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## ECONOMIC GOVERNANCE

# Current Account Imbalances: the Role of Competitiveness and of Financial Sector Dynamics

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### The sovereign debt crisis and the long-term challenge of current account imbalances

The last Trio Presidency of Spain-Belgium-Hungary was faced with extraordinary circumstances. The joint programme laid down in November 2009 referred to the need to progressively withdraw from the stimulus packages implemented in response to the financial and economic crisis and strengthen the European economy thereafter. But, the commitment to a gradual exit strategy and to productivity-enhancing structural reforms had to give way to urgent measures in response to the sovereign debt crisis that hit the south of Europe in the first months of 2010. The Greek fiscal problem became mostly evident at the beginning of 2010, under the Spanish Presidency. Financial markets were prompt to react and started betting in favour of the country's default. The risk of contagion to indebted Ireland, Portugal and Spain became evident as of April 2010, and marginally touched Belgium and Italy towards the end of the year.

The risk of contagion prompted European Union (EU) action. On 9 May, 2010, the European Council, under the Presidency of Van Rompuy, approved a set of measures to support financial stability in Europe. The extraordinary package included three main elements: i) the extension of the Medium-Term Financial Assistance Facility (MTFA) to eurozone countries; ii) the creation of the European Financial Stabilisation Facility (EFSF); and iii) the approval of a special EU / IMF loan to Greece for a value of €110 billion. These new lending facilities were meant to provide short-term liquidity to countries in need, but they did not address the question of solvency.<sup>1</sup>

In parallel, the European Commission put together a set of reform proposals to address flaws in the EU's economic governance structure. The Council viewed and approved most of the

1. See in this volume: Jean Pisani-Ferry and André Sapir, "Sovereign Debt Crisis Resolution in the Euro Area", *Think Global – Act European*, Paris, 2011

suggested measures, welcoming the new attention devoted to non-fiscal macroeconomic imbalances. In fact, the reform package provides a series of guidelines for the monitoring and possible sanctioning of excessive external imbalances.

There are at least two reasons why current account imbalances deserve special attention in the present context. First, they are tightly intertwined with the way in which the debt crisis has evolved. All the countries that financial markets have been targeting after Greece had relatively high current account deficits (i.e. Ireland, Spain and Portugal), a good part of which was accumulated in the private rather than in the public sector. The risk, as perceived by financial markets, was that private debts would turn into a public liability, as happened in Ireland through the government rescue of the banking sector. Second, independently of the reactions and pressures from financial markets, excessive external imbalances signal the need to intervene, mostly through fiscal consolidation and structural reform, lest the external debt trajectory appear unsustainable.

This brief note looks at macroeconomic imbalances in the eurozone through the lenses of the debt crisis. Part II provides a description of the current situation, analyses the possible determinants of current account imbalances and the extent to which they can be attributed to cross-country differences in price competitiveness, as implicit in the recent economic governance reform packages. Part III describes possible automatic and discretionary adjustment paths and highlights gaps in the current economic governance reform package.

## The current situation

Current account imbalances are not new to Europe or the global economy, but they have increased remarkably since the early 1990s and more so in the eurozone than in other Organisation for Economic Co-operation and Development (OECD) countries.<sup>2</sup> The suggestive evidence is that capital flows have been the main driver of the rapid surge in current account imbalances, especially after 2003 when, with the elimination of exchange rate and country risks, financial investors have just been looking for the highest relative returns. Another interesting feature of current account imbalances in the eurozone is that they have developed in a symmetrical fashion. Europe is now divided between debtor and creditor countries, that is countries with large current account deficits on the one hand (i.e. Greece, Spain, Portugal and Ireland) and countries with relatively large surpluses on the other hand (i.e. Germany, Austria and the Netherlands).

