

Macroeconomic Imbalances in the Euro Area: Symptom or cause of the crisis?

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Abstract. *Lax financial conditions can foster credit booms. The global credit boom of the last decade led to large capital flows across the world, including large movements of resources from the Northern countries of the euro area towards the Southern part. Since the start of the crisis and more markedly after 2009, these flows have suddenly stopped, creating severe adjustment pressures. At this point, the common monetary policy can only try to mitigate the unavoidable adjustment by maintaining overall financial stability. The challenge is to strike a delicate balance between providing liquidity for solvent institutions while keeping the overall pressure on for a rapid correction of the imbalances.*

The general point of this paper is straightforward: there is little a common monetary policy (or macro prudential tools) can do to affect directly the correction of existing macroeconomic imbalances. In the euro area, imbalances were built up over the last decade as massive capital flows moved from the North to the South of the Monetary Union. Their legacy is a debt overhang which leads to financial market distress. The details of the debt overhang vary from country to country, but one can distinguish two groups: In Spain and Ireland, foreign capital was used to sustain massive construction booms. In Greece and Portugal, foreign capital was used to finance consumption. Italy seems to be a special case as it did not experience a pronounced credit boom, but its low growth rates has made a pre-existing large stock of public debt appear less and less sustainable in the long run.

The expansion in domestic demand financed by the capital inflows was the main reason why Southern euro area countries became uncompetitive. Their loss of competitiveness was thus a symptom, rather than an independent

additional cause for the present imbalances. This implies that unless exports pick up significantly, the re-balancing has to come through lower domestic demand, which inevitably lead to lower GDP. Moreover, given that the debt accumulated during the boom years is very large, the adjustment is likely to take a long time.

Introduction

During the first decade after the start of EMU, the euro area and more broadly the global economy experienced an unprecedented credit boom. The expansion of credit was particularly robust in the Southern countries: Greece, Portugal and Spain, as well as in Ireland. The difficulties these countries are now experiencing are the consequence of a 'sudden stop' in the private capital flows they became accustomed to receiving during the boom years.

Market financing, which had been excessively abundant until 2009 for both governments and the private sector, suddenly dried up during 2010, and the government of Greece and later of Ireland and Portugal were no longer able to fund themselves at any sustainable price.

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One question that is often asked why did financial markets, which had provided Greece with ample financing over years when its current account deficits and the (approximate) size of its public debt were well known, suddenly review their position almost out of the blue.

The answer must be that markets did not realise that the behaviour of investors affects the so-called fundamentals. In Southern Europe growth was strong during the boom years because of the capital inflows. For example, Greek GDP, as well as that of Ireland and Spain, was growing in nominal terms by over 7% while nominal (long-term) interest rates were around 4%. The countries thus had a higher growth rate than the interest rate they were paying and thus appeared solvent. The problem was that investors did not stop to calculate what the growth would be if the capital inflows stopped. Indeed when the crisis broke, nominal (actual and expected) growth rates became much smaller or even negative. At the same time market interest rates rose along with a generalised increase in risk aversion. As a result the growth rate – interest rate differential turned around by a large margin and the countries no longer appeared solvent – which reinforced the capital flight. (See Alcidi & Gros (2011) for more details.)

Moreover, the Southern countries had accumulated a large stock of foreign debt, which nervous investors in Northern Europe (and elsewhere) are no longer willing to hold. This is the nature of the ‘euro crisis’.

On key crucial questions now is about how to correct imbalances, how to share the burden of the adjustment and what is the role of the European Institutions, foremost the ECB, in this process.

The remainder of this Policy Brief is organised as follows. Section 1 identifies macroeconomic imbalances, focusing on intra-euro area current account disequilibria and the role of competitiveness. Section 2 briefly assesses the role of the common monetary policy and the monetary transmission mechanisms in the build-up of the imbalances. Section 3 introduces the possible role of the ECB and the ESRB in the process of rebalance and potential sources of inconsistency. The last section concludes.

