Shaping the Future of Europe

Hungary's Vision for the 2024 Presidency

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RESTORING EUROPEAN COMPETITIVENESS

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The European Union's economic competitiveness has received much attention from both politicians and analysts. The Hungarian presidency has sought to make it a priority. While the causes are hotly debated, it is generally recognized that the European Union is suffering from a competitiveness crisis. The challenges that are typically highlighted include: regulatory burdens, poor productivity growth, fragmented financial markets, and low levels of public and private investment. Research and development has also been highlighted as an area in which the European Union lags behind its peers, most notably China but also the United States.

The situation in Europe has become so bad that some are discussing the prospect of deindustrialization of the continent. "Europe has a huge challenge and huge risk of deindustrialization," said Ilham Kadri, CEO of Solvay, a chemicals multinational based in Belgium, at the recent World Economic Forum in Davos. The tendency, however, is to focus on peripheral issues. For example, at the WEF Mr. Kadri complained about the fact that there was too much bureaucracy in Europe. But when talking to investors in earnings calls, he highlighted what was the most important component driving the competitiveness crisis—especially in his own industry of chemical manufacturing: high energy prices. "The European chemical market has been growing only weekly for about a decade. The significant increase in natural gas and electricity prices over the course of [2022] is putting pressure on chemical value chains," Kadri said during an earning call last October (Irwin-Hunt, 2023).

In the following chapter, we postulate that the true driver of Europe's competitiveness crisis—and the potential for a deindustrialization of the continent—is the high energy prices that have been brought about by the war in Ukraine and the sanctions and countersanctions associated with it. We make this case using extensive data to highlight the impact that high energy prices have had on both wages and the cost of manufacturing. Then

we turn our attention to the cause of the high energy prices themselves.

We conclude that the only way for the European Union to regain its competitive edge and fend off deindustrialization is to once more gain access to cheap and reliable energy supplies.

FROM MICRO TO MACRO

Debates around competitiveness often tend to focus on microeconomic policy. A country is deemed competitive if the government regulates in such a way that businesses can develop. It is deemed uncompetitive if there are regulations in place that do not allow for business to grow and develop. Consideration also might be given to local infrastructure, not just in terms of transport but also in terms of availability of quality business services, for example. These microeconomic approaches to competitiveness implicitly assume that all else is equal; that is, that every country optimizes its resource usage and so the only variable component in the competitiveness equation is microeconomic in nature and the result of government regulation.

But the largest shocks to competitiveness are rarely regulatory. Rather they come when large exogenous events interfere with the basic structure of a country's economy. These shocks impact variables like wage costs, raw material costs, and energy costs. If such a shock hit the entire world economy at the same time, we might be able to assume—if it was evenly distributed—that it would not impact the relative competitiveness of any given country. But if it hits one country or region disproportionately then it will greatly impact that country or region's competitiveness—often in a way that renders discussions of the microeconomics of competitiveness completely redundant.

This is what has happened in Europe since the beginning of the Russo-Ukrainian war in February 2022. The war and the resulting sanctions and countersanctions have led to a major and rapid deterioration in European competitiveness, especially manufacturing competitiveness, as energy prices have risen and with them the European wage bill.

To understand the impact, we must first understand that most of the components involved in the cost of production—tooling cost, raw material cost, maintenance cost, and investment cost—are also associated

with the two more basic costs: energy and labor. Indeed, the only cost component that is truly independent of energy and labor inputs is the raw materials cost. Stripped down, the aggregate level of production in any given economy can be reduced to labor inputs, energy inputs, and raw materials inputs. If any of these are disturbed by an external or exogenous event, the country experiencing this event will experience a significant competitiveness crisis. We believe that this is what has happened in the European Union today.

