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# Belgium's 2008 recentralization of wage-setting mechanisms and the decentralization-unit labor costs-net exports link: Chronicle of a Death Foretold?

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# Belgium's 2008 recentralization of wage-setting mechanisms and the decentralization-unit labor costs-net exports link: Chronicle of a Death Foretold?

## **Abstract**

Anchored on scholarly literature on international competitiveness and the classical definition of competitiveness as net exports, policy making institutions support decentralized wage-setting mechanisms. The rationale is that decentralized wage-setting systems lower wages and unit labor costs (ULC) and, therefore, increase net exports. This paper contains a literature review on the wage-setting–ULC–net exports link and challenges conventional rationales by examining the co-evolution of Belgium's real wages and net exports across wage percentiles and sectors. Belgium is a case in point, since the country experienced both increasing real wages and increasing net exports after recentralizing wage-setting mechanisms in 2008.

## **Keywords**

wage-setting mechanisms, unit labor costs, net exports, Belgium, real wage evolution, 2008 financial crisis, German labor market, competitiveness, European Union, EMU

## **Cover Page Footnote**

I would like to acknowledge Professor Hans-Helmut Kotz for his guidance during the process of boiling down the paper's topic to wage-setting mechanisms in the EU as well as his bibliography suggestions. I'm also very grateful to London Lowmanstone IV and Carissa Chen for their support and encouragement to publish the article.

Changes made to original article:

- Indented all paragraphs except those following the heading of new sections
- Made the font Times, size 12 and the font of notes for graphs Times, size 10
- Changed the wording of the Introduction and Conclusion
- Reduced the spacing between different sections of the text
- Made the text single spaced
- Removed the title page and abstract
- Copyedited
- Added two people to the acknowledgements text box

## **Introduction**

Scholarly and institutional literature on international competitiveness mainly uses countries' net exports or current account balances as a measure of their competitiveness and/or economic soundness (following this template, here current account balance and net exports are used interchangeably). As such, mainstream economic research deems countries with higher current account balances more competitive than countries with lower net exports, arguing that such export success is to be achieved through lower export prices, wages, and unit labor costs. In line with the literature, most EU countries have progressively adopted decentralized wage-setting mechanisms.

Economists point out Germany as an empirical example of the wonders that low unit labor costs can work on net exports, since the country has held the position of number one exporter in Europe for several years; they hold it as the golden standard for competitiveness in the EU, with international institutions designing German-inspired policy recommendations for a diverse group of nations. Some economists have pointed to labor market characteristics and decentralized wage-setting mechanisms as the reasons accounting for Germany's (and other nations') export success (Dustmann et. al, 2014), which has led others to generalize decentralized wage bargaining as a one-size-fits-all solution to meager exports. The reasoning behind this rationale is that decentralized wage-setting leads to lower salaries, which in turn lower the costs of exported goods, making them more appealing to foreigners and raising the country's trade balance and competitiveness.

However, several problems arise in this analysis: 1) it is not clear that a country's trade balance as opposed to other economic indicators is a good measure of its international competitiveness 2) Germany's high exports cannot be justified solely on its labor market and wage-setting policies 3) Germany's export success is not without its disadvantages both at national and EU level, and 4) some countries' net exports have risen even after the implementation of centralized wage-setting mechanisms. Each of these observations is analyzed in this paper to conclude that 1) decentralized wage-setting systems are not incompatible with high net exports, Belgium being a case in point, as product quality, real exchange rates, investment incentives, and resistance to imports also affect current account balances and 2) given the subjective nature of the concept of competitiveness, it might be preferable for national governments to determine their policy-making agenda based on whichever definition of "international competitiveness" best fits their country's needs, strengths, and values, instead of adopting other nations' or mainstream competitiveness-oriented policies.

An emphasis is put on Belgium as one of the few European countries to have adopted more centralized wage-setting mechanisms after the 2008 crisis and to have seen rising wages as well as rising net exports thereafter. The fact that Belgium moved against the present trend of progressive wage-setting decentralization makes the country one of those economic natural experiments which economists so anxiously await and deeply adore. The unusual character of such a move added to the fact that the country's net exports increased, despite the predictions of conventional economic theory, make Belgium's labor market much worthy of analysis.

### **Section 1.0 The history of the concept "competitiveness"**

International competitiveness has been viewed from two perspectives: a micro (competition among firms) and a macro (national) one. The latter is to be interpreted as a means to an end: raising citizens' real income and standard of living, through investment, trade, and economic production, although international trade performance has been the main measure of international competitiveness. The macro definition of competitiveness has its origins in Ricardo's theory of comparative advantage and Heckscher-Ohlin's factor abundance theorem, whereby countries specialize in the production of goods they manufacture more efficiently and trade them for goods that other nations can produce more cheaply. In this view, relative prices are the only factor underlying trade flows, since a country's comparative advantage in producing one good means it is able to export it at a price lower to that of its competitors. Later theories of international trade added a broad array of economic factors to Ricardo's analysis, such as labor productivity, capital output ratio, research and development, differences in human capital, and real wages, giving rise to the new "neotechnology theories". Given that the price of exports affects foreigners' taste (or distaste) for such goods, and that labor costs affect this price greatly, it was argued that lower unit labor costs (UCL) would translate into cheaper and therefore larger exports. The consideration of an increasing number of economic variables in trade flows analysis generated a need for agreement on a measure of nations' competitiveness, to facilitate cross-countries analysis among economists and institutions. After several proposals of economic indicators by research and financial institutions, relative unit labor costs were adopted as the standard measure of international competitiveness. Soon after, however, several economists concluded that variables concerning national industries, innovation, and a specific country's socio-economic and political goals might be of greater importance in studies of international competitiveness (Waheeduzzaman and John K. Ryans Junior, 1996).