1. Macroeconomic imbalances and the EIP

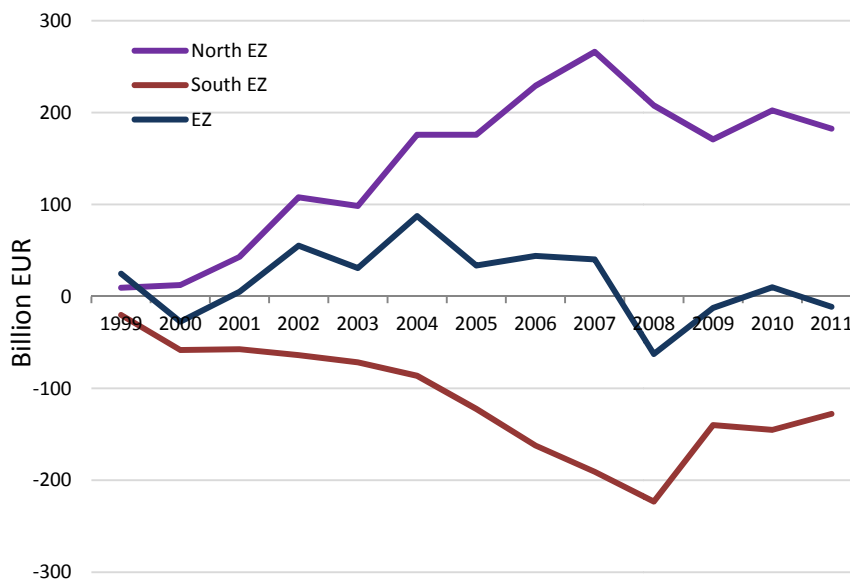
Since the onset of the financial crisis, and even more after the start of the sovereign debt crisis in the euro area, a lot attention has been devoted to macroeconomic imbalances. Within the euro area, macroeconomic imbalances refer to the existence of disequilibria in the external position, i.e. the current account of member countries, vis-à-vis each other, rather than to the position of the entire area vis-à-vis the rest of the world.

The major imbalance within the euro area is the one arising between the group of countries with a current account surplus, mostly North of the Alps and rated AAA by the major ratings agencies, and the countries with current account deficits, mostly South of the Alps, with the exception of Ireland.

Figure 1¹ shows that that the current account of the entire euro area has remained roughly in balance since the start of EMU, but after 2001 the balances of the North and South behave like mirror images of each other with movements of opposite sign.

¹ The two groups are simply defined according to the common behaviour of the current account balance since the creation of the EMU. The North eurozone includes Austria, Germany, Belgium, Luxembourg, Netherlands & Finland, countries which had current account surplus each year (or almost) over the period 2000-10. By contrast South eurozone includes Greece, Italy, Spain, Ireland & Portugal, which displayed a deficit every year (or almost). France is intentionally left out as its current account behaviour exhibits a mixed feature, surplus over the period 2000-05 and deficit afterwards. Holinski et al. (2012) use cluster analysis to identify two different groups of countries and end up with similar conclusion. The main difference is Italy which according to their results is in a position similar to the one of France (i.e. not sharing clearly the features of either group).

Figure 1. The flow problem: Current account imbalances (selected eurozone countries)



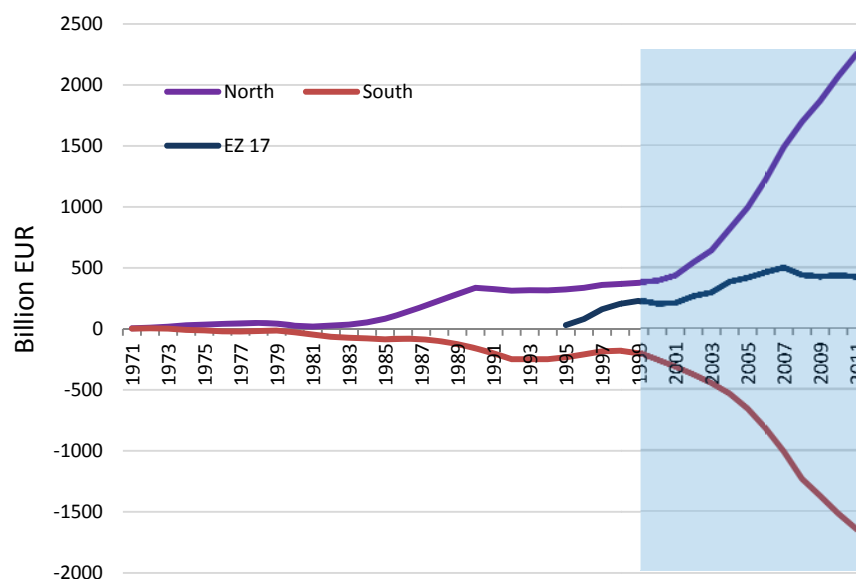
Source: Own calculation on European Commission Services (Ameco) data.

Note: North eurozone includes Austria, Germany, Belgium, Luxembourg, the Netherlands & Finland. South eurozone includes Greece, Italy, Spain, Portugal & Ireland.

