ANALYSIS

Cost-competitiveness remains at a better level than before

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AUTHOR

Lauri Kajanoja

Finnish cost-competitiveness has improved in recent years, following a long period of deterioration. The greatest improvement in cost-competitiveness was seen in 2017, when the Competitiveness Pact entered into force. According to different indicators, cost-competiveness remained mostly flat in 2018 or improved slightly. Similarly, forecasts for 2019 predict neither significant improvement nor deterioration in cost-competitiveness. From the perspective of employment and output in the economy's tradable sector, it would be prudent to see a further slight improvement.

The Bank of Finland evaluates the development of cost-competitiveness with the help of several

different indicators. These indicators were presented in the article 'Measuring cost-competitiveness in Finland'.

Measuring cost-competitiveness

The Bank of Finland uses several different indicators for measuring cost-competitiveness. The most important of these comprise 1) terms-of-trade-adjusted unit labour costs for the economy as a whole, 2) profitability in manufacturing and 3) unit labour costs in industries which produce intermediate goods for the manufacturing sector. All three variables are compared with those of other countries. In addition, labour cost growth on its own can be compared with other countries.

With these indicators, the Bank of Finland looks at Finnish developments in relation to two groups of comparator countries. One comprises a broad group of Finland's 14 main advanced trading partners. When Finnish developments are weighed up against this group, each country is weighted by its share of Finland's foreign trade. The second comparator group consists of the first twelve countries to have joined the euro area (euro area 12), all of which are traditional industrial economies, although some indicators are based on comparisons with the full euro area 19 group, owing to the availability of data.

Terms-of-trade-adjusted unit labour costs

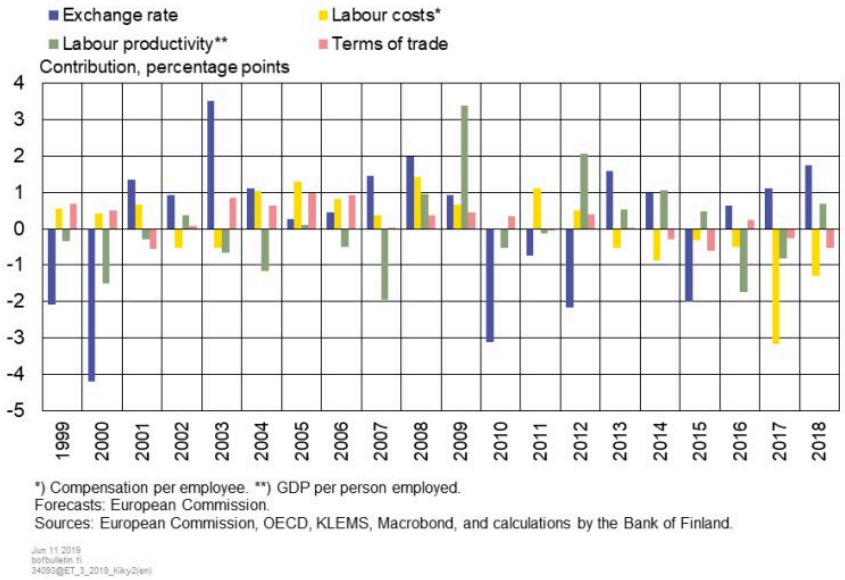
Unit labour costs adjusted for the terms of trade are a robust measure of cost-competitiveness that look at developments in all industries. By this metric, Finnish cost-competitiveness began to improve from 2015 onwards, relative to the broad group of trading partners, and, relative to the euro area 12, beginning from 2016 (Chart 1).

In 2018, Finland's terms-of-trade-adjusted unit labour costs continued to edge down slightly relative to the euro area 12 but began increasing relative to the trading partner comparator group, which includes non-euro area countries. This discrepancy is mainly due to the appreciation of the euro in 2018, which had the effect of lowering costs outside the euro area relative to countries within the currency union, when expressed in the same currency.

Chart 1.

In 2018 labour cost growth was slower in Finland than in other countries, but cost-competitiveness was dampened by weak productivity developments and appreciation of the euro

Contribution to year-on-year change in relative terms-of-trade-adjusted unit labour costs



*) Compensation per employee. **) GDP per person employed.
Forecasts: European Commission.
Sources: European Commission, OECD, KLEMS, Macrobond, and calculations by the Bank of Finland.