Still, a great portion of contemporary scholarly economic literature defines competitiveness in terms of ULC and net exports. International institutions such as the ECB, the European Commission, and the IMF also refer to current account balances to measure a given country's competitiveness in their publications. Indeed, a 2008 ECB report read: "Cumulative increases in labor costs across euro area countries can be indicative of growing imbalances and losses in competitiveness and, as such, are an important early sign of the need for adjustment. Relative developments in labor costs across the euro area countries, together with other indicators of competitiveness, have therefore to be closely monitored". However, as mentioned before, some economists have formulated different yet not less valid definitions of competitiveness, some examples being Porter's work on research, firm innovation, and knowledge creation (Porter 1990), and Reiljan, Hinrikus, Ivanov's appeal to strategic government investment in underdeveloped socio-economic and equality of opportunities (Reiljan, Hinrikus, Ivanov, 2000). The aforementioned economists' work deserves attention, because it underlines the fact that some countries might very well be extremely competitive while not being considered so under traditional economic views. In other words, there is room for economists, national governments, and international institutions to disagree on which definition of competitiveness fits a country's specific conditions best without engaging in unfounded, unreasonable discourse. As such, their research results suggest that national governments must develop their own clear, idiosyncratic definition of competitiveness, so to: firstly, design intentional policy plans that fit their country's economic conditions well, then identify those aspects of their country's economy which are underdeveloped, and finally channel investment in those directions.

In his 1990 article *The Competitive Advantage of Nations*, Michael E. Porter argued that a nation's competitiveness relies on the degree to which its industry will be able to innovate, when challenged by other firms or economic conditions. In his view, "companies benefit from having strong domestic rivals, aggressive home-based suppliers, and demanding local customers", because this forces them to upgrade (Porter, 1990). Under Porter's definition of competitiveness, countries with negative trade balances but entrepreneurial business environments will be considered competitive. The U.S., for example, has been running fiscal deficits since 1970, except for 1998 to 2001, and holds the world's highest current account deficit, but is widely considered one of the strongest economies today. In fact, very few would argue the U.S. is not competitive in the international arena. In line with Porter's view on competitiveness, such could be justified by its unmatched technological and research development – the world's biggest tech companies, such as Microsoft, Apple, and Intel are headquartered in Silicon Valley – and the incentives put in place to foster entrepreneurial, innovative activities, such as government distributed patents. Simultaneously, an "alternative" definition of competitiveness should not be employed as an easy way to justify reckless fiscal policy.

In their work on competitiveness, economists Janno Reiljan, Maria Hinrikus, Anneli Ivanov argue that an optimal strategy to increase competitiveness needs to balance developmental aspects at a general, societal, industrial, and regional level. Their final recommendation for national governments is that when designing policies concerning each of these levels, they should decide whether to uniformize opportunities or invest more on relatively underdeveloped areas. This line of work on competitiveness argues that equality of opportunities and/or strategic government investment as well as a clearly defined political agenda for development are the basis for competitiveness. On this vein, one could argue that, for example, Northern European countries, with universal basic income and which have a differentiated investment agenda with more funds allocated to underdeveloped regions are more competitive than countries with stark regional and social differences in development levels. Nonetheless, some of these Northern countries, for instance Finland hold negative current accounts.

Even a hypothetical consensus on competitiveness as net exports would not suffice to settle the age-old debate over international competitiveness, since there is also the question of exactly which price index captures export performance more accurately, which researchers have been pondering (e.g. 2006 Deutsche Bundesbank report *The impact of alternative indicators of price competitiveness on real exports of goods and services*). Divergences over the true definition of competitiveness are not restricted to economists, however, as European national governments' views on the matter differ from those of international institutions such as the ECB, the European Commission, and the IMF.

Since the 1980's, European countries have followed a trend of decentralization of wage-setting mechanisms, which has been accentuated by the 2008 financial crisis, with the ECB, the European Commission (EC), and the IMF including decentralization policies in their recommendation packages to EU nations (Eurofound report, 2014). Even when following the wage-bargaining decentralization policies designed by these international institutions, European national governments' expectations about the effects of such policies do not align with the goals of the ECB, EC, and IMF.

When interviewed by the Eurofound (European Foundation for the Improvement of Living and Working Conditions), members of European national governments highlighted macro-economic and micro-economic factors as well as recommendations or requirements from the European Commission and/or the ECB and/or the IMF as the main contributors to policy changes in wage-setting mechanisms after the 2008 financial crisis. Macro-economic factors pertain, for example wage moderation while micro-economic ones relate to the adaptability of firms. Export prices and trade balance are the macro-economic variables commonly used to make the argument that decentralization of wage-setting mechanisms increases competitiveness as well as the targets of decentralization policies designed by international institutions, because they rely on the traditional definition of competitiveness. So, one would expect correspondents to have claimed that macro-economic factors were a more important contributor to policy changes in wage-setting mechanisms than micro-economic goals. Nonetheless, out of the four national governments that reported state policies, recommendations, and requirements from the EC, ECB, and/or IMF influenced their wage-setting policy-making, only one country, Belgium, also reported being influenced by macro-economic factors, with most correspondents referring to micro-economic motivations for decentralization in wage bargaining.

This incoherence could be attributed to the fact that governments believe their country will increase its competitiveness if national firms become more flexible and adapt more easily to changing market conditions, that is, through micro-economic competitiveness, whereas international institutions believe the same goal of international competitiveness can be achieved through the macro-economic channel of wage moderation and cheaper exports. Ironically, macro-economic factors were reported to be influential in the two countries – Belgium and Finland – which have experienced centralization in wage-setting arrangements, precisely the opposite policy route that institutions relying on macro-economic arguments of competitiveness would recommend. Nonetheless, other national governments' views on competitiveness seem to align well with those of international institutions. In Ireland, for example, the break-up of national bargaining was reported to have been motivated in part by macro-economic reasons (securing wage moderation).

Ultimately, because the concept of competitiveness is political and subjective, it is up to each national government to establish priorities for effective economic investment and policy making based on its own considerations of which sectors or investment practices align best with their national goals and values.