THE COMPETITIVENESS CRISIS IN EUROPEAN WAGES

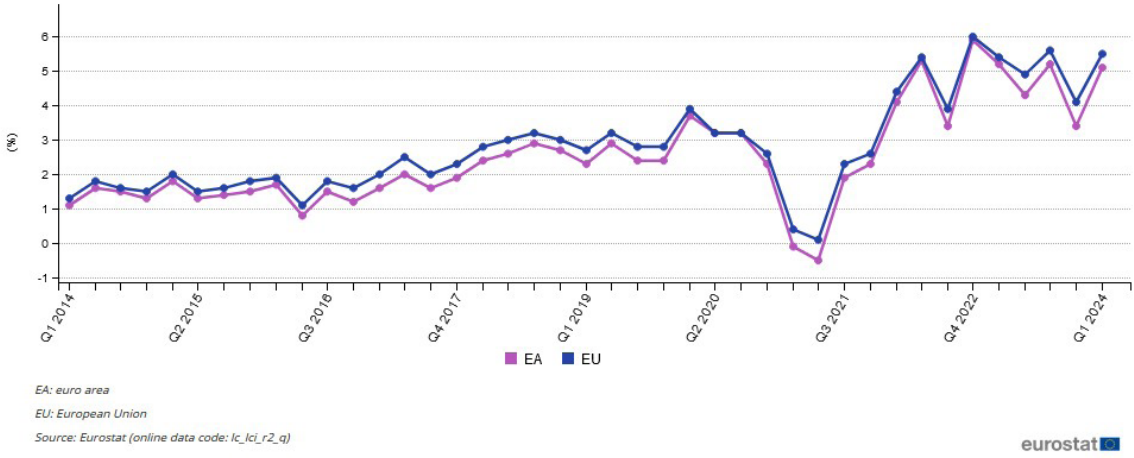
The recent inflation that we have seen in Europe is a stark reminder that a major component of competitiveness is wage costs. Business surveys show that wage costs compose up to 70 percent of the average company's total costs. All else being equal, if wage costs go up then a company only has two choices: slash profit margins or pass on the wage costs and become less competitive. Since profit margins are usually dictated by market competition, cutting them for any significant length of time and remaining in business is difficult.

This does not mean, however, that wages can never grow. If workers are producing more goods than before due to technological improvements or superior management and organization, then wages can increase and profit margins can be maintained. The entire pie gets bigger, and the company and the workers can take a share in this growth. For this reason, to measure the competitiveness of labor—which, recall, is the largest cost in business—economists use a measure called unit labor costs (ULCs). ULCs measure how much wages grow relative to worker productivity. If one country's ULCs are rising faster than another, this means that the country with the larger rise in ULCs is becoming less competitive in comparison to its rival.

When we look at ULCs in Europe, we see that they have seen a very large uptick in recent years. Since early 2022, we have seen quarterly increases in European ULCs of between 4 percent and 6 percent a year. This is substantially higher than we saw between 2014 and 2020, when quarterly ULC increases were between 1 percent and 3 percent. ULC growth in Europe has more than doubled in the past two years.

Figure 1

Nominal Hourly Labor Costs in the European Union and the Euro Area (Percent Change Compared to the Same Quarter of the Previous Year)



Note. From "Labour cost index - recent trends," by Eurostat, 2024, https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Labour_cost_index_-_recent_trends. CC-BY 4.0.

As already stated, ULC growth is only a concern from the point of view of competitiveness if it is rising in one economy faster than it is rising in another. We would be best placed comparing European ULCs with Chinese ULCs. This is because in the past few years, China has become a major competitor of Europe in everything from high-end consumer electronics to electric vehicles. If European ULCs are rising substantially faster than China's, we can say that Europe is losing ground to China competitively. We find that Chinese ULCs are notably lower than ULCs in Europe, and they are rising at an increasingly slower rate, especially since 2021. After a brief rebound following the large decline during the pandemic, the rate at which Chinese ULCs are rising has fallen by around 30 percent since 2021 (Trading View, 2024).