The size of the current account 'im'balances has diminished during the last two years. The 'flow' imbalances are thus becoming somewhat less acute. But the legacy of many years of flow imbalances is large 'stock' imbalances. Figure 2 shows that the North and South have accumulated huge stocks of opposite sign: net foreign assets of more than €2,000 billion for Austria, Belgium, Finland, Luxembourg,

Germany and the Netherlands and a huge foreign debt of almost €1,400 billion just for Greece, Portugal and Spain, against amounting to over €1,600 billion for the entire 'South'. Even if the flow imbalances diminish (or were to disappear completely), large stocks constitute a potential problem since they have to be rolled over continuously. Financial crises arise mainly when investors refuse to roll over existing stocks.

Figure 2. The stock problem: Cumulated current account imbalances



Note: See Figure 1 for definition of the groups.

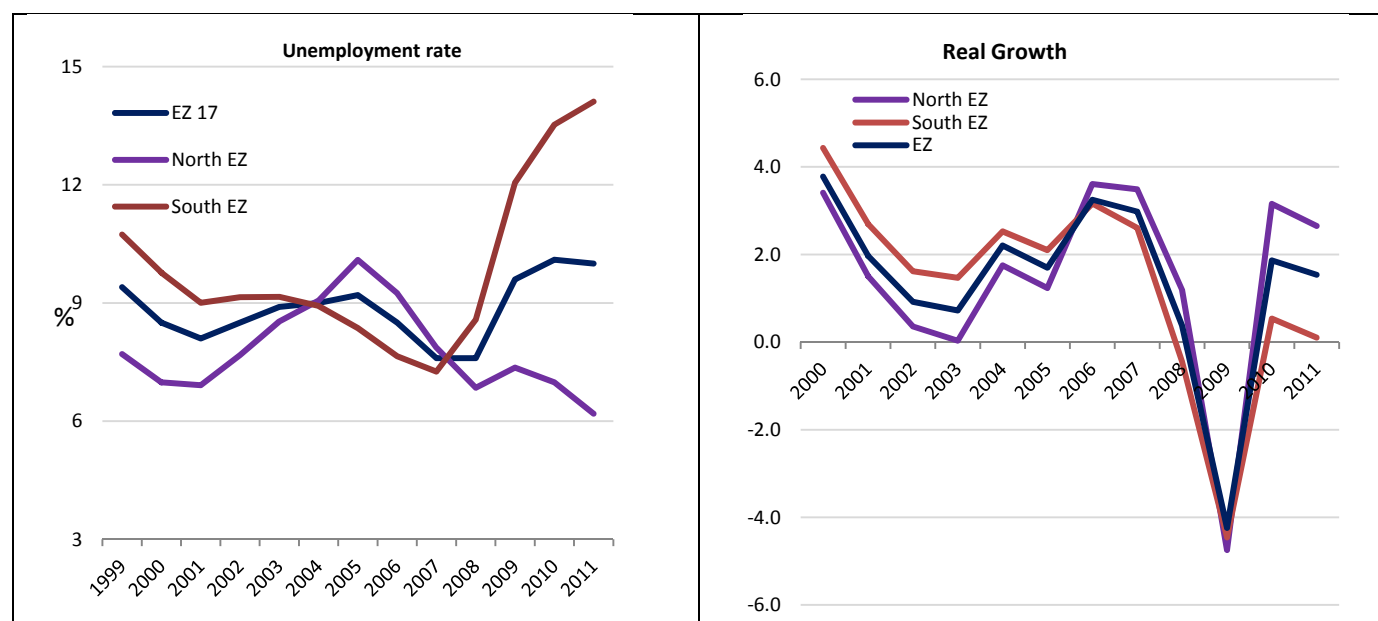
Source: Own calculations based on European Commission Services (Ameco) data.

One cannot interpret the imbalances in Figures 2 directly as bilateral imbalances between the North and the South of the euro area, since there is a global capital market and the current account is always *'erga omnes'*. However, the close negative correlation in the flows suggests a link. In reality, the link might be due to the structure of financial markets in the savings-rich Northern eurozone countries. There most of the excess savings is intermediated by the banking system and other highly regulated intermediaries (insurance companies, pension funds, etc.). These intermediaries have a strong 'home bias', or rather a bias towards investing in the euro area. For financial intermediaries, most regulations impose limits on investments outside the euro area or non-euro denominated. For small savers, investment in the home currency is always the first choice. This implies that, under normal conditions, there is a strong propensity for the excess savings in the North of the euro area to be invested elsewhere in the euro area itself. In this

sense, one can speak of a flow of resources running from North to South since the introduction of the single currency.

Since 2009, however, private cross-border flows have reverted suddenly and since the start of the euro crisis a massive withdrawal of foreign private resources has taken place in the South of the euro area. Adjusting to this sudden stop in the inflows of capital that benefited South eurozone countries for years is the key task at present. Without the previous capital inflows that had financed construction (in Spain and Ireland), and consumption (in Greece and Portugal and to a lesser extent Italy), Southern euro area countries are now forced to cut both construction investment and consumption, with large negative effects on GDP and unemployment, as shown in Figure 3 below. By contrast, the Northern eurozone countries benefit from very benign financial conditions, which keep their growth rates up and employment down.