For clarity's sake and given that this paper relies on data from European institutions, which mostly employ the traditional definition of competitiveness, here the term "competitiveness" relates to a country's trade balance, unless otherwise specified.

### **Section 1.1 Can the traditional definition of competitiveness be detrimental?**

Of course, besides the question of whether the traditional definition of competitiveness as net exports is theoretically correct, there is also the issue of whether pursuing policies based on it might actually weaken a country's economy (rather than being neutral). In this spirit, a 2006 IMF country report analyzing Germany's high trade balance (*Exports and Domestic Demand in*

*Germany: Has the Nexus been Altered by Globalization*) raises the question of whether the country's strong exports are actually a sign of structural weaknesses in its economy.

Explicitly, the IMF report uses economist Sinn's work to argue that Germany's large current account surplus reflects internal economic weaknesses and the export of capital. Sinn's thesis (paraphrased in the report) is that the move towards globalization represented a competitiveness shock to the German economy, but that due to labor market rigidities, wages were sluggish to respond and became high vis-à-vis foreign wages. Labor-intensive exporting sectors failed due to high labor costs and had to release excessive labor supply, causing German unemployment to rise. The freed-up labor was not absorbed in the services sector, because services wage costs were too high and labor mobility tends to be too low. In summary, "Because adjustment in the domestic labor market is drawn out, specialization in capital-intensive/exporting sectors overshoots, and investment and employment in domestic service-oriented sectors undershoots" (IMF report, 2006 citing Sinn 2006). As a result of globalization, firm capital largely moved abroad to be combined with less expensive foreign labor. So, in this view, Germany's large current account surplus is a sign of insufficient conditions and incentives for investment in domestic non-tradable sectors.

To make the logical jump from this point to Germany's high net exports, the IMF's report implicitly leans on the three-panel diagram macroeconomic model, according to which higher net exports and a lower exchange rate mean higher net capital outflows (NCO) and lower domestic interest rates. Given that NCO equals net exports (euros of capital invested in the foreign country will be used to buy German products in euros), positive and high NCO implies by definition that institutions and/or households have a preference to invest capital abroad rather than domestically. Consequently, the criticism with which one may address the three-panel diagram is also to some extent valid for the rationale exposed on the IMF's report. Thus, one counterargument to Sinn's conclusion could be that German investments in foreign countries does not necessarily provoke higher exports: for example, consumer preferences might limit foreigners' demand of German goods, regardless of German capital investments in that country. One other question to be raised is: if foreign wages are lower and if globalization increased German unemployment, decreasing the purchasing power of at least the unemployed why aren't exports from those countries (imports from the German perspective) also cheaper and preferred by Germans? That is to ask: why wasn't an increase in imports counterbalanced by Germany's strong exports? (see section 4.0 for a brief overview of German imports resistance)

It's also worth drawing attention to the fact that even though high Germany's high net exports are attributed to its low wages, the IMF report exposes the gap between higher German and lower foreign wages as the motor of their strong exports. This apparent paradox thus supports the view that the link between wages and exports is not as simple as European economic policy might wish it to be.

## **Section 2.0 – The History of German labor market reforms**

As of 2017, Germany was Europe's largest exporter, followed by France, and the Netherlands, with Italy taking fourth place, and is therefore held as the golden standard for competitiveness in

the EU. There, since 2005, unemployment rates have steadily decreased, and participation rates increased. Since 2011, labor compensation has increased moderately. Although the main economic indicators featured in the literature on Germany's exceeding competitiveness are the country's unit labor costs, export prices, and trade balance, for many years, the key challenge for Germany was to reduce high and persistent unemployment. Indeed, the continuous rise in unemployment until the mid-2000s, which earned Germany the nickname of "sick man of Europe" at the time, can clearly be seen in Figure 1. Germany's route from the unemployment trap of the early 2000s to becoming an "economic superstar" has received global attention. Its labor market robustness to the impacts of the 2008 Great Recession (unemployment changed very little as a result of the crisis) has also caught policy-makers eye. It has therefore been argued that Germany could be a reference model for nations with labor market turmoil (Schneider and Rinne, 2017).

Germany's past unemployment rate has often been linked to high employment protection, high labor costs, and strictly regulated labor markets. In this context, the labor market reforms (the 2003-2005 "Hartz reforms") are considered to have played an important role in reducing unemployment. Under the reforms, flexible forms of employment such as fixed term contracts, temporary agency work, and marginal employment became more attractive, unemployment benefits duration for the elderly was lowered, and all welfare recipients considered able to work were included in activation schemes. Intermediate forms of unemployment compensation were abolished, and item-wise approved welfare payments were replaced by a monthly lump-sum, lowering unemployment benefits and making monitoring activities for the unemployed stricter. Hence, matching between unemployed workers and job vacancies accelerated. In conclusion, the labor market reforms successfully reduced unemployment by incentivizing job search, abolishing ineffective policy instruments such as job creation schemes, and enforcing the requirements for the unemployed to prove ongoing job search efforts. (Schneider and Rinne, 2017).

Another factor which lowered Germany's youth unemployment rates was the dual apprenticeship system, which besides providing skills and qualifications in demand, also reduced facilitated school-to-work transitions. Increased participation rates among older workers, mainly triggered by the labor market reforms, which effectively reduced monetary incentives for early retirement also contributed to decrease unemployment. Moreover, unions and employers increasingly used the collective bargaining process to arrive at more flexible labor arrangements via opening clauses in contracts between unions and employers' associations, which were valid during financial crisis (Schneider and Rinne, 2017).