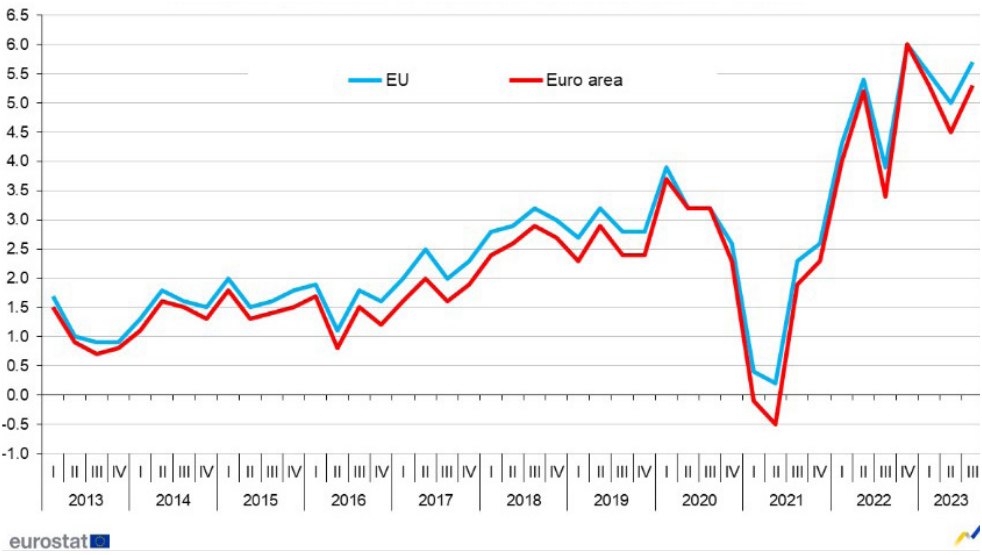
The Chinese economy has been experiencing deflation. This deflation seems to be arising from the capacity of Chinese businesses to rapidly cut prices for key items, most notably electric cars. Put differently, the difference in ULCs is mostly explained by an enormous rise in the productivity of Chinese workers, especially in the automotive sector. This presents an obvious problem for Europe: as Chinese labor becomes *more* competitive due to enormous productivity increases, European labor becomes *less* competitive. To understand why this is we must explore the roots of rising European ULCs.

ULCs can rise in two ways. Either productivity can fall faster than wages or wages can increase faster than productivity. In the EU, labor productivity has been rising since 1999 outside of two recessions: the large post-2008 recession and the mini recession brought on by the pandemic and the lockdowns. Since the pandemic, labor productivity has stalled somewhat, and between 2022 and 2023, it fell slightly—which was unprecedented for the EU outside of a recession. The reason for the decline in productivity is likely the decline in the European manufacturing sector that we will discuss in the next section. This decline in productivity does not explain the large rise in ULCs in Europe, however, because the decline in labor productivity in Europe in 2023 is not very large while the rise in ULCs is, and the acceleration in ULCs in Europe started in 2022 (Eurostat, 2024c).

Let us then turn to wages. The following chart shows the rise in hourly wages in the European Union and the Eurozone. When we compare this chart to the chart depicting ULCs, we see that they overlap almost perfectly. This shows that the main driver of the fall in European wage competitiveness is a large rise in the costs of labor.

Figure 2

Nominal Hourly Labor Costs in the European Union
(Percent Change Compared to the Same Quarter of the Previous Year)



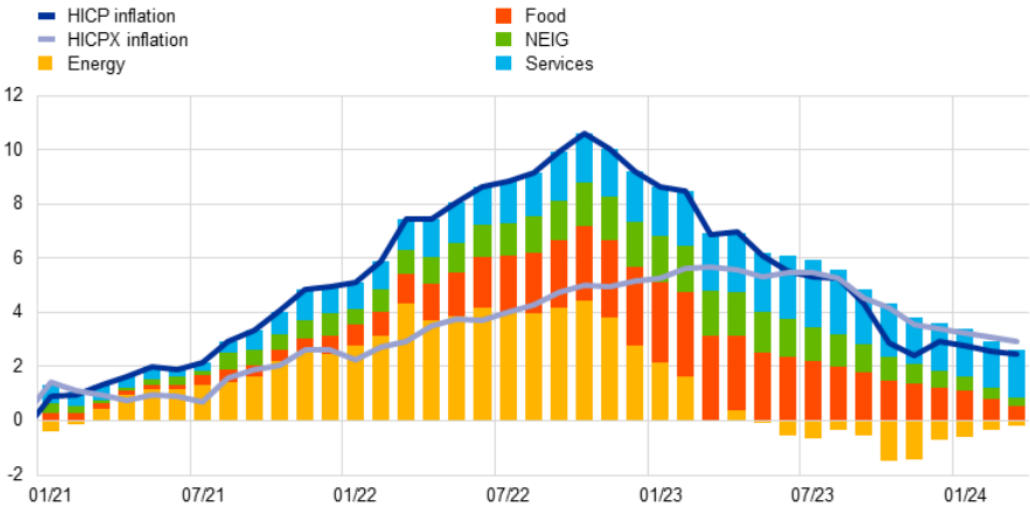
Note. From "Annual increase in labor costs at 5.3% in euro area," by Eurostat, 2023, https://ec.europa.eu/eurostat/documents/2995521/18133596/3-15122023-BP-EN.pdf/f5a6a8b7-0aca-98ce-2cab-b51e064c726c. CC-BY 4.0.