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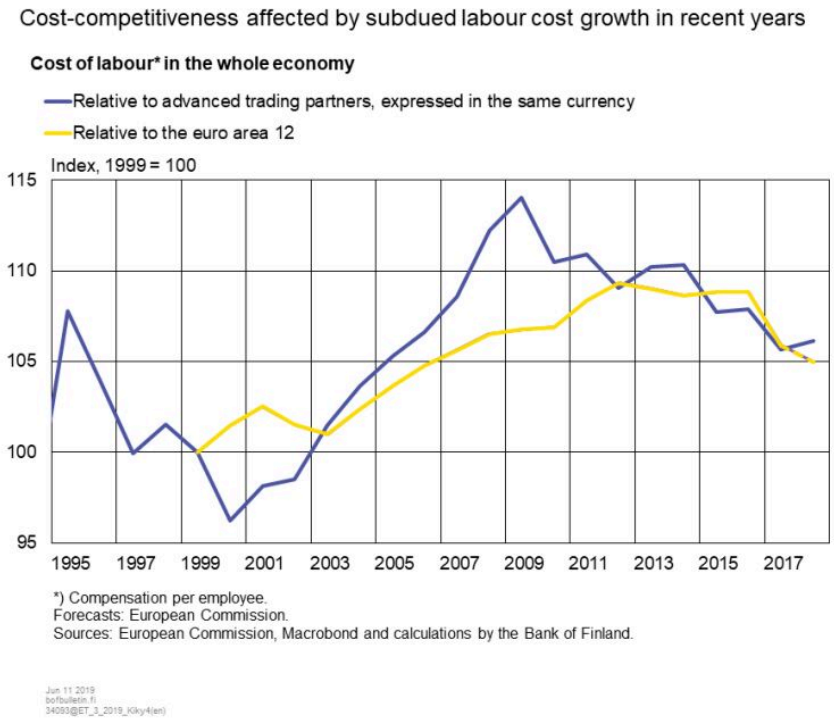
Terms-of-trade-adjusted unit labour costs measure the development of labour costs relative to real domestic income. They are affected by the price of labour, labour productivity and the terms of trade. When approached as an indicator of cost-competitiveness, they are viewed in relation to corresponding developments in other countries', with nominal exchange rate movements also taken into account.

Chart 2 decomposes how these four factors have contributed to Finland's terms of-trade-adjusted unit labour costs relative to the 14-strong group of trading partners. In relation to the comparator countries, Finnish cost-competitiveness was improved by developments in labour costs as well as labour productivity in 2016 and 2017.

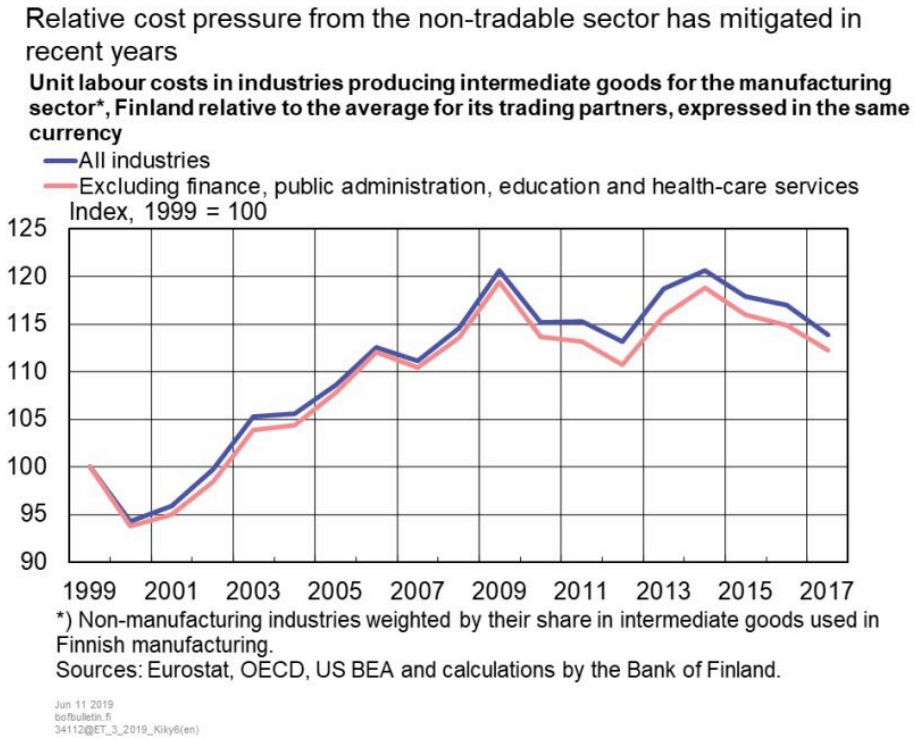
Chart 2.