Currently, the German system of industrial relations is laid out in contracts and mutual agreements between trade unions, employer associations, and works councils - the worker representatives who are typically present in medium-sized and large firms (Dustmann, Fitzenberger, Schönberg, and Spitz-Oener, 2014). In Germany, wage-setting is quite decentralized, with contractual agreements on wages, wage floors, and working time between unions and employers being periodically negotiated on the region-industry or firm level, without government interference. In fact, Germany had had no minimum wage imposed by the political process until 2015. Consequently, as Dustmann et. al argue, "negotiations are usually far more consensus-based and less confrontational than in other countries. For example, Germany lost on average 11 days of work each year per 1,000 employees by strikes and lock-outs between 1991 and 1999, but only five days per 1,000 employees between 2000 and 2007. These figures for the earlier and later time

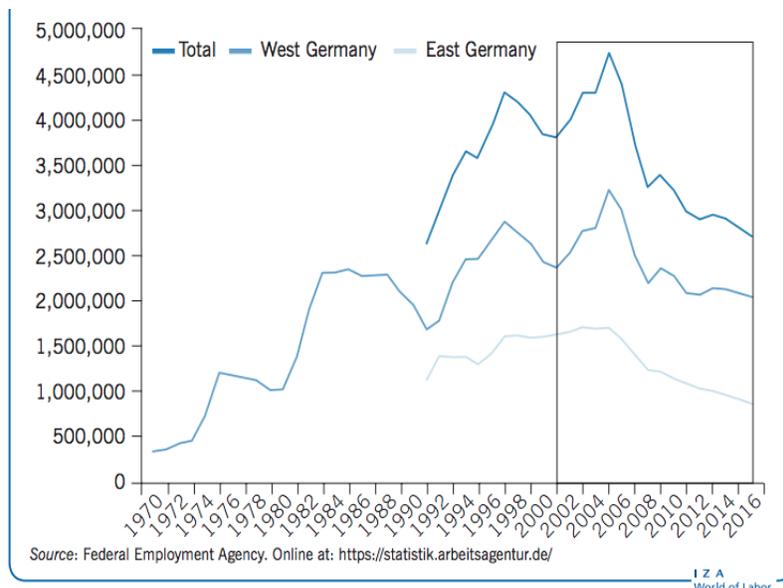


Fig 1. Germany's unemployed workers, 1970-2016 source: Schneider and Rinne, 2017

period compare to 40 and 32 days per 1,000 employees in the United States, 30 and 30 days in the United Kingdom, 73 and 103 days in France, 158 and 93 days in Italy, and 220 and 164 days in Canada (Dustmann et. al 2014 citing Lesch 2009)” (Dustmann, Fitzenberger, Schönberg, and Spitz-Oener, 2014).

A distinguishing feature of German labor markets are the opening clauses in employment contracts introduced by the Kratz reforms. Indeed, even within industry level union wage contracts, “opening” or “hardship” clauses allow for

wage renegotiation at the firm level in times of financial distress, provided that workers’ representatives agree. Such clauses also mean that German firms can choose whether or not to recognize a given trade union as well as union’s wage bargaining contracts. Furthermore, German firms that recognized union contracts in the past can opt out at their own discretion. In summary, such policies allow for the possibility of wage renegotiations or layoffs during financial turmoil, increasing firm adaptability to changing economic conditions.

Germany’s labor market has increasingly moved from industry or region level wage bargaining to firm-level negotiations, that is towards decentralized wage-setting, as from 1995 to 2008, the share of employees covered by industry-wide agreements fell from 75 to 56 percent, while the share covered by firm-level agreements fell from 10.5 to 9 percent (Dustmann, Fitzenberger, Schönberg, and Spitz-Oener, 2014). Dustmann et al. attribute Germany’s evolution in the direction of more flexible labor markets and decentralized wage-setting to the German reunification and to globalization. Their argument is that Eastern migration exerted downward pressure on wages and that the opportunity to move production abroad (which globalization generated) discouraged German firms to pay high union wages. Firms’ disincentives to pay high wages forced unions and/or works councils to become willing to negotiate pay rates directly with companies and to accept deviations from industry-wide labor agreements, which often translated into lower wages for workers.

## Section 2.1 – A reflection on Germany’s unemployment reduction miracle

Germany’s move towards increased labor market flexibility and decentralized wage-bargaining seems to have succeeded in reducing unemployment via the Kratz reforms, the government’s goal. In my view, such results were achieved, because, from the unemployed workers’ perspective, the

reforms substantially lowered unemployment benefits, incentivizing job search. From the perspective of the firms, the reforms allowed for companies to both layoff but also hire workers quicker, increasing the speed at which matching between unemployed workers and jobs took place. Additionally, the fact that companies can recognize union wage-contracts at their own discretion effectively constitutes a significant transfer of power from employees to firms, since it often forces workers to accept lower wages, which reduces production costs and could increase firms' profits or decrease the final price of the goods they produce. A causal link between such reforms and Germany's export success via cheaper exports, however, is not by any means clear, since it is possible that German firms chose to add on the difference between the older, higher wages and the later, lower ones to their profits instead of lowering their exportable products' prices. Note that lower export prices are required for traditional views of competitiveness as cheap and abundant exports to hold. Germany's superior export performance could be due to other factors entirely. Moreover, one could argue that lower wages reduce households' purchasing power, which can hurt firms' profits, given that, according to a Keynesian view of the world, such reduces aggregate demand, slowing down economic growth (despite also reducing imports along with demand for other goods). Nonetheless, advocates of wage-setting decentralization have used Germany's labor market evolution to argue that such systems are superior to centralized ones. I believe the conclusion that Germany's decentralized wage-setting is the reason behind its strong exports is erroneous. In my view, it ultimately stems from the fact that institutions such as the IMF, the ECB or the EC have not been able to identify the mismatch between the target economic variable of the Kratz reforms which they copy to a certain extent (unemployment) and the target of their wage-decentralization policy recommendations (exports). Recommending German-style reforms to other governments, erroneously treating such policy packages as one-size-fits-all, can be problematic, because implementing the same labor market policies in economic environments different from the one where those policies succeeded and in order to reach a goal different from the one its original designers had in mind is not only incoherent but also likely to lead to unexpected outcomes.

Similarly, as mentioned in section 1.0, national governments also implement international institutions' policy recommendations expecting to achieve micro-economic goals while the policy designers at those institutions wrote them with a macro-economic mindset. If such goals cannot be achieved simultaneously, this divergence most likely will lead to disappointment from either party's side (whoever fails to reach its objective) and successive changes in policies.