The question then, is what drove this rise in wage costs? Sometimes, especially in times of full employment, workers band together and negotiate higher wages simply because they want higher wages. But this is not often the case. It is unusual to see a sharp uptick in wages that is simply the result of workers becoming greedy. The typical cause of an upsurge in wages is a large increase in the cost of living. Such an increase pushes workers *en masse* to demand higher pay from their employers so they can pay the higher bills that they face.

The following chart shows consumer price inflation in Europe in the period when wages and, with them, ULCs started to rise. The chart also shows the components of the consumer price index, which allows us to better understand what forces were driving costs upwards. Here we see a very clear story. The rise in energy prices is the source of the shock. Starting in mid-2022, food prices also start to rise, as energy prices feed into food prices due to, for example, fertilizer production being a very energy intensive industry. Services start to rise at this point, although much more gradually. This can be read as the general inflationary pressure being passed on to the wage-intensive services sector as the cost of living rises.

Figure 3

Headline Inflation in Europe and Its Main Components (Annual Percentage Changes)



Note. From "Economic, financial and monetary developments" in Economic Bulletin Issue 3/2024, by European Central Bank, 2024, https://www.ecb.europa.eu/pub/pdf/ecbu/eb202403.en.pdf. Copyright European Central Bank, 2024.

From the point of view of wages, this increase in the cost of living, passed on to the wage bills of companies and thereby reflected in higher ULCs, has rendered Europe permanently uncompetitive compared to countries like China when it comes to the wage bill. Later in the chapter, we will explore the dynamics that led to the increase in energy prices, but first let us turn to the competitiveness of the European manufacturing sector.

THE COMPETITIVENESS CRISIS IN EUROPEAN MANUFACTURING

When looking at wage competitiveness, we can only look at the rise or fall of wages. We cannot see the direct effects of wages on competitiveness directly. This is because, as we have seen, wages are only one component amongst many in the production process—although wages are the most important component. When it comes to the competitiveness of firms, however, especially that of manufacturing firms, we can see the effects immediately. When a sector like manufacturing becomes uncompetitive, so too do its products. These become too expensive for the marketplace and so production declines.