Figure 3. Unemployment and growth



Data Source: European Commission Services.

The fact that the current account of the entire euro area remains broadly balanced means that the euro area, taken as a whole, has sufficient resources to fund the financial needs of all the countries of the eurozone, including those of the governments running large deficits. But why a 'euro crisis', if enough 'domestic' resources exist to deal with it? The key problem is the distribution of savings within the euro area.

As documented above, large savings are available in the north of the Alps but, savers from core eurozone countries no longer are willing 'to cross the Alps' to finance southern countries such as Italy, Spain and Greece. This is the essential reason why the South is experiencing a financial crisis while, at the same time, financial conditions in Germany remain benign and the German government could issue short-term paper at zero or negative rates.

Current account imbalances rarely occur in isolation. It is thus difficult to keep them separated from the accompanying fiscal and competitiveness issues. Here we will focus on the link between current account imbalances and competitiveness divergence.

How to manage the adjustment: The role of competitiveness

The official diagnosis of the current account imbalances within the euro area is quite simple: the South let its competitiveness deteriorate via unjustified wage increase, whereas the North (Germany *in primis*) kept costs under control and became more competitive. However, this diagnosis provides at best a partial explanation of the run-up to the crisis and is seriously incomplete, if taken in isolation, as a guide for policy.

Divergences in competitiveness within the euro area have been central to the policy debate for some time now. The former President of the ECB, Jean-Claude Trichet, is said to have shown at each meeting of the European Council over the past several years a chart showing the divergence in

unit labour costs (ULC) among euro area member countries. This has apparently struck a responsive chord in policy-makers. The new Macroeconomic Imbalances Procedure (MIP) – introduced by the European Commission as part of the large package of changes to the economic governance of the eurozone in 2010 – contains within its ‘Scoreboard’ (see Box 1), two competitiveness indicators as key elements: relative unit labour costs and consumer prices (relative to a large number of industrial countries). One legacy of the euro crisis thus is that competitiveness indicators now play a key role in the economic governance of the eurozone.

In the ‘Scoreboard for the Surveillance of Macroeconomic Imbalances’ (2012), the European Commission emphasises that the indicators are neither policy targets nor policy instruments. Rather, in the alert mechanism, the results of the scoreboard are interpreted from an economic perspective with a view to identifying developments in member states that may point to a risk of imbalances and therefore require further in-depth analysis.

Box 1. Scoreboard for the surveillance of macroeconomic imbalances

The initial scoreboard consists of a set of ten indicators with indicative thresholds. Two indicators aim at monitoring external positions, three indicators capture competitiveness developments and the subsequent five indicators reflect internal imbalances.

1. three-year backward moving average of the **current account balance** as a percent of GDP, with a threshold of +6% and -4%;
2. **net international investment position** as a percent of GDP, with a threshold of -35%;
3. five-year percentage change of **export market shares** measured in values, with a threshold of -6%;
4. three-year percentage change in **nominal unit labour cost**, with thresholds of +9% for euro-area countries and +12% for non-euro-area countries, respectively;
5. three-year percentage change of the **real effective exchange rates** based on HICP/CPI deflators, relative to 35 other industrial countries, with thresholds of -/+5% for euro area countries and -/+11% for non-euro-area countries, respectively;
6. **private sector debt** as a percent of GDP with a threshold of 160%;
7. **private sector credit flow** as a percent of GDP with a threshold of 15%;
8. year-on-year changes in the **house price index** relative to a Eurostat consumption deflator, with a threshold of 6%;
9. **general government sector debt** as a percent of GDP with a threshold of 60%; and
10. three-year backward moving average of the **unemployment rate**, with a threshold of 10%.

Source: European Commission Occasional Paper No. 92, February 2012.

The idea behind the IEP is to use these indicators as potential warning signals and then to force member countries to take 'remedial action' should these indicators signal 'excessive imbalances'.

However, this obsession with competitiveness is unlikely to lead to better policies. There are several reasons for this:

1. It is difficult to determine the right or 'equilibrium' level of competitiveness.
2. The link between competitiveness and exports
3. Wage costs are determined in labour markets, not by government fiat => governments can do little in the short run to affect competitiveness.
4. Wage costs are determined in labour markets => competitiveness is endogenous.

We now discuss each aspect in turn.

What is the equilibrium level of competitiveness?