### **Section 3.0 The wage-setting mechanisms – ULC – exports connection**

Decentralization of wage-setting mechanisms is widely associated with lower unit labor costs and consequently cheaper exports and a stronger trade balance, so much so that after the financial crisis of 2008, a great number of European countries shifted their wage-setting mechanisms towards more decentralized ones, in an attempt to become more competitive. As we read in a 2014 report from Eurofound: "The prevalence of decentralization since the onset of the crisis continues and has accelerated; it is the predominant tendency in the evolution of wage setting mechanisms observed since the late 1980s." However, other economists have argued that the link between wage-setting mechanisms, unit labor costs, and exports is actually weak. In this section, I present an overview of the literature on the decentralization-ULC-exports connection.

The traditional economic view on the ULC-exports link is that globalization and its associated increase in international competitiveness have made exports more sensitive to costs. Thus, “the focus on unit labor costs as a measure for competitiveness is based on the idea that increases in unit labor costs are passed on in the form of higher export prices, resulting in a deterioration in the balance of payments, hampering economic growth and increasing unemployment” (Decramer, Fuss, Konings, 2016).

In the specific case of Germany, while some economists argue that the Kratz reforms played a role in increasing the country’s exports, as mentioned in the previous section, German economist Christian Dustmann et al. makes the argument that the reforms succeeded in creating incentives for seeking employment but “did little to support the remarkable wage restraint witnessed since the mid 1990s, which is the key factor in explaining the gain in competitiveness” (Dustmann, Fitzenberger, Schönberg, and Spitz-Oener, 2014).

Instead, Dustmann et al. argue that proximity of labor unions to firms and flexible, decentralized wage and labor contract negotiations are the true reasons behind Germany’s export success. The specific structural parameters of German industrial relations, they argue, allowed for an unprecedented decentralization of the wage setting process, leading to a decrease in real wages, especially at the lower end of the wage distribution. The sharp decline in the share of workers covered by union agreements and the increase in opening clauses that strengthened the role of firm-based works councils in wage determination relative to trade unions, they argue, contributed to this development.

Apparently contrary to this view, data from the IMF and the ECB show that German unit labor costs had been rising even before the 2008 financial crisis. A perplexing fact indeed: how does Germany manage to keep number one place as Europe’s biggest exporter while its ULC and export prices increase? Dustmann et al. explain this observation, by analyzing the evolution of ULC across separate sectors individually, namely non-tradable sectors, tradable manufacturing, tradable services. The IMF and ECB, on the contrary, account for the evolution of wages across all sectors without cross-sector distinctions. The graphs in figure 2 show that, while German wages in tradable manufacturing have increased since 1990, wages in non-tradable sectors and tradable services have decreased since 1998 and 2004, respectively. Dustmann et al. use these results to explain why German exports have remained competitive even after wages in some sectors increased. The value added to exported products in manufacturing, they argue, is only roughly one-third of the value of the end product, with the remainder value coming from other industries’ inputs (domestic or foreign). So, the manufacturing sector benefited from low wages in other domestic sectors, namely domestically provided non-tradable and especially tradable services, where real wages fell between 1995 and 2007, as well as from cheap imports (production inputs) from abroad. Dustmann et. al further argue that Germany’s manufacturing sector may have experienced increases in productivity which exceeded the increases in wages in the manufacturing sector, since productivity increases in the manufacturing sector have exceeded the increases in the two other sectors.

In Germany, the manufacturing sector comprised 21.6 percent of all jobs in 1995, but 17.7 percent of all jobs in 2007, while the value added of this sector (in current prices) remained

essentially unchanged at 22.8 percent of all value added in 1995 compared with 22.7 percent of value added in 2007 (Dustmann, Fitzenberger, Schönberg, and Spitz-Oener, 2014). So, the manufacturing sector must rely to an increasing extent on inputs from other domestic sectors and on imported inputs, because the share in final products has increased while the share in value added has remained the same. Finally, to increase the competitiveness of its own fiscal products, the manufacturing sector has made increased use of trade integration with Eastern European countries through inputs imported from abroad, more so than other European countries. These inputs made up 14.5 percent of total output in the manufacturing sector in 1995 and 21.5 percent in 2007 (Dustmann, Fitzenberger, Schönberg, and Spitz-Oener, 2014).

As such, in this view, Germany's rising unit labor costs are not a counterargument to the traditional link between low ULC and higher trade balances (and competitiveness), but more so an expression of imperfect data representation.

Nonetheless, in an entirely opposite vein, as early as the 1970s, Kaldor (1978) demonstrated that countries with the highest growth rates in GDP also tend to have increasing unit labor costs, which is known as the 'Kaldor paradox' (Decramer, Fuss, Konings, 2016).

Similarly, Decramer, Fuss, and Konings, in their 2016 study of Belgium firms' exports reactions to changes in ULC, found that the elasticity of exports with regard to unit labor costs varies between 0.29 and 0.40. Moreover, this elasticity differs across sectors and firms, with more labor-intensive firms being more sensitive to changes in unit labor costs than firms that use more capital and export mainly to the EU market. The financial and economic crisis affected exports, but the elasticity of exports with respect to unit labor costs did not change (Decramer, Fuss, Konings, 2016).

The economists concluded that while their results show that unit labor costs have an impact on the intensive and extensive margin of firm-level exports, the impact is rather low for the average exporting firm. This suggests that pass-through of changes in labor costs into prices is low or that demand is fairly inelastic with regard to prices, which indicates that other factors such as taste and quality may be just as important to incorporate into indicators of competitiveness, as suggested by recent trade models focusing on quality and taste parameters. Also, the finding that the elasticity of exports with regard to unit labor costs is larger for labor-intensive firms suggest that cost competitiveness is more important for these firms (Decramer, Fuss, Konings, 2016).