In 2018, labour cost developments helped bolster Finland's cost-competitiveness, owing to moderate earnings growth and the reduction of employers' social contributions as set out in the Competitiveness Pact. On the other hand, cost-competitiveness was weakened by productivity growth coming to a virtual halt and the euro appreciating against other currencies. The terms of trade have not had a significant impact on cost-competitiveness in recent years.

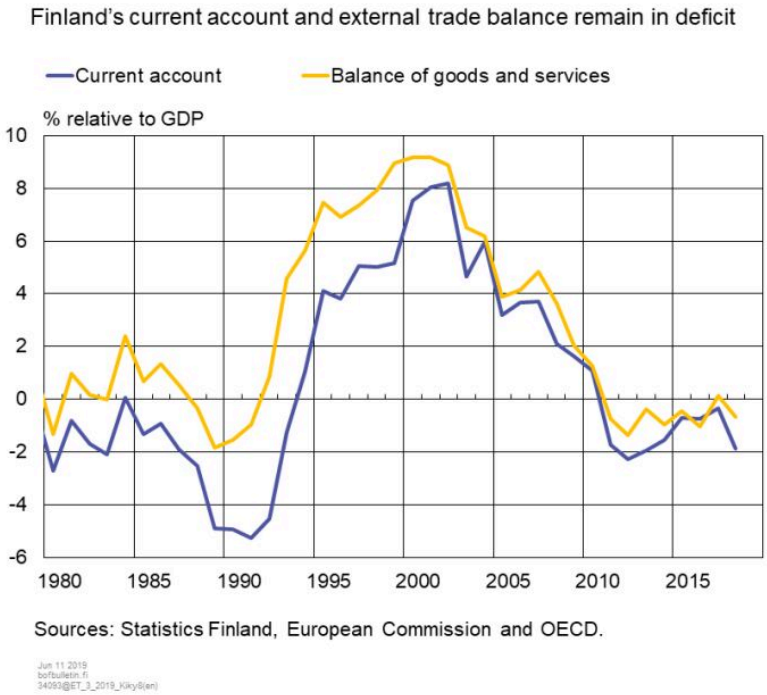
Cost-competitiveness broadly improved relative to other countries from 2015 onwards. It especially improved in 2017, with the only notable exception being against the United Kingdom, due to the depreciation of the pound sterling. In 2018, cost-competitiveness continued to improve relative to the major euro area economies; however, it weakened against the United States and Sweden due to the appreciation of the euro.

Chart 3.



Labour costs have played an important part in shaping cost-competitiveness over the longer term. This has especially been the case from 2014 onwards. Relative to its trading partners, labour costs in Finland climbed without interruption during the period 2004–2012, when measured in the respective currency of each country (yellow bars in Chart 2). This trend turned in 2013. Since then, the growth of labour costs has been slower in Finland than in the comparator countries.

Chart 4.



Similarly, when expressed in the same currency, there is an obvious long initial upward trend in labour costs relative to other countries, followed by a trend downwards (Chart 4). The appreciation of the euro raised Finnish labour costs compared with the broad group of trading partners, especially in 2007 and 2008, after which the euro's depreciation had the reverse effect. In 2018, Finnish labour cost growth was more muted than in the euro area 12, but overall slightly faster than in its advanced trading partners, when expressed in the same currency.