A first point is that competitiveness, usually measured as a relative unit labour cost (ULC), is a relative concept. The gain of one country is the loss of another. Hence restoring the competitiveness of a member country (e.g. Greece) implies deterioration for others (Germany in the first instance): the adjustment might come about either through wage increases in the lower labour cost countries or cuts in those with a too high cost. There is a consensus that no country should be forced to increase wages and everybody gains if structural reforms increase productivity, but this does not change the fundamental fact that if German wages increase (relative to productivity), intra-eurozone divergence is reduced by definition. Indeed this is what is happening now.

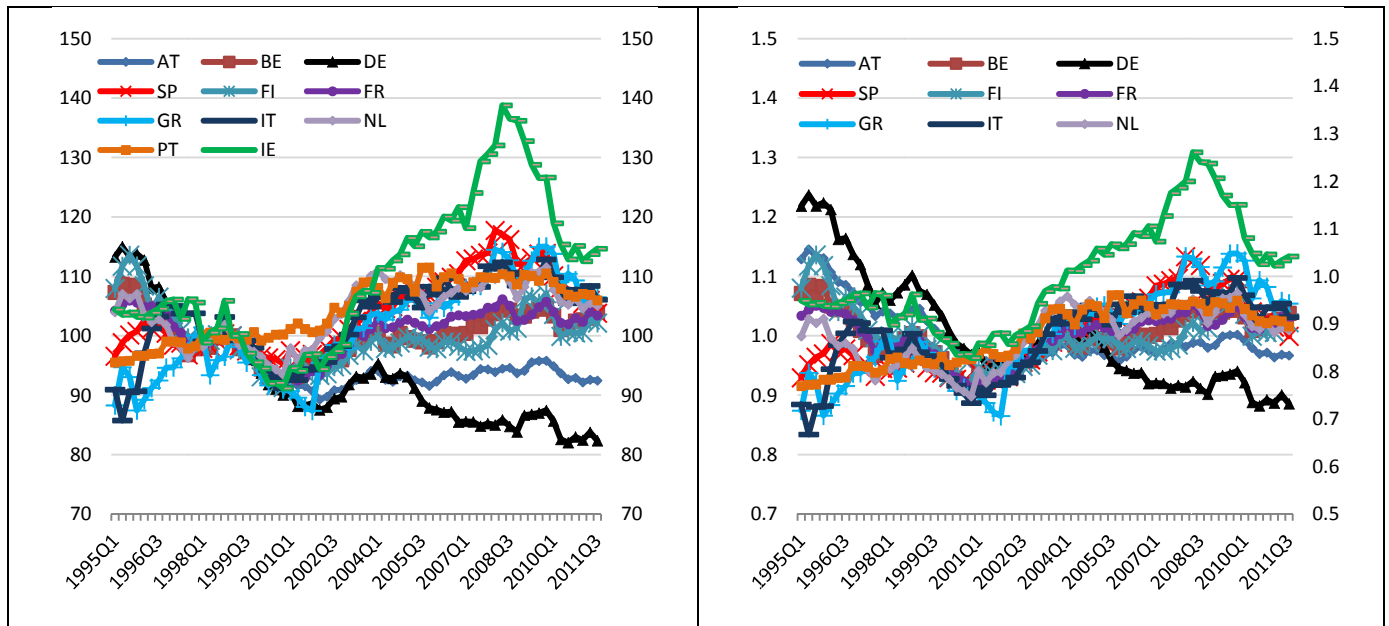
A second point is that it is always difficult to determine the proper base year for the competitiveness index. It is usually assumed that the start of EMU is an equilibrium and hence the best base, but there is no actual economic ground for it. When EMU started Germany had a current account deficit and it was widely accepted at the time that it had entered the euro at an overvalued exchange rate, and that in a monetary union would have had hard time to regain competitiveness.²

² See Wyplosz (1999).

The chart on the left hand side of Figure 4 shows the evolution of the ULC in some euro area countries, assuming that 1999 is the base year, while the chart on the right hand side shows the same index re-scaled dividing it by its average over the period 1995-2010 to remove the bias induced by the choice of the base year. The comparison suggests that 1999 might not have been equilibrium itself. When the long-term average is taken as equilibrium concept, 2003 appears to be year of the smallest cross-country differences. It also emerges that prior to 2003 Germany was one of the countries with lowest competitiveness (many countries were below the 100 line), while after 2003, the countries that have experienced a significant loss in competitiveness are those where bubbles had developed, e.g. Ireland and Spain (see Gros, 2010).³ Importantly, the consequence of a bias in the base year is a bias in the measurement of the divergence. Any analyses based on 1999 as equilibrium year will conclude that countries now in difficulties have lost about 25-30% in terms of ULC relative to Germany, while using the long term average as equilibrium concept suggests a loss of about 15%, a substantially smaller estimate of the remaining divergence. The purpose of these simple considerations is not to show that unambiguously 2003 should be taken as proper base year, but how difficult it is in practice to measure divergences in competitiveness.