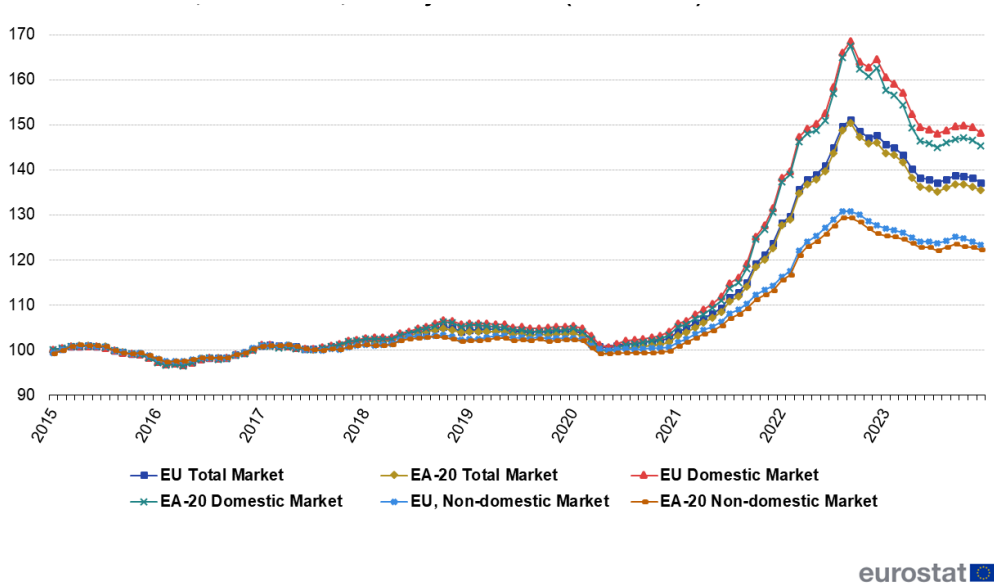
The first place to look for a decline in European manufacturing competitiveness, then, is in the output figures themselves. Industrial production was on an upward trend until 2022. Since 2023, however, production has been on a clear downward trend. Today, it remains around 5 percent lower than its peak—or 7 percent lower if we focus on the Eurozone—compared to the 2021 baseline (Eurostat, 2024f). Since there has not been a recession in Europe, we can infer from these numbers that European manufacturing is becoming increasingly uncompetitive. If European manufacturing becomes increasingly uncompetitive, Europe will continue to deindustrialize.

The most obvious first place to look to find evidence of the causes of this falling competitiveness is in prices. We have already looked at consumer prices in Europe, now let us turn our attention to producer prices, which are shown in the chart below. Here we see that between 2015 and 2021 producer prices were extremely stable in Europe. They then started to creep up in mid-2021 before exploding in 2022. At their peak toward the end of 2022, EU producer prices had risen 50 percent for the total market. Although they have fallen somewhat, they remain over 35 percent

higher than they were in early 2021. With input price increases like these, it is unsurprising that European industry has become uncompetitive and industrial production is falling.

Figure 4

Industrial Producer Prices on Domestic and Non-Domestic Markets



Note. From "Industrial producer price index overview," by Eurostat, https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Industrial_producer_price_index_overview&oldid=644126. CC-BY 4.0.

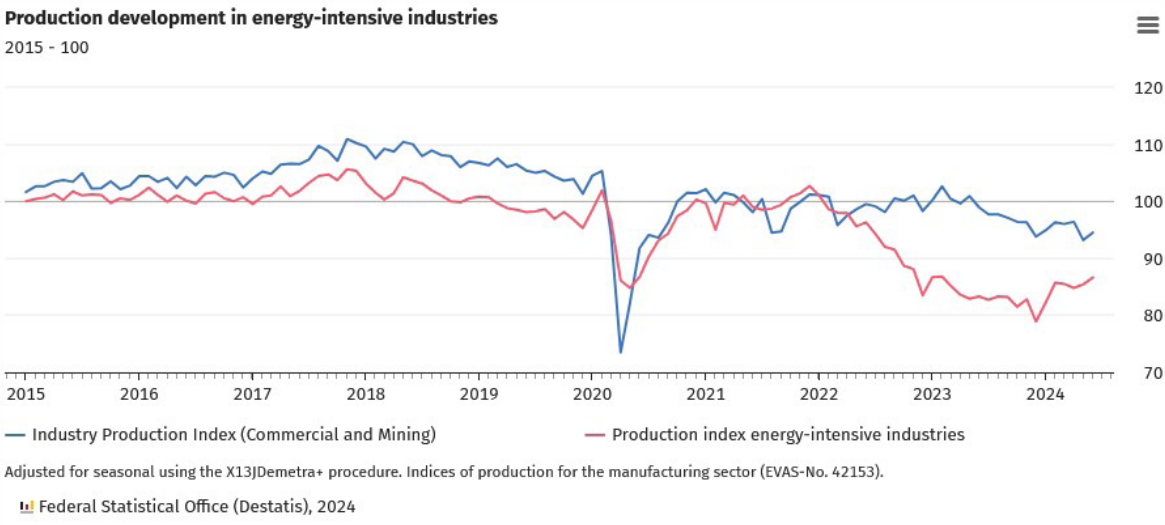
We have already seen that the main cause of the rise in consumer prices was the rise in energy prices. Since manufacturing is even more intensive than consumer households, we can only assume that this sector was badly hit by the rise in energy prices. Excluding taxes, household prices have increased around 42 percent since the impact on energy prices. Meanwhile, for businesses, energy prices excluding taxes rose 125 percent (Eurostat, 2024b). Clearly the impact on business is enormously disproportionate, and while subsidies may help ease the pain, it is questionable how long these can be undertaken.

