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Do Unit Labour Costs Matter? A Decomposition Exercise on European Data

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This paper contributes to the understanding of the Eurozone crisis. One key aspect of this crisis is the widening of macroeconomic imbalances among Member States from the Euro's inception up to the 2008 global financial crisis. These imbalances took the form of strong differences in the dynamics of unit labour costs. They increased much faster in "peripheral" economies than in "core" countries. This paper shows that economic integration is a significant driver of these costs.

Unit labour costs show how wages evolve relative to productivity. They are used by the European Commission as an early indicator for potentially harmful imbalances and competitiveness losses. Some observers argue that the relative loss of competitiveness in the periphery comes from fiscal profligacy while others emphasize the role of catching-up processes or the role of capital misallocation. All of these factors have certainly played a role, but had not yet been confronted to quantify the importance of each one.

In this paper, I confront and quantify various views on the reasons for increased unit labour costs in the periphery. To do so, I build a theoretical framework that is able to provide an accounting decomposition of the growth of unit labour costs into various effects of economic integration and policy intervention. In this model, the dynamics of the non-tradable sector is key: the loss in aggregate competitiveness does not reflect a loss in the competitiveness of the tradable/export-led sectors, but an increase in the share of the less competitive non-tradable sector.

Confronting the theoretical framework to the data, it is possible to quantify the contribution of each of these effects to increasing unit labour costs in peripheral economies (compared to core countries). Before the global financial crisis, in Greece and Portugal in particular, the two main drivers of increasing unit labour costs are productivity gains in the tradable sector, and decreasing interest rates. These results suggest that, at least in Greece and Portugal, economic (both trade and financial) integration was an important driver of increasing macroeconomic imbalances.