³ See Gros (2010) *Adjustment Difficulties in the GIPSY club*, CEPS Working Document No. 326.

Figure 4. Real Harmonized Competitiveness indicator: unit labour cost (ULC) in total economy. LHS: ULC base year 1999, RHS: re-scaled to average 1995-2005



Note: ECB EER-20 group of currencies and euro area 17 country currencies.

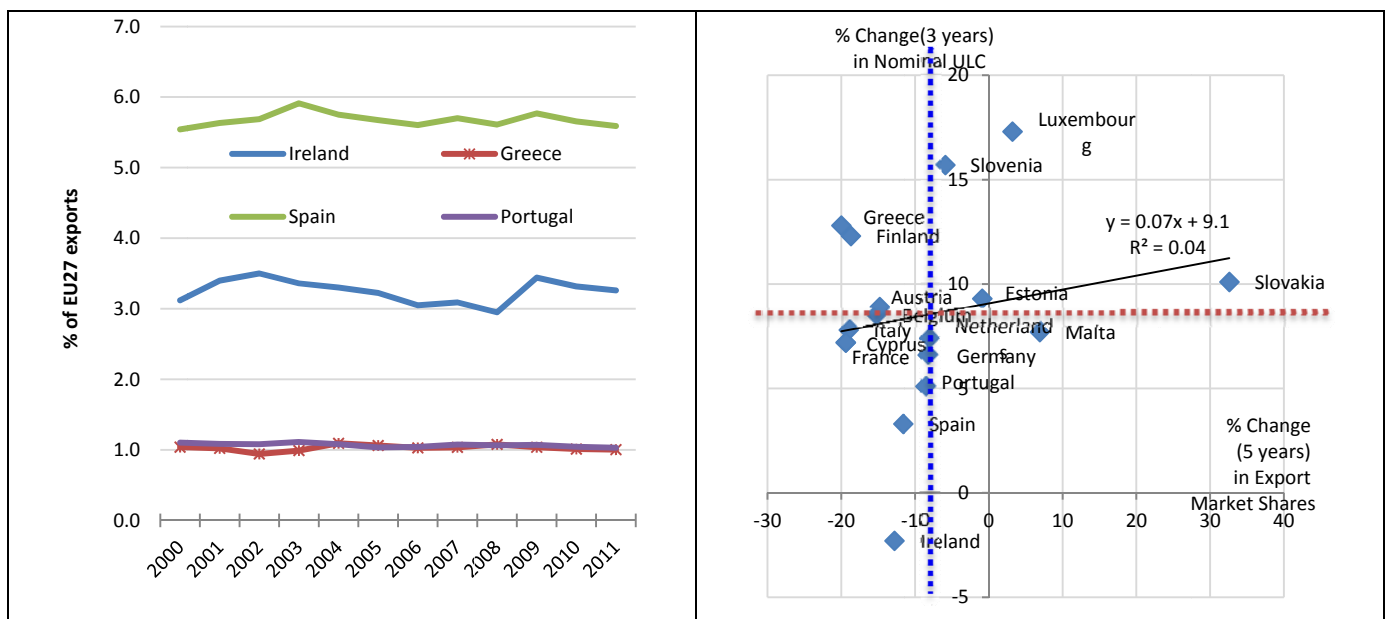
Source: ECB Statistical Warehouse and own computations.

Does competitiveness determine export success?

A more fundamental reason to be sceptical about the usefulness of the standard competitiveness indicators is that their power to predict export success is rather low. In principle a loss of competitiveness should lead to lower exports, or at least lower market shares. Given that all five

countries of the South have current account deficits, it seems obvious that their loss of competitiveness must reside at the core of their problems. However, a closer look at the data reveals that this is not necessarily the case.

Figure 5. Exports of goods and services and competitiveness vs. market share (MIP 2011)



Source: European Commission Services (Ameco database).

A first problem with the standard view is that the most important and immediate consequence of a loss of competitiveness should be lower exports. But the evolution of the export market shares does not support this hypothesis. Figure 5, on the left hand side, shows the share of the exports of goods and services of each country in overall EU-27 exports: all lines are essentially flat and not downwards sloping as one would expect. The only exception is Italy, the country which experienced the lowest loss of competitiveness.

The relatively strong export performance of these supposedly 'uncompetitive' economies raises the question: where do their deficits come from? The easy answer is an excess on the import side: excessive domestic spending, consumption in Greece and Portugal (and to some extent Italy) and construction in Spain and Ireland could be responsible.

