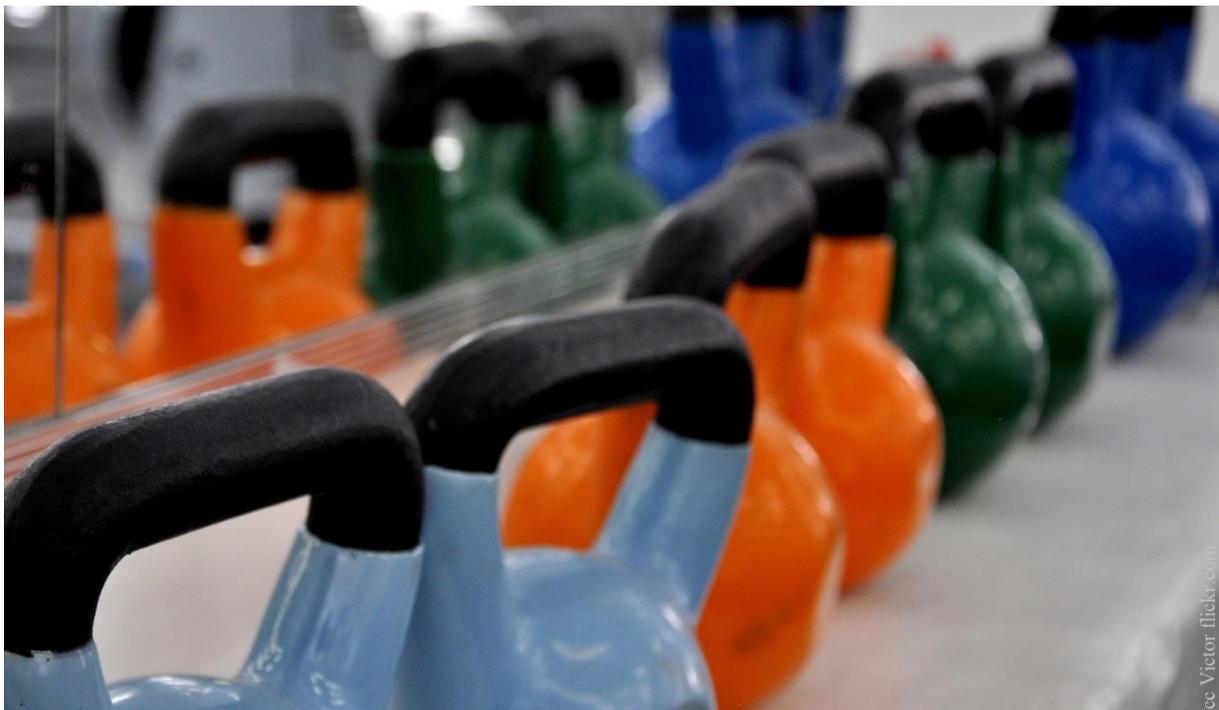


POLICY BRIEF 18.12.2018

Europe's growth starlets: Wages and productivity in 4 export-oriented economies

Pola Schneemelcher and Philipp Ständer

Policy Fellows at the Jacques Delors Institute Berlin



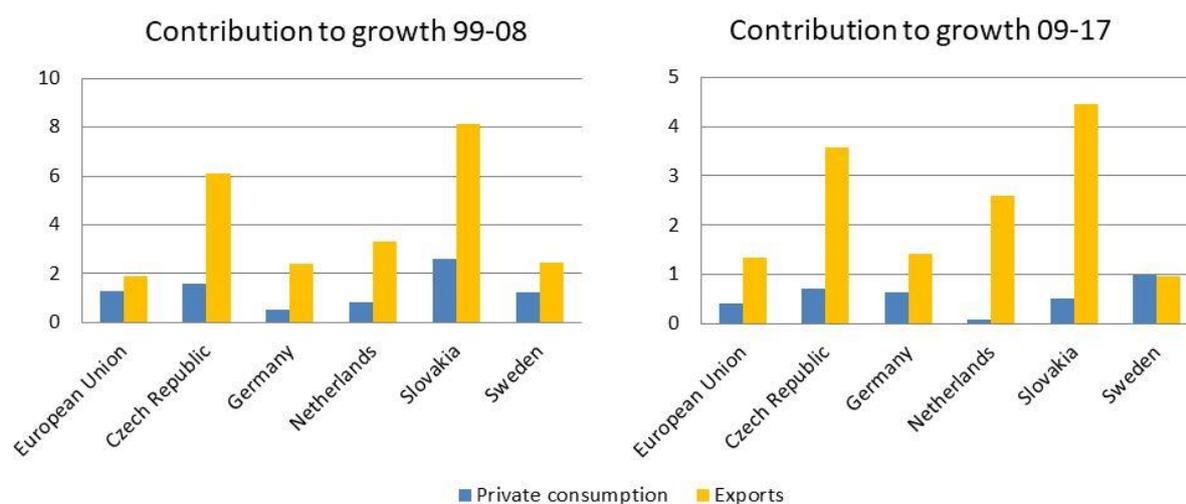
Under which conditions do European economies achieve solid and balanced wage and productivity growth? In this blog post we analyse two economic models in the EU exemplified by four countries that appear to realise solid wage and productivity growth and compete successfully in global markets. We distill their comparative advantage and point to future challenges such as skills shortages, transformation to a knowledge-based economy and social disparities.

In search for EU economic models to follow

When faced with economic challenges European governments often look to their neighbours for inspiration and models. Emmanuel Macron, for example, lists German labour market reforms as inspirational for his political decisions. Yet, in European political discourse, such examples are few and far between and understanding why certain countries perform well is often limited. From the outside, we mostly look at key economic indicators such as growth, unemployment, productivity, the fiscal balance and current account to judge how far a given growth model is viable. More deeply rooted institutional foundations for certain growth models are, however, often overlooked as it requires a holistic understanding of areas such as skill-formation, wage-setting, innovation and labour market policy.

In a previous [blog post](#) we discussed the relationship between **productivity** and **wages** in the four biggest European economies, starting from the premise that solid and aligned growth of both indicators is a sign of economic health as it shows that a country is maintaining its competitiveness vis-à-vis trading partners while household incomes are rising.¹ We now want to broaden the perspective with some less established best-case examples by looking at four countries that appear to compete successfully in global markets while at the same time achieving wage growth in line with productivity. Our case studies are: the **Czech Republic**, the **Netherlands**, **Slovakia** and **Sweden**. All four countries have higher trade openness than the EU average and exports are a strong contributor to economic growth for the last two decades. As we see in Figure 1 some of them depend more strongly on exports to achieve growth than Germany did between 1999 and 2008, though Sweden stands out as the most balanced case over both periods. Besides being strong trading powers, the four also show other signs of economic health, such as sound public finances, strong and dynamic labour markets and below average poverty and income inequality.

Figure 1: Average annual contribution of consumption and exports to GDP growth since 1999