### Section 3.1 The wage setting – ULC – exports link – Belgium as a counterexample to mainstream economic competitiveness theory

From  
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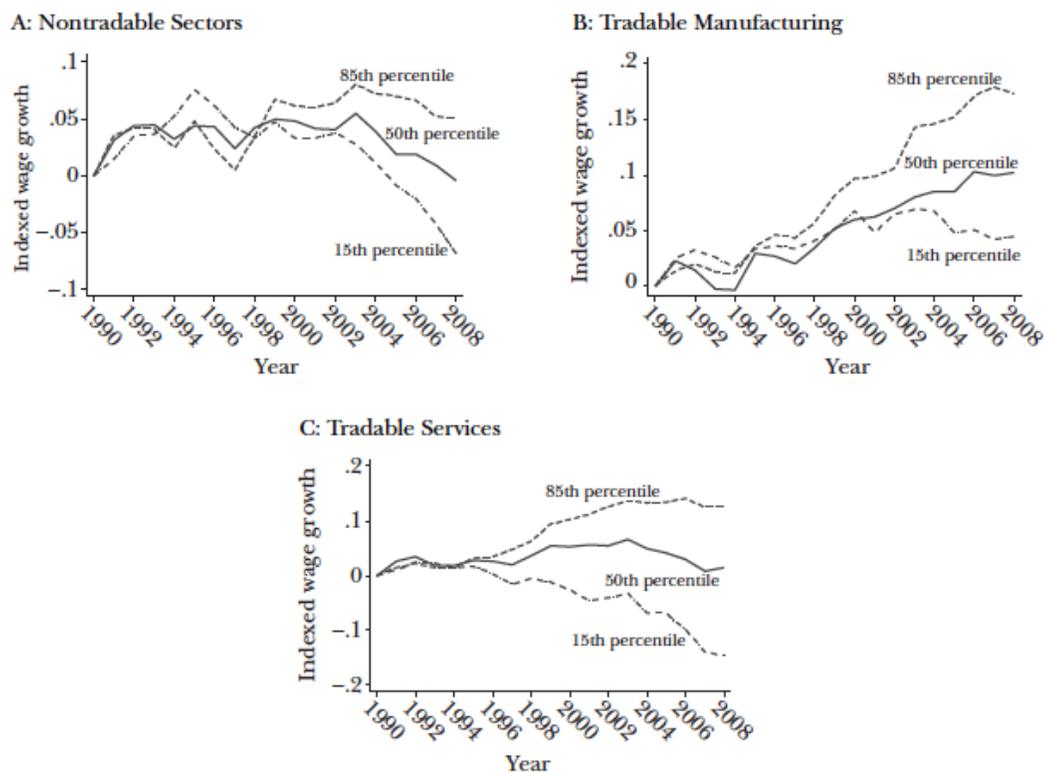


Fig 2. Germany's real wages evolution, from 1990-2008, across nontradable sectors and tradable manufacturing and services; source: Dustmann, Fitzenberger, Schönberg, and Spitz-Oener, 2014

countries in the aforementioned Eurofound report for which the dominant tendency from 2008-2011 was decentralization of wage-setting mechanisms, the prevalent regime shifted from single- to multi-employer bargaining (recentralization) in two countries: Belgium and Finland. Whereas Finland's trade balance decreased from 2008-2011, corroborating the common view that centralized wage bargaining hurts exports, Belgium's current account increased after recentralization (according to data from the IMF). Belgium's trade balance evolution from 2008 is therefore an interesting counterexample supporting this paper's argument that there are aspects other than wage-setting mechanisms contributing to a country's net export level.

Although data from the IMF and the ECB show that, similar to Germany, Belgium's ULC have risen since after the 2008 financial crisis, as Dustmann et al. have implicitly argued in their aforementioned research, such does not provide enough information on the evolution of Belgian wages for one to conclude that there is no link between Belgian ULC and exports with confidence. I have therefore translated labor market data from the National Bank of Belgium and plotted the graphs in figures three through five, which reflect the evolution of nominal wages across non-tradable sectors and tradable manufacturing and services in the country from 2000-2017. The method employed here is similar to that employed in Dustmann's paper, to allow for comparisons between German and Belgian data, but it is nonetheless inferior.

As in Dustmann's paper, tradable manufacturing consists of manufacturing sectors for which the export base is above the 25<sup>th</sup> percentile of Belgium's total export volume while exports of non-tradable sectors are below this threshold. In contrast, tradable services are not computed, due to a lack of information on the export percentage of specific services. Instead, the wage evolution across all tradable services is included. Inflation-adjusted real wages are shown and the data dates from 2000 to 2017 (instead of indexed wage growth from 1990 to 2008 as in Dustmann's paper).

Since I could not collect enough

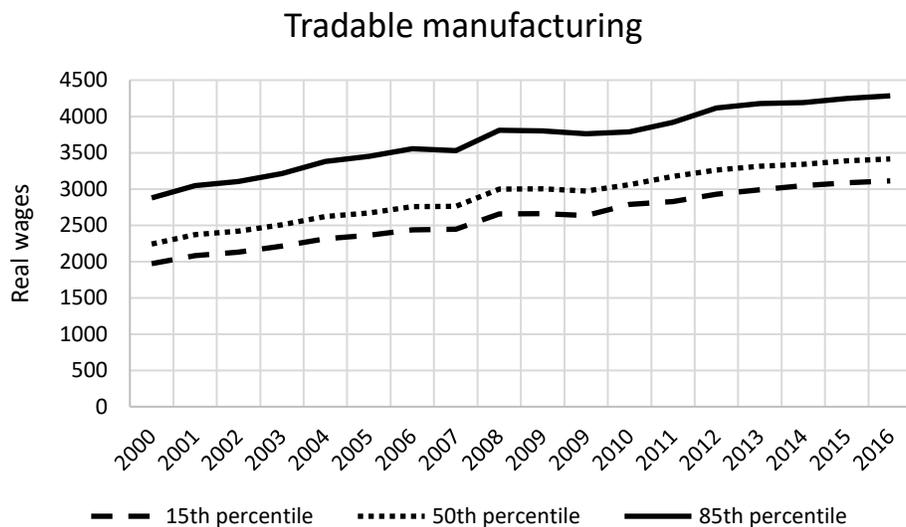


Fig 3. Belgian real wage evolution, from 2000-2017 in tradable manufacturing sectors and specified by wage percentile; constructed using data from the National Bank of Belgium

information on manufacturing labor productivity to draft conclusions on Belgian unit labor costs accurately, the graphs that follow only allow for wage evolution comparisons in Belgium versus Germany.