However, for most of the GIPS, the balance of trade (in goods and services) has actually improved between 2000 and 2010. This suggests that in a country starting with a large imbalance, not only exports need to grow significantly, but much more than imports for the trade balance to improve. In the case specific case of Greece the current account was already in large deficit when the country joined the euro and the trade balance changed little between 2000 and 2010 (despite the huge increase in relative ULC), but the current account did not improve because other flows turned negative (income, unilateral transfer and transfers from the EU). The negative impact on the income balance is explained by the huge accumulation of foreign debt which the country has to service. This provides evidence that a country which has run large deficits for a long time cannot simply return to the 'status quo ante', but must actually run a surplus on goods and services in order to service its debt.

The real challenge for countries with a large foreign debt materializes when financing conditions deteriorate and a larger part of income must be devoted to service the external debt—whatever the situation in terms of the usual competitiveness indicators.

Competitiveness is not a policy variable

Policy discussions about competitiveness suffer usually from one key oversight: EU member countries are not centrally planned economies. There is little a government can do in a market economy to force lower wages in the private sector. Governments can of course enforce wage cuts in the public sector. This has been done in almost all EU countries and most notably in Latvia, Greece, Ireland and Spain for example, but there is little empirical evidence that public sector wage trends have an economically significant impact on wage growth in the private sector.⁴ The most recent data show that nominal wages have fallen in the year 2010 in the Baltic countries and in Ireland, while in 2011 only in Ireland and Greece.

Competitiveness is endogenous

The view that a loss of competitiveness constitutes the root cause of the difficulties in the periphery must somehow start from the proposition that wage costs are some an exogenous variable. However, while many countries have a 'wage policy', labour costs are in the end mostly determined by the interaction of demand and supply in the labour market.

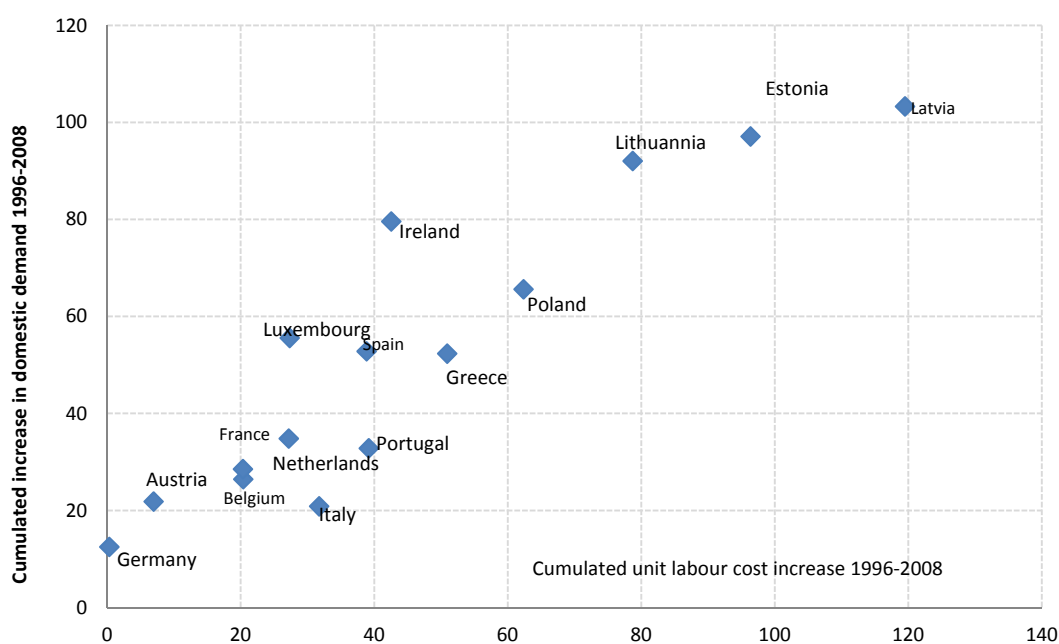
Figure 6 shows a strong correlation between domestic demand and labour cost. The countries which have experienced the largest expansion in domestic demand are the same who have also see the largest loss in competitiveness.

On this ground, one may argue that, if labour markets are allowed to work, the losses of competitiveness, observed during the boom phase, should reverse themselves over time during the burst.

Data suggest that after 2010 domestic demand has strengthened (or better, is less weak) in the surplus countries. This should imply that over time the labour markets in these countries should tighten leading to relatively larger wage increases. The opposite should occur in the South. This is the kind of process that will lead to a fall in labour cost divergences.

⁴ See Lamo et al. (2008) for empirical studies that find econometrically significant effects, but the orders of magnitude remain so small that any politically feasible autonomous change in public wages would have only a negligible impact on private sector wages.