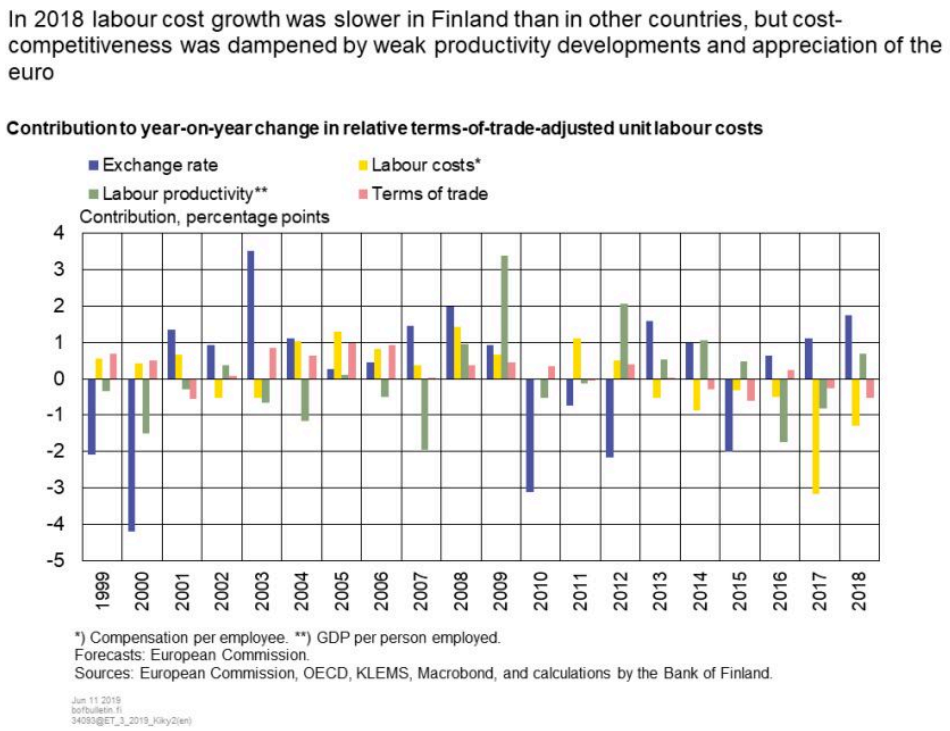
Profitability in manufacturing

When labour costs in manufacturing are viewed in relation to the value (not volume) of its value added, the resulting indicator measures real unit labour costs. By extension, the inverse of real unit labour costs are an important measure of unit profitability in manufacturing. When examined in relation to corresponding developments in other countries, the resulting indicator denotes relative change in the unit profitability of manufacturing.

Manufacturing accounts for the largest share of the economy's so-called tradable sector and offers up-to-date statistical data from different countries. Manufacturing comprises much more than output produced in factories. Accordingly, the sector accounts for about three quarters of Finland's goods and services exports.

The manufacturing sector's relative profitability has strengthened in recent years, owing to developments both in nominal value added per employee and in the price of labour (Chart 5). In 2018, manufacturing's relative profitability continued to improve.

Chart 5.



The impact of labour costs in the non-tradable sector

Labour costs in the non-tradable sector affect the price of intermediate goods and services supplied to the tradable sector and, by extension, unit profitability in the tradable sector. Nominal unit labour costs in domestic industries that supply intermediate goods and services to the manufacturing sector are, therefore, an indicator of cost-competitiveness that capture the impact of costs in the non-tradable sector.

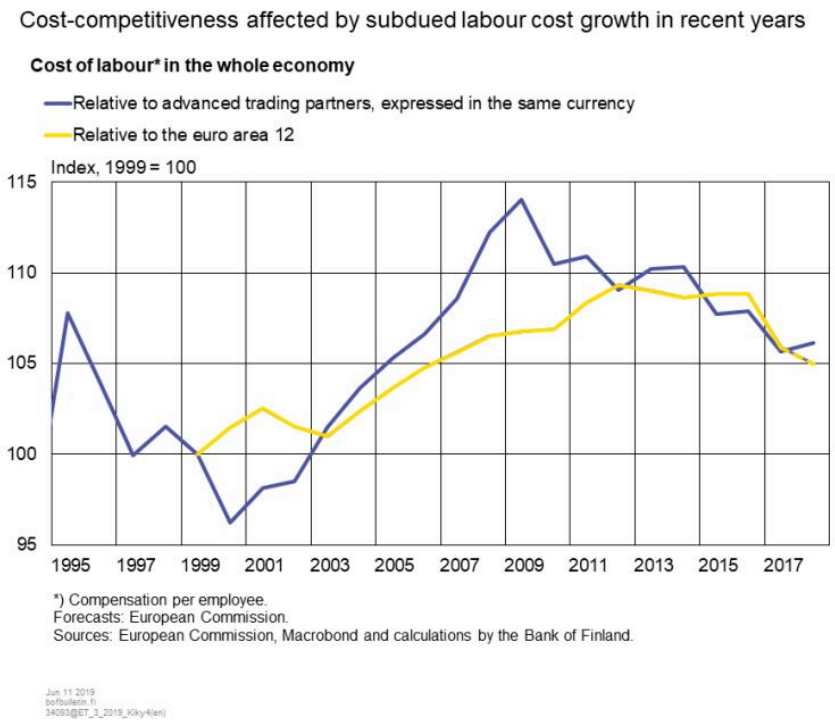
In this indicator, each industry in the non-tradable sector is weighted by its share of intermediate goods and services supplied to manufacturing. Accordingly, the industries with the largest weightings are wholesale and retail trade; transportation and storage; accommodation and food services; and professional, scientific and technical services. This indicator can also can be construed without industries where measuring productivity is known to be widely opaque, namely the financial industry and public services.