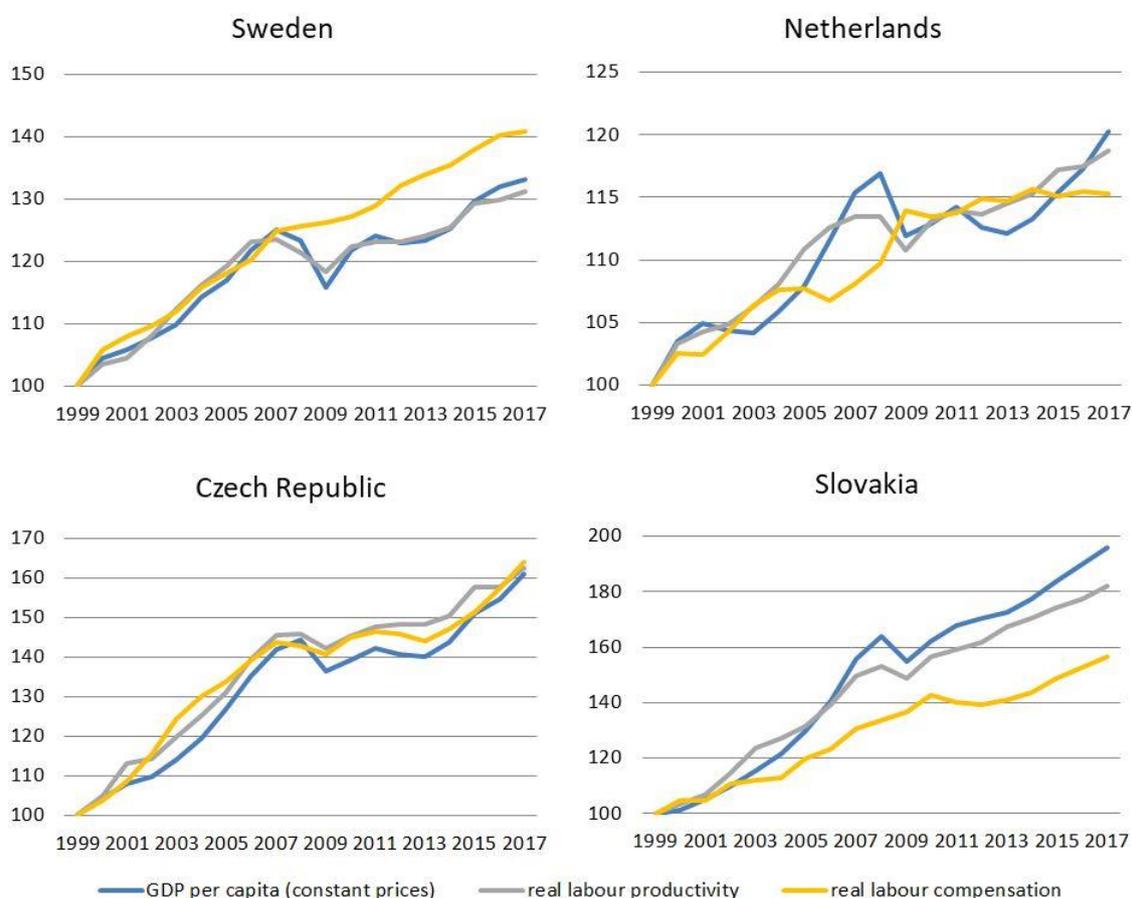
Source: AMECO.

¹ For an in-depth account of wage-productivity developments in the EU we recommend Eurofound (2018), [Developments in collectively agreed pay 2000–2017](#), Publications Office of the European Union, Luxembourg.

Yet these countries also represent two very different economic models: Sweden and the Netherlands are two **advanced open economies** that have maintained among the highest standards of living in terms of GDP per capita but also quality of life and public services worldwide for many decades. The Czech Republic and Slovakia by contrast represent two post-communist **catch-up economies** that, as part of the Visegrad group, demonstrate a strong economic convergence process because they provide comparatively cheap but skilled labour in industrial sectors that can be smoothly integrated into European value chains. Their competitive advantage is in price-sensitive industrial sectors such as complex and durable consumer goods, most importantly the automotive industry.

Therefore, the two models exemplify two ways of being competitive in the EU inside and outside the Eurozone, which might inspire other EU economies searching to enhance their competitiveness at the same time as enjoying real wage increases and rising living standards.

Figure 2: GDP per capita, labour productivity & wage developments, index value (1999 = 100)



Source: Authors' own calculations based on Eurostat, AMECO.

In the following sections we analyse how each of the countries has developed in terms of wages and productivity since 1999. The overall perspective for this analysis is the economic structure and comparative advantage, labour market developments and specific long-term challenges for future growth and competitiveness. Here, the [European Semester country reports](#) of the European Commission serve as a major source. In the last section we reflect on similarities among the four and point out some model-specific challenges such as addressing skills shortages, dealing with social divergence or poor innovative capacities.

