mandatory welfare contributions; the other is the existence of labour market regulations that are unfavourable for job creation.

The two causes of the shortfall in jobs in services are simultaneous; as is well known, if there were as many per capita jobs in services (understood as “sectors not facing international competition”) in France, for example, as in the United States, there would be 2.5 million jobs more in France. Another well-known fact is that the minimum wage is close to 50% of the average wage in France, versus 30% of the average wage in the United States and this has played a role in the sluggish job creation for unskilled labour in France.

Which problem has to be solved first? A comparison of the economic policies recently implemented in Germany and Italy is very interesting from this viewpoint. In Germany, due to the different employment contracts with lower remuneration – one-euro jobs, mini-jobs and Ich-AGs – the approach based on reducing labour costs has been implemented. The real wage and purchasing power of wage earners have declined since 2001, in an impressive way recently (–2% year over year for the real wage per head in Germany).

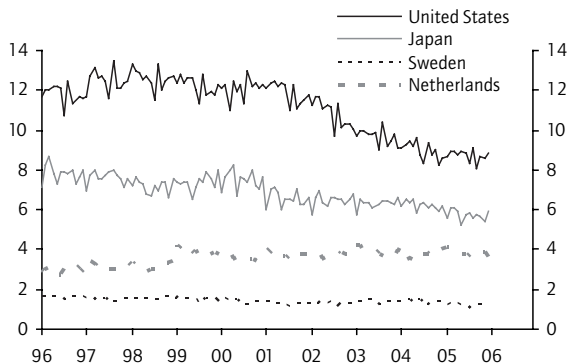
In Italy, with employment contracts providing lower job protection introduced in the early 2000s for the categories of labour suffering from a high unemployment rate, the approach based on deregulating the labour market has been chosen, without a significant squeezing of payroll costs.

Currently, the outcome suggests Italy’s choice is better: employment has grown 12% between 1998 and 2005, and 17% outside industry. In Italy, the unemployment rate has sharply declined (from 11,5% in 1999 to just above 7% in the first half of 2006), while in Germany, even though the labour market has stabilized the squeezing of wages has led to a contraction in domestic demand and real activity.

The ideal would obviously be, for a country, to be able – as in Germany (Figure 5) and Japan – to win back market shares in manufacturing (which entails lowering unit costs and a drive to boost innovation and product differentiation) as well as create a lot of jobs in services, as is the case in Spain and, to a smaller degree, in the United States. Employment in services has increased by 20% over the last 10 years in the US, by 60% (!) in Spain. This would enable the country to renew with full employment despite the inevitable losses of industrial jobs, due to productivity gains, outsourcing, etc.

Figure 5

Ratio of Country Exports (in % of total exports)



Sources: DRI, IXIS CIB.

This requires channelling government expenditures into applications that favour innovation, drawing public and private research closer; accepting job losses in manufacturing and outsourcing as well as doing away with regulatory obstacles in the way of job creation in services. No European country has managed to do so to date: France and Italy have been losing export market shares since the late 1990s, Spain holds very small market shares; Germany is not creating jobs in services while the Netherlands has been losing jobs in services from 2002 to the middle of 2004. Such changes will not occur in Italy and Spain, where the handicap with respect to producer costs in industry is too serious to be corrected. Among major European countries, France might be able to adapt, as Italy's example shows that the so-called "New Hire Contract" could be a success and where public credits for research (National Research Agency, competitiveness hubs, etc.) are increasing, as could Germany, if the approach based on reducing wages is dropped to the benefit of the approach drawing on the flexibility of employment contracts.

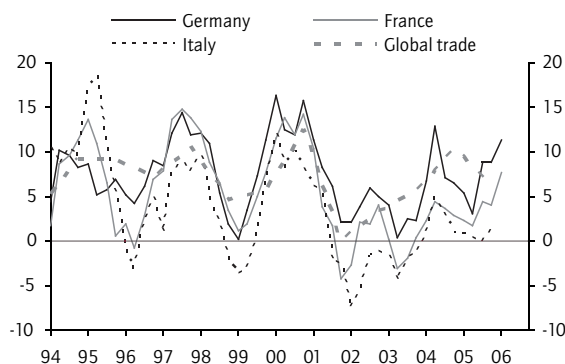
4 An Analysis of the Causes of the Divergence in Export Performances between Germany, France and Italy

4.1 A Deterioration of Foreign Trade in France and Italy

Let us have another look at the problem of "success in manufacturing industry". Figure 6 shows that, since early 2001, and above all between 2002 and 2005, Italian and French exports have grown at a far slower pace than German exports and world trade. Such a situation did not prevail between 1997 and 2000 for France. All in all, the contribution of foreign trade to growth is negative and has been increasingly negative in France since 2002, while on average it has been positive in Germany.