Relative to the group of 14 trading partners, the cost pressure inflected on the tradable sector by the non-tradable sector has abated in recent years, having increased significantly before (Chart 6). These trends have affected a swathe of different non-tradable industries.

Overall, the development of relative unit labour costs in the non-tradable sector has not notably diverged from that of the terms-of-trade-adjusted unit labour costs for the economy as a whole. Exchange rate movements have, for their part, contributed to the year-on-year change in the non-tradable sector's labour costs relative to other countries, when they are compared in the same currency.

The non-tradable sector's impact on the tradable sector in terms of cost developments is illustrated by new research published by the Bank of Finland (Aino Silvo: Palkkojen nousun vaikutus tuotannon kokonaiskustannuksiin eri toimialoilla. www.eurojatalous.fi, in Finnish). It estimates that a one percentage point wage-rise in the non-manufacturing sector will roughly have the same impact on raising production costs in manufacturing as a one percentage point-wage rise in manufacturing itself.

Chart 6.



The significance of cost-competitiveness

Cost-competitiveness refers to the preconditions for output and employment in the economy's tradable sector with respect to how domestic costs evolve relative to other countries. The tradable sector comprises those industries facing direct external competition. Their preconditions for output and employment are also influenced by other factors. These include other countries' demand for imports, different disturbances and disruptions that affect firms and industries, as well as other factors that fall under so-called real competitiveness.

Cost-competitiveness indicators present the development of domestic costs and unit profitability in relation to other countries'. In these indicators, labour costs are generally expressed relative to the wage-paying capacity of firms. If the latter increases at a faster pace, unit profitability in the tradable sector rises.

If cost-competitiveness improves, its macroeconomic impact is determined by the amount of slack in the economy, such as the level of unemployment, and by conditions in the economy's tradable sector. If unemployment levels are low and output in the tradable sector is strong, neither can be expected to improve by all that much. If, on the other hand, unemployment is high and export performance subdued, improving cost-competitiveness can be expected to usher in favourable developments.

Increasing output and employment in the tradable sector raises the generation of income for the economy as a whole. Thus, it also strengthens the necessary conditions for employment growth in industries driven by domestic demand. Conversely, a sustained decline in cost-competiveness is detrimental to the conditions for employment in the whole economy.

A further slight improvement in cost-competitiveness is still needed

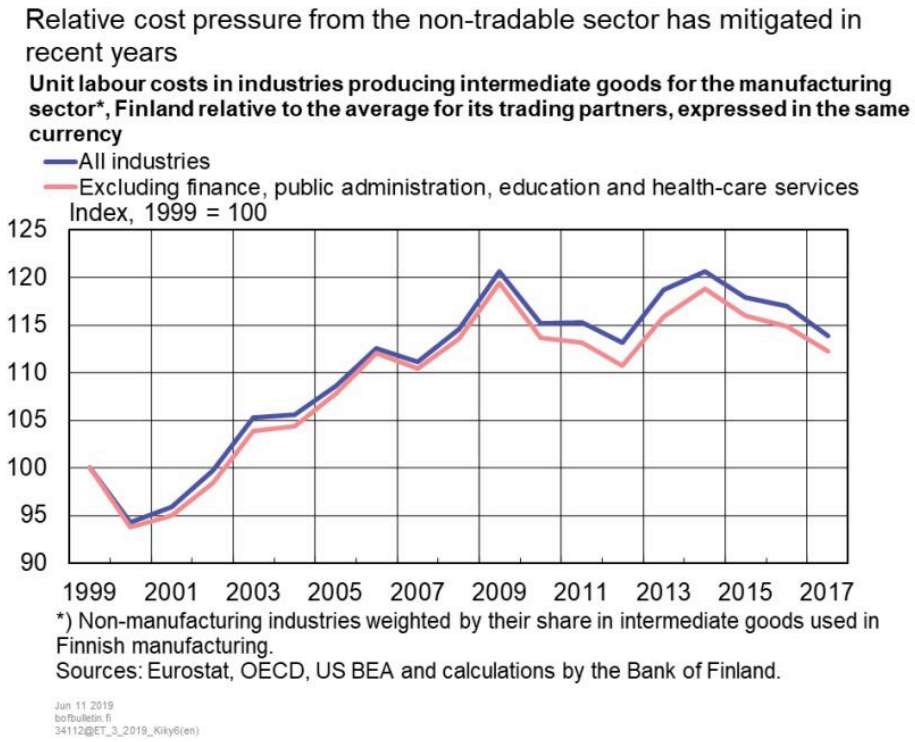
According to different indicators, cost-competiveness remained mostly flat in 2018 or improved slightly. Similarly, forecasts for 2019 predict neither significant improvement nor decline in cost-competitiveness. Particularly important for the immediate years ahead are Finland's upcoming rounds of collective wage negotiations as well as international developments.