With impacts on energy prices like this, we would assume that the hit to businesses—especially industrial businesses—would be enormous. We have already seen the impact on European producer prices and on industrial

production, and these impacts have confirmed this intuition. But to better establish causation, it is also instructive to look at how businesses have been impacted by their level of energy intensity. If energy intensive businesses are feeling much more pain than businesses that are not energy intensive, this would be strong evidence in support of our hypothesis that the main issue regarding competitiveness in the EU today is energy. The following chart shows industrial production numbers for energy intensive and energy non-intensive businesses in Germany since 2015. The results are striking: Production in energy-intensive industries is down nearly 15 percent, while total industrial production is down less than 5 percent.

Figure 5

Total German Production and Production in Energy-Intensive Industries



Note. From "Production in energy-intensive industries in Germany," by the Federal Statistical Office, 2024, https://www.destatis.de/DE/Themen/Branchen-Unternehmen/Industrie-Verarbeitendes-Gewerbe/produktionsindex-energieintensive-branchen.html. Copyright Statistisches Bundesamt (Destatis), 2024.

Naturally, with this crisis of competitiveness driven by energy we would expect there to be some impact on trade. If industrial production is down due to a lack of competitiveness, then we should see other countries buying fewer European exports than they did before. Indeed, in 2021 and 2022, against a backdrop of high energy prices, the EU saw a massive rise in imports that far outstripped exports. This was due to high energy prices feeding into the EU's

trade account. But as the high prices petered out, imports fell dramatically. At the same time, exports began to stagnate—presumably as European products became less competitive (Eurostat, 2024a).

Now that we have established that the main issue when it comes to European competitiveness today is energy, it is worthwhile looking at the European energy market itself to see what is driving the structurally higher energy prices.

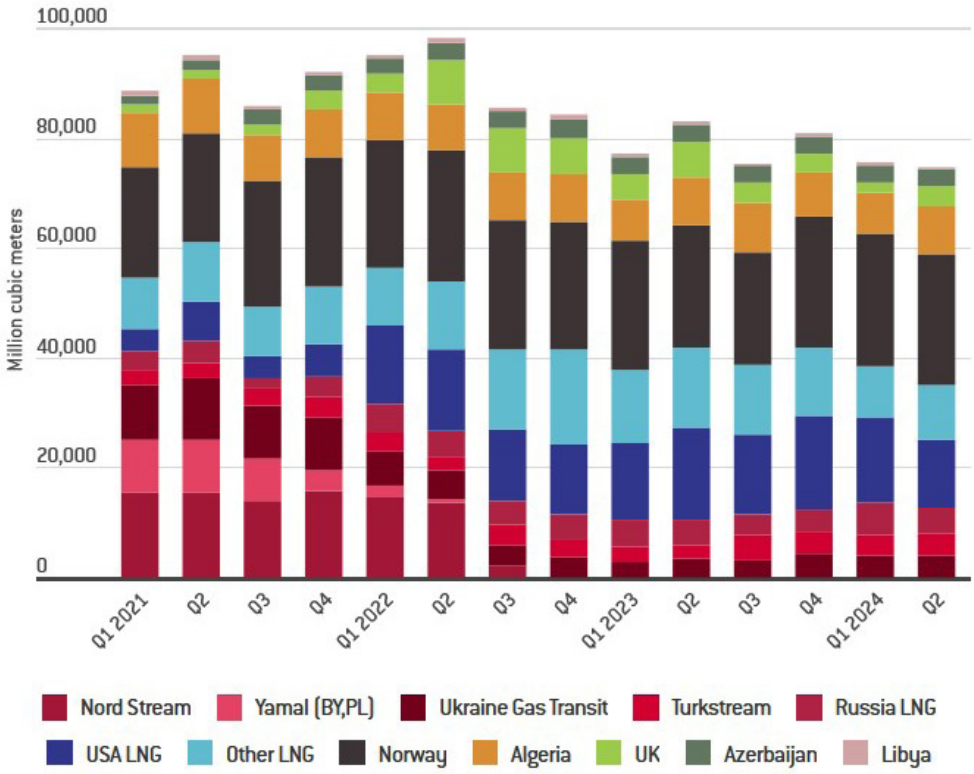
ENERGY MARKETS AND ENERGY PRICE STRUCTURE