Current account imbalances have been having slightly different causes in individual countries. Greece's large current account deficit is mainly the result of a lax fiscal policy. Public finance

2. Olivier Blanchard and Francesco Giavazzi, "Current Account Deficits in the Euro Area: The End of the Feldstein Horioka Puzzle?", *Brookings Papers on Economic Activity, Economic Studies Program*, the Brookings Institution, vol. 33/2, pp. 147-210, 2002

figures for Greece show that the country's fiscal problems preceded the financial and economic crisis. The country suffered from the incapacity to control public expenditure growth, but also from weak fiscal planning capacity, as manifest from the fact that actual deficits almost always overshoot planned budgetary outcomes<sup>3</sup>. The consequences on financial markets are well-known. Greek bonds' yield spreads over Germany rose sharply in the spring of 2010 and Irish, Portuguese and Spanish bonds followed suit, although at a distance from Greek ones. These other countries have been much more fiscally virtuous in the preceding years than Greece. Debts accumulated instead in the private sector, giving rise to significant current account deficits. The negative reaction from financial markets internalised the belief that private liabilities could easily turn into public ones.<sup>4</sup>

Implicit to the design of the recent economic governance reform is the idea that southern European countries have accumulated large current account deficits because poor price competitiveness impeded them to export abroad. Thus, the indication is that the problem of macroeconomic imbalances originated on the export side. There is no doubt that deficit countries have seen their prices growing more rapidly than surplus countries. From 1994 to 2007, Greek, Spanish and Portuguese prices have been growing respectively by 18%, 17% and 14% above those in the rest of the eurozone, whilst in Germany they declined by 15%.<sup>5</sup> However, the relationship between current account positions and price indicators is weak for those indicators that truly capture competitiveness developments (i.e. real effective exchange rates based on wage costs in the manufacturing sector or export prices), whilst much stronger for those indicators that reflect the strength in demand conditions and the evolution of prices in the service and government sector relative to the manufacturing sector (i.e. real effective exchange rates based on Gross Domestic Product (GDP) deflators and unit labour costs for the total economy).

At the same time, the data show a strong correlation between private debt and current account deficits. Households' debt accumulated for consumption purposes had a strong effect on external positions in Greece and Ireland, whilst Spain has mainly borrowed from abroad to finance investment in the real estate sector.

Even if relative price developments may have not been at the root of current account imbalances, they have nevertheless contributed to those real demand conditions that incentivised borrowing in the south of Europe. Financial market integration allowed the free movement of capital, and monetary unification eliminated the exchange rate risk. With EMU, capital could move freely and financial investors had no reason to discriminate amongst countries on the basis of expectations regarding exchange rate movements. Against this background, financial investors had an especially strong reason for investing in countries in which economic growth

3. See Marzinotto, Pisani-Ferry and Sapir, "Two Crises, Two Responses", *Bruegel Policy Brief*, March 2010

4. It is a standard argument in the literature that trade account imbalances trigger debt crises, see for example: Paolo Manasse and Nouriel Roubini, "The Rule of Thumb for Sovereign Debt Crises", *IMF Working Paper*, N°42, 2005

5. In Ireland, average prices rose by a more modest 5% relatively to the rest of the eurozone

was buoyant such as Ireland, Spain and Portugal. Strong cyclical conditions came in fact with higher prices than in the rest of the eurozone and, because the nominal interest rate is set by the European Central Bank (ECB) for the whole area, the end-result was that growing economies in the south of Europe benefited from below-average real interest rates that functioned as an incentive to invest and hence to borrow in order to invest.<sup>6</sup>

Even if relative price competitiveness is not at the root of current account imbalances, improvements in competitiveness would allow indebted countries to grow out of their own debt and represent the least painful way out of the crisis. Some of the adjustment is expected to come about in an automatic fashion, and the crisis has already partly contributed to it.<sup>7</sup> Further automatic forces should be at play.

First, the recovery is distributed asymmetrically. Deficit countries are suffering from poor growth, whilst some surplus countries enjoy an unexpectedly strong recovery. The reversal in growth trends relatively to the pre-crisis period will allow indebted countries to grow out of their own exports towards booming economies.

Second, risk aversion has increased in the crisis. Where demand will pick up will be mostly in the form of consumption rather than investment. This should come with a relative advantage for deficit countries that have some specialisation in the production and export of consumption goods. Revealed comparative advantages may offer a better picture of competitiveness trends in the eurozone than just relative prices. Spain and, to a minor extent, Ireland have a comparative advantage in the production and export of consumption goods and have thus good chances of being supported by the upswing in other euro area countries.