Cost-competitiveness has improved substantially in recent years, but not as much as it deteriorated in the years earlier. Key indicators show that cost-competitiveness is not yet at a strong level, when the current situation is compared with longer-term averages.

Output and employment in the economy's tradable sector have increased in recent years. Yet

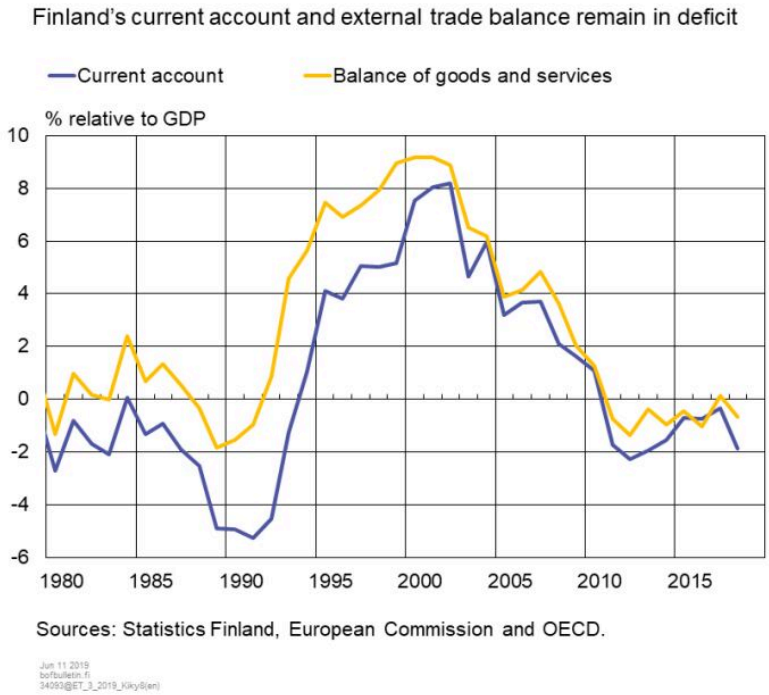
when compared with their long-term trends, not even they are performing strongly. Finland's market share of exports turned upward in 2016 and 2017, but declined again in 2018 (Chart 7).

Chart 7.



Finland's balance of trade and current account deficits have narrowed in recent years (Chart 8). While partly due to the expansion of exports, this might also be seen as a consequence of the sustained weak generation of income in the tradable sector having had a larger impact on domestic demand than before—as subdued domestic demand, for its part, constrains import growth. In 2018, the balance of trade weakened again slightly and the current account even more so.

Chart 8.



The economy's employment situation has improved markedly, which, in part, may be thought to reflect the improvements in cost-competitiveness. However, in spite of its recent decline, Finland's unemployment rate is still the highest in Northern Europe. In April 2019, higher unemployment in the EU countries was only to be found in Greece, Spain, Italy, France, Croatia and Cyprus.

Although the rise of labour costs in Finland has been subdued for several years now compared with past decades, it has not been particularly slow relative to other advanced economies. If prices and wages had risen in other countries at rates corresponding with their long-term trends, Finland's moderate pace of wage growth would have improved its cost-competitiveness rapidly indeed. Yet this has not been the case.

Nevertheless, labour costs have picked up during the past two years in the EU countries and in a share of Finland's other trading partners. This has contributed to competitiveness improvements in Finland.

At present, the global economic outlook is being clouded by the knowledge of moderating growth and risks, such as those related further trade war escalation, among others. Growth decelerating more quickly than anticipated could also prove detrimental to Finnish cost-competitiveness, particularly if labour cost growth were to rapidly decline outside Finland.

Key words

competitiveness, cost competitiveness, employment, industry, productivity, unit labour costs