While energy prices were rising in 2021 as the global economy reopened after the pandemic and lockdowns, this was always set to be a temporary effect. These higher energy prices would have eventually stabilized as the world economy and global energy markets settled into their normal, pre-pandemic path. The pandemic and the lockdowns left no structural barriers that would have resulted in higher global energy prices, and the impact of these events was a cyclical one that should have faded away after a brief period. It was the beginning of the Russo-Ukrainian war and the sanctions and countersanctions on Russia that established permanently higher European energy prices.

We can see this if we look at European natural gas imports and their sources. It is common knowledge that Europe relies heavily on natural gas for its electricity and general energy production. This is the result of a move away from what EU institutions see as "dirtier" sources of energy, like coal. In 1985, for example, around 9 percent of electricity in the European Union was generated using natural gas while around 21 percent was generated using coal. By 2022, these numbers had flipped, with around 19 percent generated using natural gas and around 9 percent generated using coal. The following chart shows the EU's overall natural gas imports by source. As we can see, three interesting developments have taken place since the start of the Russo-Ukrainian war. First, natural gas imports from Russia via the Nord Stream pipeline have fallen to zero. Second, Liquefied Natural Gas (LNG) imports from the United States have increased dramatically. It should be noted that this LNG is far more expensive than the piped gas it has replaced—some estimates that LNG has a 40 percent premium compared to piped gas. Third, the overall amount of gas imported has fallen significantly.

Figure 6

EU Quarterly Imports by Source



Note. From "EU natural gas imports," by B. McWilliams, G. Sgaravatti, & G. Zachmann, Bruegel Datasets, 2024, https://www.bruegel.org/publications/datasets/european-natural-gas-imports/.

To better understand these dynamics, we have used this data to construct the following tables comparing various natural gas imports into the EU in the final quarter of 2021—just before Russia invaded Ukraine—to imports in the second quarter of 2024. A few dynamics stand out. First, LNG imports from the United States have more than doubled. Interestingly, imports of Russian LNG have increased by around a quarter—this is effectively the same gas that was bought from Russia via Nord Stream but is now being bought at a premium. American LNG imports have risen from around 6.5 percent of total gas imports to around 16.4 percent, and LNG overall has gone from about 22.2 percent of total gas imports to around 36.1 percent. Since this LNG is bought at a premium over natural gas, this accounts for

some of the rise in European energy prices. Overall, LNG imports have increased by around 32 percent, while non-LNG imports have decreased by around 33 percent.

Table 1

Natural Gas Imports into the EU (Millions of Cubic Meters)

	Q4 2021	Q2 2024	Percent (%) Change
LNG Imports	20363	26943	32.3%
U.S. Imports	5945	12275	106.5%
Russian Imports	3877	4809	24.0%
Other Source	10541	9859	-6.5%
Non-LNG Imports	71388	47764	-33.1%
Total Natural Gas Imports	91751	74707	-18.6%

Table 2

LNG as a Share of Total Natural Gas Imports into the EU

	Q4 2021	Q2 2024
LNG Imports	22.2%	36.1%
U.S. Imports	6.5%	16.4%
Russian Imports	4.2%	6.4%
Other Source	11.5%	13.2%

The decrease in total natural gas imports really stands out. Imports have fallen 18.6 percent since before the war. In other words, almost a fifth of European gas imports have been wiped out by the sanctions and

countersanctions. Even LNG, which is far more expensive than the piped gas it replaced, cannot fill the gap in the market here. The result is exactly what simple microeconomics would suggest: With a lack of natural gas at reasonable prices available to Europe, the price of energy has risen on a structural basis, and the amount of energy used has fallen. The latter is often referred to as "demand destruction" and is reflected in the dismal industrial production numbers we see in Europe today, especially in energy-intensive industries.