Third, financial markets have been treating the monetary union as a single entity since the inception of Economic and Monetary Union (EMU). With the crisis, however, the country risk has re-emerged. The medium-term effect is that financial investors will limit capital outflows towards problematic countries, but the short-term perverse effect is that recent cross-border transactions have been short-term also in countries where they had been traditionally long-term,<sup>8</sup> with the consequence that problematic countries will have to repay part of their debt sooner rather than later.

Together with the automatic component of adjustment, parallel discretionary measures are deemed necessary to set external debts on a sustainable path. The immediate and most painful adjustment path consists of a contraction in consumption, which the crisis has partially induced automatically, but could be further strengthened by means of fiscal consolidation. For example, fiscal adjustment that targets public wages in countries in which there is a large public sector will inevitably be associated with a fall in consumption, thereby

6. This mechanism has been described in depth and is known as Walters' critique

7. European Commission, "Surveillance of Intra-Euro-Area Competitiveness and Imbalances", EU Economy 1, 2010

8. *Ibid.*, European Commission

generating at least part of the required correction. The least painful adjustment path is to implement structural reforms that would enhance productivity in the tradable sector, so that future net exports match today's liabilities. The goal can be achieved through structural reform on product and labour markets.

The so-called Euro-Plus Pact adopted during the 24-25 March European Council indeed addresses these issues and includes references to the need to monitor relative wage developments, guarantee fiscal discipline by also strengthening national fiscal frameworks, make pension and other social security systems sustainable and provide a clear-cut procedure for dealing with domestic banks in difficulty. The merit of the pact is having recognised that competitiveness improvements are the least painful way out of the current crisis, and the only one that guarantees long-term results. The downside is that changes in competitive positions require time.

## Structural reform and finance

Current account imbalances were not generated on the export side, but stemmed from strong demand in countries with high growth prospects. Nevertheless, competitiveness improvements represent the least painful way out of the crisis and are useful to support the sustainability of external debts. From a governance perspective, all the discretionary measures that can be put in place to correct existing macroeconomic imbalances have a chance to succeed only if national governments assume ownership of reform, a goal that would require less, rather than more, centralisation in economic policy coordination.

Structural reform is what allows productivity gains in the tradable sector. Enhancing investment in research and development (R&D) is one way to proceed in countries like Greece, Portugal and Spain, where the share of high technology products over total exports is well below the EU average. Yet, it is not only about fostering R&D expenditures. The greatest challenge is to find ways of translating higher spending into strong comparative advantages, which would depend on the organisation of production, for example. In Ireland, exports of high technology as a share of total exports are above average, but total R&D expenditure is only 1.28% of GDP, against an average in the old Member States of close to 2% of GDP. Micro-management issues, such as the organisation of national and international production, and management practices are likely to play an important role.

Structural reforms can also tackle the functioning of labour markets. Deficit countries should better align productivity and wage growth. The Euro-Plus Pact does explicitly refer to the need to make sure that wages reflect productivity trends. The pact offers a good roadmap for crisis resolution, but it will only succeed if national governments recognise and assume ownership of reform. The whole debate about relative wage developments is a case in point. The initial idea of eliminating wage indexation had the sole purpose of avoiding inflationary

wage settlements, which occurs by definition when wages grow faster than productivity. But the scrapping of the automatic adjustment of wages to inflation is neither necessary nor sufficient to make sure that wage developments align with productivity developments. The question is one of wage bargaining modes. It is much easier to align wages with productivity when it is handy for an employer to monitor a worker's productivity, which is something you can do when bargaining takes place at the firm-level. Wage bargaining systems cannot be reformed by imposition from above. National governments need to recognise the desirability of reform, and involve the social partners in the process.

Secondly, the existing economic governance reform packages fail in one other important respect, namely they pay modest attention to the issue of financial reform and regulation, showing therewith little appreciation of complementarities between macroeconomic and regulatory issues. Key to the accumulation of external imbalances over the last decade was in fact the intermediation of the financial sector and the channelling of savings accumulated in the North to consumers and firms in the South. It is abundant credit supply that allowed consumers and investors in the South to borrow from the North so that they could consume and invest “above their means”. The upcoming Trio Presidency should devote attention to financial and banking regulation, addressing cross-border issues, in this case through more centralised economic policy coordination. Stronger coordination in financial reform and regulation should be one of the reform conditions in any future economic governance package.