In Germany both exports and imports and have grown at a brisk pace and there is a substantial trade surplus, probably 300 bn dollars in 2006.

Figure 6

Exports by Country and Global Trade (real % Y/Y)

Source: Datastream IXIS CIB.

In France, exports and imports have also surged, while a large trade deficit appeared in 2004, with energy a crucial component of this deficit but the rest of trade deteriorating as well: the trade surplus ex energy has sunk to a very low level.

In Italy, trade surpluses have vanished as has the surplus in the trade balance ex energy.

The deterioration in France's foreign trade primarily appears with the euro zone, Central Europe and China. A surplus is recorded with the EU-15 ex the euro zone and the United States. The situation is exactly the same in Italy.

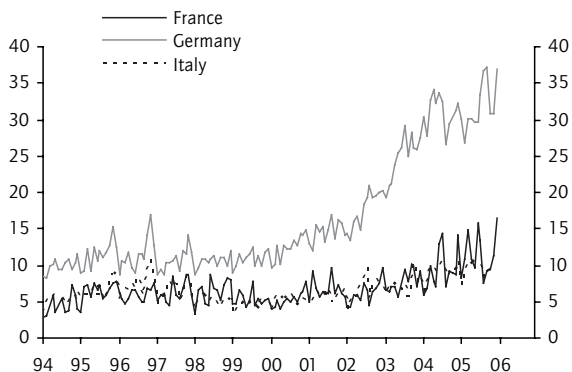
With respect to France, apart from the deficit in energy, there have been more worrisome developments: the agrifood surplus has stagnated, substantial deficits have appeared in consumer goods and intermediate goods, the surplus has disappeared and been replaced by a deficit for capital goods and transport equipment.

Italy posts a deficit in the agrifood sector, energy naturally, and intermediate goods. The Italian surplus in consumer goods has shrunk but the country still posts a surplus in capital goods and transport equipment.

In France and in Italy, growth has lagged behind Germany with regard to the level of exports of capital goods and transport equipment as well as exports shipped to emerging countries (Figures 7 and 8).

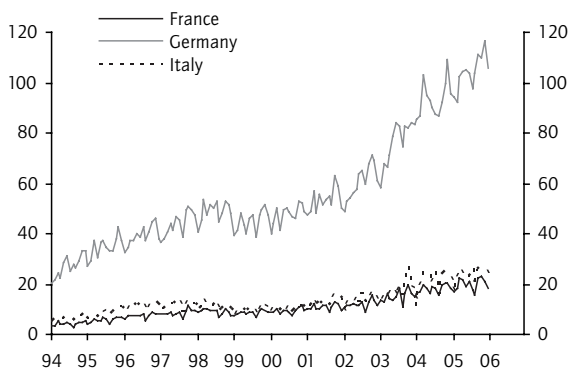
This is an interesting observation: German exporters are in a position to react rapidly to sharp increases in the demand for imported products in fast growing countries, which is not the case for French and Italian exporters, and reveals the inertia of supply in France and Italy. Overall, the relative situations of France and Italy have deteriorated significantly versus Germany with respect to export performance since the late 1990s although the situ-

Figure 7

Exports to China and Hong Kong (USD bn per year)

Source: Datastream IXIS CIB, IMF.

Figure 8

Exports to CEEC and Russia (USD bn per year)

Source: Datastream IXIS CIB, IMF.

ation is slightly less serious in Italy because of its performance in the field of capital goods.

If we consider these developments in a long-term perspective, nevertheless, France has made noteworthy efforts to adapt to international competition. From 1970 to 1999, France's market share in the global trade of industrial and agricultural goods excluding commodities, for instance, declined by only 4 points, versus 15 points for Germany or the United States.

In 2000, the divergence in France and Italy's performance when compared with Germany became unfavourable. From this year onwards, the French and Italian economies apparently lost ground with respect to the new conditions of globalisation, whereas the German economy, despite price-competitiveness problems, adapted more efficiently. Germany's relative global market share, in comparison with France and Italy, renewed with its long-run average in the early 2000s.

4.2 The Problem Does Not Result from the Geographical Destinations or from the Structure by Major Groups of Products of French Exports

We will now focus more specifically on the case of France.

When we compare the geographical structure of exports, we can see that the EU accounts for a smaller share in Germany, and a larger share is held by the United States, Asia and especially Central Europe (Tables 2a and 2b). When we compare the structure by major groups of products, clearly capital goods and transport equipment are far more substantial in Germany (Table 3).

Against the context of very robust growth in emerging countries, and therefore substantial investment, by definition the fact that a country holds a large or a small position in the global market of capital goods is not neutral.

Unfortunately, in this sector, France's weight is negligible: it posts a surplus of 0.3% of the global market, i.e. more than ten times less than Germany.