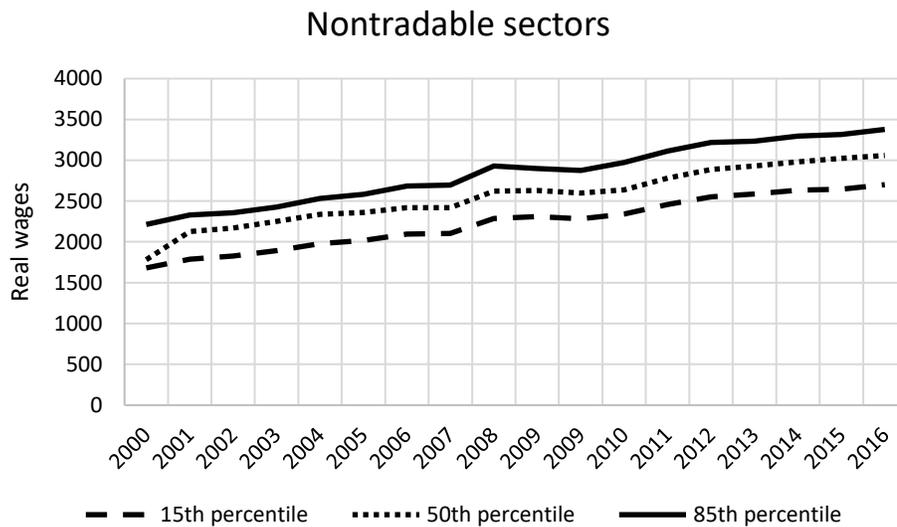


Fig 4. Belgian real wage evolution, from 2000-2017 in non-tradable sectors (below the 25<sup>th</sup> percentile of total national export base) and specified by wage percentile; constructed using data from the National Bank of Belgium

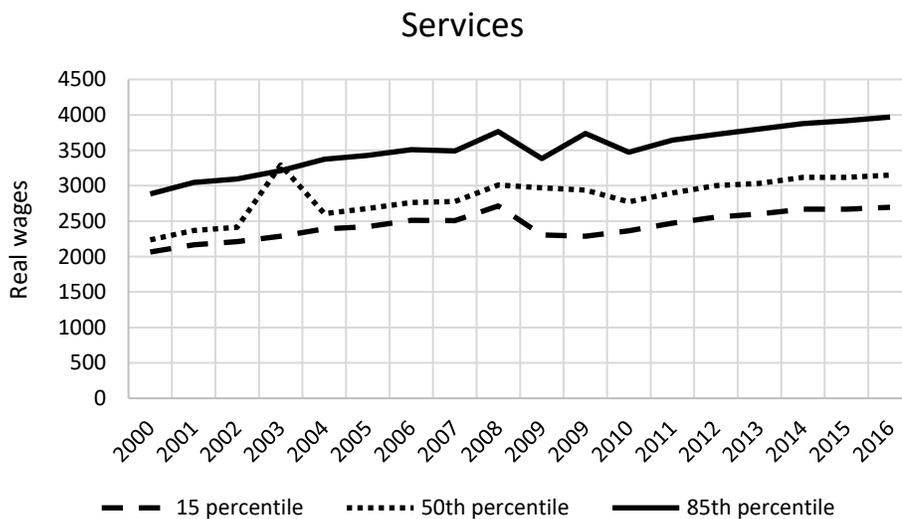


Fig 5. Belgian real wage evolution, from 2000-2017 in services (all levels of total national export base) and specified by wage percentile; constructed using data from the National Bank of Belgium

According to data from the National Bank of Belgium and unlike the German pay rates featured in Dustmann's paper, Belgian real wages across all sectors and the 15<sup>th</sup>, 50<sup>th</sup> and 85<sup>th</sup> percentiles have increased from 2000 to 2017. There are, thus, several conclusions to be drawn from the graphs above. Firstly, the fact that wages had been following an upward trend since before the 2008 wage-setting recentralization implies that more decentralized wage-setting systems do not necessarily mean lower real wages and ULC; such also means that recentralization does not imply higher wages and ULC. Secondly, because Belgian real wages have increased across services and nontradable sectors, Dustmann's conclusion that product costs of tradable manufacturing can decrease due to the lower labor costs of those sectors that supply inputs to tradable manufacturing does not apply to Belgium.

Note that only the evolution of real wages is analyzed here and that unit labor costs, that is considerations of both wages and the evolution of labor productivity in Belgium are not made. Ultimately, since both real wages and exports have increased after Belgium's 2008 shift towards recentralization, we can conclude that Belgian data contradicts the conventional wage-setting mechanisms-wages-net exports link. As for the unit labor costs – net exports link, the graphs above cannot be employed to fully support or contradict conventional economic theories. Nonetheless, the aforementioned data on Belgium corroborates the view that policy recommendations for increased decentralized wage-setting systems which rely on the argument that such mechanisms will increase exports and competitiveness are flawed, their results depending on country-specific characteristics.

One could argue that even though Belgian export levels have increased, they are still lower than those of Germany (one could also argue Belgium is a smaller country, etc.) and that German (more decentralized) labor markets are therefore superior. However, these arguments very philosophically lead us back to the “what is competition?” question from the beginning of this read by begging the question: with whom/what is each country competing: their own past export performance or that of other countries? Those who answer “the former” will probably react positively to the evolution of Belgium's export levels and its 2008 wage-setting recentralization. Those answering the later are more likely to argue that Belgium's turn towards recentralization has not succeeded in significantly boosting its competitiveness.