1 Sweden

Sweden's economy has been expanding at a faster pace than most other Northern or Western European countries in recent years. Although it took longer to return to pre-crisis levels than, for example, Germany and productivity growth stagnated between 2007 and 2014, the economy is today in very good shape, benefitting from a mix of export growth, high investment due to buoyant construction activity and solid domestic demand.

Throughout the observation period **real wages have grown strongly**, standing today 40 percent above 1999 levels. Productivity growth was in line with wage growth until the crisis but stagnated between 2007 and 2014. Despite this positive wage drift, the [Commission](#) attests that Swedish competitiveness in export markets is of no concern and that Sweden is particularly strong in non-cost competitiveness such as product innovation. Some trends are, however, clouding the outlook for productivity growth such as the shift to a services-based economy or decreasing returns from ICT adoption.

To understand how the country achieved such strong real wage growth we need to take into account the specialization of Swedish firms and the general structure of the economy. Like the other cases, Sweden is an open economy that generates much of its wealth through trade. Yet it is special in two ways: First, it competes in high value added (niche) sectors where pure **price-competitiveness is less important** than innovation and intellectual property. Examples are the ICT sector or business services. Sweden does not, moreover, depend on industrial exports alone, it also maintains a trade surplus in services that have outpaced goods exports in volume. Second, economic **growth is more evenly driven** by exports and domestic consumption than the catch-up economies but also more so than Germany, which is specialized in more price-sensitive sectors.

To be successful in high value-added sectors high-quality education and vocational training is crucial. While Sweden generally has a well-functioning **education system** it **has recently faced a number of problems** that will be challenging in the long run. The first is a rising skills shortage in specific sectors against the backdrop of the highest employment rate in the EU at 82 percent in 2017. For example, there is an acute lack of ICT graduates, which might pose a risk to the otherwise advanced adaptation of the economy to digitalisation. Second, Sweden is getting to grips with the integration of several hundred thousand [newly arrived migrants](#) that have to be integrated into a labour market with already too few opportunities for the low-skilled and into an education system designed to be highly egalitarian but becoming more unequal as pupils' skills attainments start to diverge.

This should be seen as one aspect of a broader [transformation process](#) of the Swedish model since its severe financial crisis in the 1990s, after which the highly egalitarian welfare system became less redistributive and public spending was cut to create stronger incentives to take up work. This **increasing market orientation** might be a way of dealing with rising net immigration because it allows for a wider spread in wages but it comes at the cost of less social cohesion. Despite the general trajectory towards a less extensive public sector and welfare state, Sweden is still making significant investments in its integration policies, apparently trying to find a middle way.

2 Netherlands

Like Sweden, the Netherlands is an advanced open economy that depends heavily on foreign trade, traditionally running a current account surplus. Net exports and a shift to the construction, manufacturing and trade-related sectors have thus **pushed post-crisis productivity growth** to solid levels.

Nevertheless, **wages have so far not caught up**. This may become a problem for economic development, because, according to the [Commission](#), private consumption is one of the main growth drivers in the future. Why is there this divergent development? While labour markets were severely hit during the Dutch “double-dip recession” (see Figure 2), the situation has improved gradually with an unemployment rate of 4.9 percent and an employment rate of 78.0 percent in 2017. However, an increasing number of temporary jobs and self-employed people has been the main contributor to the recovery in employment. This shift to flexible employment can be explained by, for example, favourable tax treatments and differences in social security and labour protection rules. Thus, **increasing labour market segregation**, in combination with substantial labour market slack², leads to wage growth lagging behind other economic fundamentals.

Another challenge to the long-term economic development is **public spending in growth-enhancing areas** (such as public R&D and education), which **lags behind** top-performers like Denmark, Sweden or Belgium.