EUROPE'S EXISTENTIAL COMPETITIVENESS CRISIS

These findings raise an extremely important long-term question: What is the plan for Europe moving forward? Unless Europe can gain access to affordable energy and bring down energy costs to pre-war levels, the continent will remain uncompetitive on both a wage basis and a business cost basis, and industrial production will continue to fall. This is another way of saying that Europe will undergo a process of deindustrialization. At the beginning of the war, the plan appeared to be to replace Russian piped gas with LNG. Promoters of this plan—mostly tied to the American energy sector—claimed that if Europe imported more LNG, its price would fall as more investment flowed into the sector. This represented a basic misunderstanding of simple microeconomics. Competition and investment can drive down prices, but there are hard technological limits. LNG is more expensive than piped gas simply due to physical transport costs, not to mention the costs associated with compressing the gas into a liquid state in the first place. LNG prices were never going to come down sufficiently to compete with piped gas prices.

It has now been over two years since these promises were made. European energy prices remain high and European gas imports have fallen by nearly a fifth. No coherent plan has replaced the bet that competition and investment would drive down LNG prices. Indeed, it appears that the European Commission simply wants to avoid the question. But as we have seen, it is the only truly relevant question regarding competitiveness in Europe today. Without access to energy at a reasonable price, the European continent will continue to be plagued with economic stagnation and its industry will disappear. Eventually, the lack of exports will cause trade deficits that will have to be closed, meaning drastically lowering living

standards on the continent. The European Commission must immediately reevaluate its energy policy and consider any and all options available to regain access to affordable energy. It is no exaggeration to say that this is a truly existential question, both for the countries in the European Union and for the project of the European Union itself.

CONCLUSIONS FOR THE HUNGARIAN PRESIDENCY

The European Union's economy continues to have very strong points in its favor. The fact that it has a well-functioning common market with a combined GDP of over $25 trillion and nearly 450 million consumers ensures that it will remain one of the world's most important economies in the coming years. The continent still has many advantages, including a highly developed business culture, a well-educated workforce and world-class infrastructure. Yet the continent is undergoing a process of deindustrialization due to high energy costs. This process has resulted in a large, consumer-oriented European economy that is struggling to grow—indeed, a deindustrialized Europe could see living standards fall significantly. The Hungarian presidency is well-placed to address this important, existential question.

In its presidency program, the Hungarian government specifically notes the impact of higher energy prices on European competitiveness:

> In the current international context of multiple challenges, where Europe is lagging behind its global competitors, it is vital to improve the productivity and thus the competitiveness of the Union and its Member States, and to stimulate growth. It is in our common interest to address the effects of the difficult economic circumstances of the recent years, such as high inflation, increased public debt, *high energy prices* [emphasis added], fragmentation of international supply chains, or lower European productivity and slower economic growth compared to our competitors, and to put the EU economy back on an upward trajectory ("Programme of the Hungarian Presidency," 2024, p. 4).

As our work has shown above, the energy question is not simply one among others. It is at the very core of the current competitiveness crisis that the European Union is facing. It is undoubtedly true that there are other issues

with European competitiveness—as the program notes—but none of these can be realistically addressed without first securing access to cheap reliable energy for the European economy.

Another core component of the strategy for the presidency is ensuring that Europe has an adequate and coherent security policy—one that places an emphasis on the European Defence Technological and Industrial Base (EDTIB). Energy policy is also integral to this goal. Without access to cheap and reliable energy, Europe will not be able to develop the industrial base needed to ensure that it can adequately cater to its own security needs.

Questions surrounding European energy policy appear to have been put on hold since the outbreak of the war in Ukraine. To move it forward, the adoption of a New European Competitiveness Deal is at the core of the presidency's efforts to strengthen European competitiveness. The Hungarian presidency is a perfect opportunity to make progress on finding solutions that will ensure the European economy maintains its status as a superpower into the twenty-first century.

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