#### **Section 4.0 What other factors influence export performance?**

The data and arguments presented in the previous sections should lean even those at the higher end of the stubbornness distribution to agreeing that several factors other than ULCs determine the attractiveness of a given country's exports. Indeed, parameters, such as product quality, real exchange rates, rising global demand, variations in the business cycle, and resistance to imports also play an important role in explaining the evolution of countries' net exports.

In 2005, the IMF published the report *Explaining Differences in External Sector Performance Among Large Euro Area Countries*, which analyzed the evolution of the traditional determinants of exports and imports during 2001-2004 in France, Germany, Italy, and Spain. The publication concluded that the countries' imports are well explained by domestic and foreign demand for said imports, while competitiveness across different imported goods played is not as relevant. All countries' export levels rose due to rising global demand (globalization and the

opening of foreign markets), with Spain profiting the most and France the least. Similarly, all countries experienced real exchange rate appreciation, with Italy suffering the most (its exports became more expensive to foreigners and therefore decreased) and Germany the least. The report refers to an “unexplained part of exports”, which was positive for Germany and negative for the other three countries.

As such, not only does the above IMF report indicate that big European countries’ exports are affected by factors other than ULC, but that German exports in particular seem to be preferred to other nation’s goods. A reason for foreigners’ preferential taste for German products could be the higher quality of their products. Indeed, on their 2014 study on France and Germany’s import demand (resistance) Thanagopal and Le Mouel test this hypothesis by comparing the ability of France and Germany to resist foreign competition. After a comparison of French and German products’ reality quality and prices, they conclude that German products (especially in sectors producing highly differentiated products) employ better competitive practices than French ones, because they tend to be less substitutable and highly differentiated vis-à-vis their foreign counterparts (Thanagopal and Le Mouel, 2014). These results point towards product differentiation as the key to strong exports and suggest that policy-makers should encourage enterprises to invest in technology, research, and higher-quality inputs to entice foreigners’ appetite for their products.

## **Section 5.0 How do differential ULC and net exports across Europe affect the EMU?**

Economic research on the influence of cost competitiveness on national growth has been partly triggered by ongoing debates about growing imbalances in the euro area as these are attributed to negative current accounts in economically weaker countries in opposition to large positive ones in stronger European economies. Some economists have even gone as far as arguing that Germany, as the largest economy in the EU, has the responsibility to purposely raise its ULC to correct such imbalances.

Under the EMU, each individual member state must attempt to meet the ECB’s inflation target of close to but below 2%. However, meeting a common inflation target entails constraints which can be detrimental to member countries, some of which related to the evolution of labor costs, because these are important in determining the inflation rate. The increase in European ULC should have been compatible with the EU’s inflation target. Instead, during the past 11 years a group of countries in the euro area has reported unit labor cost increases close to the EMU average - Finland, France, Belgium, the Netherlands, and Austria. By contrast, Germany’s average unit labor cost increase - merely 0.6% - is far below from the ECB’s target. At the same time, the evolution of ULC (which have been significantly corrected) in Greece, Italy, Portugal, Ireland and Spain constituted relevant upward deviations from the euro area average until the onset of the 2008 crisis (Niechoj, Stein, Stephan, and Zwiener, 2011).

As Torsten Niechoj, Ulrike Stein, Sabine Stephan, and Rudolf Zwiener’s conclude in their 2011 paper *German labour costs: A source of instability in the euro area*: “It is not sufficient for the respective countries to reach the low unit labor cost growth of Germany, as this would not help to improve the domestic competitiveness vis-à-vis Germany... Preserving the European Monetary Union in its current composition and avoiding a transfer union, is only possible, if wage inflation

in Germany exceeds 2 % for several years". The aforementioned economists seem to thus belong to the group of advocates for uniform ULC in the EMU at the expense of higher German wages. Despite the fact that policy recommendations towards greater equality of ULC in Europe differ there seems to be a broad agreement that unequal labor costs across the EU are one source of economic inequalities in the union and that measures should be taken in order reduce such differences.

## Conclusion

Given that a broad agreement on "the one true" definition of international competitiveness is most likely impossible to reach, it is the responsibility of each national government to design its own definition of the concept and craft an economic agenda consisting of policies aimed at improving their country's specific competitiveness conditions. International competitive is an inherently political concept, and as such policy makers and policy supervising institutions should consider writing recommendations tailored to different countries' economic characteristics and investment/developmental needs and wants. Ultimately, countries might become competitive (whatever this means) by investing in underdeveloped areas or taking advantage of those sectors/activities/resources at which they have a comparative advantage, differentiating themselves and their products from those of other nations, not by mimicking policies which worked well in addressing general labor-market issues (not even necessarily competitiveness) in other nations (but only due to those nations' specific economic environments). Thus far, however, to increase countries' competitiveness these institutions have mostly advocated for decentralization of wage-setting mechanisms, based on how successful decentralization was in reducing Germany's unemployment.

The historical prevalence of the rationale that lower wages imply cheap exports, which in turn mean higher net exports has greatly influenced institutions like the IMF, the EU Commission and the ECB. Nonetheless, several countries constitute counterexamples to the widely accepted view that decentralization of wage-setting mechanisms leads to higher net exports, Belgium being the particular case analyzed in this paper. Belgium's wage evolution after centralization of wage-setting mechanisms is proof that country idiosyncrasies are an important factor affecting economic policies' efficiency and that unconventional policy routes (wage-bargaining centralization for example) can be just as beneficial as conventional ones. Rather than advocating that centralized wage-setting increases exports or that decentralization is inefficient, this paper aims at questioning the definition of competitiveness itself and argues that establishing straightforward causal chains between wage-setting mechanisms and exports is erroneous. Consequently, national governments as well as EU institutions would probably benefit from incorporating directives targeted at improving more general economic factors other than wages in their policy packages, namely research and innovation, technology, and product quality and differentiability.

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