Overall, the strong focus on foreign trade and the opportunity to shift from crisis-hit sectors such as ICT, energy or the financial sector to more resilient sectors such as manufacturing and trade have given the Netherlands strong post-crisis productivity growth. In a future perspective, however, it will be crucial to enable the workforce to share in this economic upswing through higher wages and to invest sustainably in education in order to avoid skill shortages.

3 Czech Republic

The Czech Republic certainly is the epitome of a catch-up “growth starlet” among the Visegrad countries: a healthy economic upswing and [real GDP growth of 4.5% in 2017](#) is accompanied by **steadily converging wages**. These developments were briefly dampened by the crisis but, overall, the Czech economy has performed strongly since the early 2000s.

This is mainly because the country is constantly **benefiting from its trade openness** and running significant trade surpluses. The interconnectedness with highly developed European markets like Germany and a comparatively low level of wages facilitate FDI inflows, which stimulate investments in productive fields (e.g. infrastructure) but also result in dividend outflows that balance the current account. This also makes the Czech Republic one of the EU countries with the strongest growth in high-tech and knowledge-intensive sectors. Simultaneously, sound - according to the Commission - economic policies create a favourable business environment for both domestic and foreign investment. Thus, productivity is on a good path, mainly in the manufacturing sector.

² Labour market slack is the difference between the actual volume of work available and the volume of work desired by workers. In contrast to the mere unemployment rate, this measure takes e.g. people into account who would like to work or would like to work more hours.

The fact that, unlike in, for example Germany or Slovakia, wages have developed consistent with productivity growth makes private consumption likely to be one of the most important drivers for real GDP growth in the future. This positive wage development is not only due to what the Commission calls a **top performing labour market**, but one that is ever tightening. However, this could quickly turn into a damper: while job creation has been strong, the employment rate is well above the EU average (78.5 percent) and unemployment is the lowest in the EU (2.5 percent), labour shortages are increasingly a problem. What is more, the number of people equipped with a tertiary education qualification is still below the EU average, so skill shortages are set to become a prime obstacle to productivity growth as well. This is of major concern as the Czech economy shifts to knowledge-intensive activities with the help of FDI inflows.

Albeit blessed with **the lowest income inequality in the EU**, the Czech Republic faces several socio-economic challenges. In particular, gender and social background play a decisive role when it comes to opportunities on the labour market: The risk of poverty for people from a low-skilled background and the employment impact upon child-rearing women are among the highest in the EU. If the Czech Republic does not overcome these problems, economic growth could severely slow down in future.

4 Slovakia

Since the break-up of Czechoslovakia in 1993, Slovakia has produced one of the most impressive catch-ups among post-communist European economies. **Since 1999 its GDP per capita has almost doubled**, productivity has increased by 80 percent and wages by about 60 percent. Like the Czech Republic, Slovakia's development was and is fuelled by the [integration into European value chains](#) of mostly Western European transnational companies. Slovakia in particular has become a production hub for the automotive industry. This makes the economy comparatively FDI-dependent. Despite a trade surplus, Slovakia has a [current account deficit](#) owing to investment inflows and dividend outflows from FDIs.

The **wage-productivity development has to balance two counteracting forces**: On the one hand, the comparative advantage of Visegrad economies has been and still is the relatively cheap price of skilled labour. On the other hand, over the last 25 years large-scale investments in production facilities has made labour much more productive, calling for corresponding wage hikes. Combined with a tightening labour market - unemployment was at 8.1 percent in 2017 but there are already significant skill shortages - wages have increased significantly in recent years, albeit less than productivity.

A future key challenge for Slovakia will therefore be to **defend its very price-sensitive product market specialization** in global value chains **while also attracting skilled workers requiring higher wages**. This could become a bottleneck for expanding production and therefore further growth and investment.