Table 2a

Geographical Structure of French's Exports (in % of total exports)

	2004	
Euro zone	51.33	
EU ex euro zone	11.49	
Japan	1.60	
Canada	0.73	
Mexico	0.45	
United States	6.91	
Africa	5.49	
South America (non-OECD)	1.35	
Latin America (including Mexico) ¹	1.47	
Middle East (non-OECD)	3.15	
Far East (non-OECD)	4.88	
o/w China	1.61	1 Colombia, Mexico, Brazil, Argentina, Venezuela, Chile, Peru, and Ecuador.
Asian emerging countries ² ex China	2.87	2 South Korea, Indonesia, Malaysia, Singapore, Philippines, Thailand, and Hong Kong.
CEEC ³	3.36	3 Czech Republic, Hungary, Poland, Slovak Republic and Baltic countries.
Other	9.25	
Total	100.00	Sources: Monthly international trade data, OECD.

Table 2b

Geographical Structure of German's Exports (in % of total exports)

	2004	
Euro zone	43.50	
EU ex euro zone	12.03	
Japan	1.73	
Canada	0.66	
Mexico	0.67	
United States	8.83	
Africa	1.85	
South America (non-OECD)	1.36	
Latin America (including Mexico) ¹	1.75	
Middle East (non-OECD)	2.31	
Far East (non-OECD)	6.40	
o/w China	2.86	¹ Colombia, Mexico, Brazil, Argentina, Venezuela, Chile, Peru, and Ecuador.
Asian emerging countries ² ex China	3.05	² South Korea, Indonesia, Malaysia, Singapore, Philippines, Thailand, and Hong Kong.
CEEC ³	8.27	³ Czech Republic, Hungary, Poland, Slovak Republic and Baltic countries.
Other	12.37	
Total	100.00	Sources: Monthly international trade data, OECD.

Consumer goods are another important sectoral issue. China and now the emerging countries taken as a whole currently have a dominant position with respect to these goods. The Chinese surplus represents 8% of the corresponding global market (2002). It has doubled in ten years. China overtook Japan in this sector in the mid-1990s. Emerging countries overtook Japan in 2000. While the share held by Italy and France is negligible, Germany's position has been growing.

We can gauge the effect on export performance of these divergences in sectoral and geographical structures between France and Germany.

Table 3

Exports by Product in France and Germany (2004, in % of total exports)

	France	Germany
1: Agriculture and food	12.52	3.9
2: Intermediate goods	2.23	1.7
3: Energy	2.87	1.9
4: Consumer goods	39.80	42.0
5: Capital goods and transport equipment	42.58	50.5
Total	100.00	100.0

Source: OECD monthly foreign trade data.

Doing so shows us that both structure effects are unimportant in terms of explaining France’s underperformance (Table 4).

Table 4

Growth Gap in French and German Exports (1998–2003, in %)

Contribution of the sectoral structure effect to the total gap	9.2
Contribution of the geographical structure effect to the total gap	6.4

Source: Conseil d'Analyse Economique, France.

4.3 France Has Declined in Comparison with Germany for nearly all Products and in nearly all Markets

One can also calculate the contribution made by various sectors to the explanation of France’s underperformance in terms of export growth in comparison with Germany. The sectoral performance effect is very unfavourable for France for the four following sectors:

- Radio, television and communication equipment
- Office material and Information Technology equipment
- Aerospace
- Automobile

Taken as a whole, these four sectors account for nearly 60% of the performance effect. Only two sectors curtail Germany’s sectoral outperformance: i.e. Pharmaceuticals and, to a smaller extent, Iron and Steel. We can thus definitely see that the performance effect is favourable for Germany quite generally speaking and is found in most sectors, specially, in cars, machines, equipment ...

If one breaks down the French underperformance versus Germany by zone, one finds that:

- “Bilateral trade” is the export market that explains France’s underperformance versus Germany to the greatest extent, as it contributes 23.8% to the French underperformance: the geographical performance effect between France and Germany is accounted for by the fact that growth in German exports to France far outpaces growth in French exports to Germany. This results probably from the fact that domestic demand is more robust in France than in Germany.
- 47% of this underperformance is explained by Europe ex bilateral trade (and including Switzerland);
- 27% of this underperformance comes from the Asia and Oceania zone, as defined in Table 5, in the following order: China, South Korea and Thailand;

- to a lesser extent, 12% of the negative geographical performance effect for France is explained by the better performance of German exports to the United States;
- conversely, a significant surprise from this breakdown is found in the outperformance of French exports to the CEEC: indeed, with respect to this zone, France posts export growth rates that are overall higher in the period, and this enables France to offset the negative effect resulting from the underperformances described above.

4.4 The Reasons Accounting for France and Italy's Market Share Losses: Specialisation in Low Quality Products and Shortfall in Outsourcing

Complementary information is provided by CEPII's BACI database. The detailed data about international trade covering all exporters are collected at product level (about 5,000 products). The data allow us to calculate at a sophisticated level exporters' positioning in terms of range, for each product. We can then aggregate our findings within sectors or within overall trade in order to ascertain whether countries are specialised, generally speaking, in different product range segments within sectors, while taking into account the fact that their specialisation between sectors is less different than commonly thought, apart from the weight of capital goods in Germany.

It can immediately be seen that Germany is specialised in upmarket products (Figure 9), France in the medium- and upmarket range and Italy in the low and medium range. These specialisation aspects entail differences in pricing power for the producers of the three countries, and these differences imply differentiated reactions to a same exchange rate shock.

In other words, the quality of French and Italian products is declining. France is specialising in low quality products and is less and less specialised in high quality products. We must also look at outsourcing, a crucial characteristic of "the bazaar economy".

The concept of the bazaar economy primarily consists of the idea that such an economy becomes a re-exporting platform, with specialisation in assembling and marketing. Against this backdrop, ever fewer goods are manufactured locally.

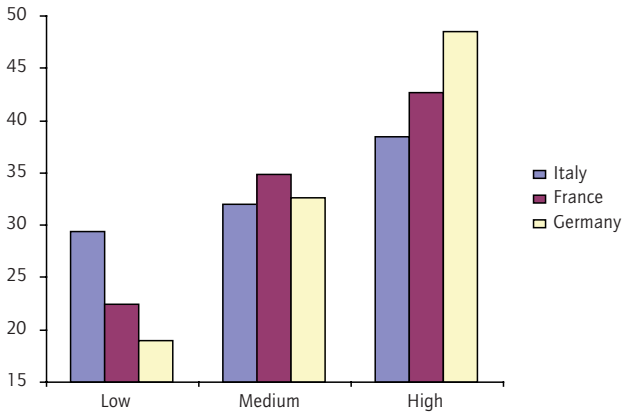
According to the partisans of this concept, the economy is then characterised by:

- growing imports of intermediate goods in connection with foreign direct investment (FDI),
- a fall in the weight of added value in production,
- the low content in jobs of exports,
- sluggishness of demand resulting from both the impact of employment on consumption and of the substitution of FDI for domestic investment,
- an acceleration in de-industrialisation and a rise in unemployment.

Figure 9

Breakdown by Quality of Exports of Good

Germany, France and Italy (2002, in %)



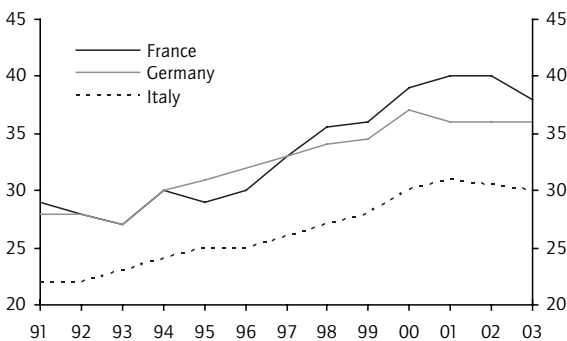
Source: CEPII-BACI.

The ratio between value added and production in manufacturing industries is a good indicator of outsourcing. This ratio has dropped 6 percentage points in Germany since 1970, and the decline, apart from the fluctuations that followed the oil shocks, really began in the second half of the eighties. Furthermore, the pace at which the ratio has fallen has been markedly gathering momentum since 1994.

Figure 10

Penetration Rate of Imports – Manufactured Goods

Strong Increase in Germany despite Sluggish Demand (in %)



Sources: STAN, IXIS CIB.

Italy has experienced a quite similar decline, while in France the deterioration has been more gradual and, all in all, less significant, in particular since the early nineties.

Figure 10 provides information that tends to add credence to the idea that the German economy, more affected than the economies other countries, is heading towards becoming a bazaar economy.

We can see that, unlike Germany, France has “insourced”: the share of imported intermediate consumption has increased in total intermediate consumption where exports have contracted.

The fact that outsourcing has developed far more in Germany than in France while German exports are more sensitive to outsourcing can explain an estimated 60% to 75% of the gap in terms of export growth between the two countries.

5 **Summary**

1. French and Italian foreign trade has deteriorated significantly since 2001;
2. The problem does not stem from the geographical structure or the structure by major groups of products of French and Italian exports;
3. France has lost ground on Germany for nearly all products and in nearly all markets;
4. The causes of French and Italian market share losses are the insufficient specialisation in high quality products and the shortfall in outsourcing to emerging countries.

The problem is durable and the solution entails reinvesting in quality and accepting the initial costs (in added value and jobs) of outsourcing.