Like the Czech Republic, Slovakia has one of the lowest income inequality among EU countries. Yet, the Commission assesses that **growth is not inclusive enough** as the increase in disposable income lags behind economic growth. Due to comparatively low wages many young people still choose to emigrate to richer member states, thereby aggravating skills shortages. What is more, the country also has difficulties in exploiting its labour potential as several socio-economic groups are disadvantaged which is reflected in a below average employment rate of 71 percent in 2017. Women and young people, for example, find it hard to enter the labour market. As the educational system provides unequal opportunities, pupils from disadvantaged

backgrounds, especially the Roma minority, are at great risk of being left behind. Furthermore, the country faces a strong regional disparity between the industrialised Bratislava region and the east.

While making growth more inclusive will be important to address the skills shortage, faster rising wages might also undermine the cost-competitiveness vis-à-vis cheaper labour from outside the EU at some point. To prepare for this, Slovakia will have to improve its innovation capacity, which is currently below the EU average, and thrive in more knowledge-intensive sectors, a transformation that appears to be already under way in the Czech Republic.

Viable models in the long run?

The four economies analysed in this blog post generally fare well against the “usual” economic parameters - one reason why we selected them - though there is also some variance:

- **Investment and productivity:** In all four countries trade is not only a driver of growth but of productivity increases. In the Visegrad countries this is most obvious as huge FDI inflows contribute to the upgrading of production sites and are expected to drive productivity growth within the next years. By contrast, Sweden and the Netherlands rely on a much stronger indigenous capital base to finance investments.
- **Labour markets and wages:** Unemployment figures are among the lowest in the EU, with the exception of Slovakia, which at 8.1 percent above the EU average. Employment rates are high in Sweden, the Netherlands and the Czech Republic but lag behind in the Slovakia. All four labour markets experience tightening as the economies all require supply of skilled labour. The Netherlands stands out because the shift towards non-standard work post-crisis has helped keep wage pressures down. The Netherlands and Sweden have a tradition of collective bargaining that aims to keep export sectors competitive and protect employment. This form of coordination is still obvious in pay settlements in both countries. In Slovakia unions are at their weakest among the four economies and, in line with this, wages most significantly lag behind productivity.

Both the catch-up and the advanced model of open economies faces short and long-term **challenges:**

In the **short-term**, skills shortages appear to be a pressing problem for all four economies. Depending on the model and labour market conditions, different responses seem appropriate. When the advanced model has used up its labour potential (like Sweden) it will have to attract skilled labour from abroad. But, at the same time, labour migration needs to be accompanied by public investment in policies to promote integration and education. The other three economies still have unused labour potential although, especially in the Visegrad countries, there are structural barriers such as deep-rooted social inequalities that hinder sufficient skills training and attainment among specific groups.

In the **long-term**, both models might face declining opportunities for boosting productivity growth. For the Visegrad countries, the long-term challenge will be to face the risk of losing price-competitiveness against other production hubs further to the east. Therefore, they would be well advised to gear the economy more towards knowledge-intensive sectors where intellectual property is generated by domestic businesses. This requires efforts in education and R&D. The stronger focus on innovative and high-end products and services in the advanced

model looks sustainable but productivity growth might also fall to lower levels as a consequence of the shift towards service-based sectors, as enhancing productivity via capital investments might reach certain limits (ICT, machinery, etc.).

It comes as no surprise that these four rather export-oriented countries with strong industrial sectors benefited immensely from European economic integration, which is most advanced in goods markets. For the observation period this applies particularly to the Visegrad countries, where trade volumes expanded most strongly. For each of the four countries the main trading partners are mainly neighbouring EU countries (and Norway for Sweden), with Germany always being the most important trading partner.

Yet the Single Market still has significant potential. Both trade in services and the integration of labour markets are areas where further integration could translate into enhanced growth potential as it could help countries for example to deal with skill shortages. Further integration calls, however, also for a much stronger social dimension of the Single Market that is able to ensure social protection of mobile workers and prevents dumping strategies so that convergence of wages can continue.

Bild: cc Victor Kettleball <https://www.flickr.com/photos/victor/8495391748/>