Figure 6. Correlation between domestic demand and ULC



Note: ULC is nominal unit labour costs: total economy (ratio of compensation per employee to real GDP per person employed.)

Source: European Commission Services (Ameco).

2. Common monetary policy and the build-up of the imbalances

The decisive driving factor behind the build-up of the imbalances was a global credit boom sustained by a high level of risk appetite throughout global financial markets.

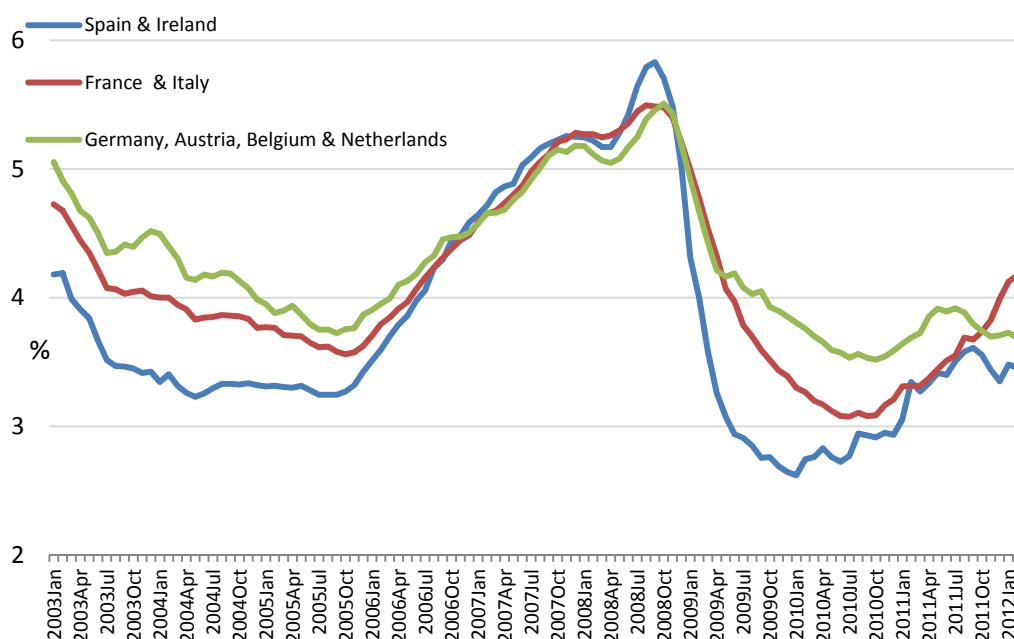
With the benefit of hindsight, one can also claim that the stance of the common monetary policy was too expansionary for too long. But we would argue that this was not the main reason for the excessive expansion in consumption and construction that occurred in some countries. It was rather the fact that monetary policy transmission mechanisms have worked differently in different countries due to large

differences in the financial structure of different member states.

The argument goes beyond the Walters' critique, which starts from the observation that the common monetary policy is bound to be more expansionary in countries where inflation is high and more contractionary where inflation rates are low because the real interest rate is lower in the former and higher in the latter.

In our view the problem was not so much about inflation differential but about credit conditions. Figure 7 gives an example of the differences across groups of member states in credit conditions by looking at lending for house purchases.

Figure 7. Interest rates on lending for house purchase



Source: ECB.

During the years of the credit boom, average interest rates on mortgages actually paid by borrowers in Ireland and Spain (blue line) were much lower relative to Germany and Northern Europe in general (green line). The reason for this is that in Ireland and Spain most mortgages were at floating rates, linked to short-term rates (like three month LIBOR) whereas in Germany most mortgages are at fixed long-term rates, which remained usually 2-3 percentage points higher.

To this one should add that also credit access was different across countries, while in Germany and Northern Europe, mortgages are usually limited to 60% of the value of the house, in Spain and Ireland loan-to-value ratios of 100% became increasingly common.

For a more detailed examination of the monetary transmission mechanisms within the euro area, see Gros (2011).

3. The role of the ECB and the ESRB

There is little the common monetary policy can do to reduce the imbalances which were built up over almost a decade. However, the ECB can mitigate the costs of adjustment by safeguarding financial stability.

The ECB is of course not the only institution concerned with financial stability. According to the ESRB Regulation: *“The ESRB shall be responsible for the macro-prudential oversight of the financial system within the Union in order to contribute to the prevention or mitigation of systemic risks to financial stability in the Union that arise from developments within the financial system and taking into account macro-economic developments, so as to avoid periods of widespread financial distress.”*

It is now too late to ‘avoid periods of widespread financial distress’, but the work of the ESRB is still very relevant in the sense that it can point out the areas where distress might become most acute as the adjustment process takes its course.

A problem that is unavoidable in this context is that, given the existing imbalances, the dangers to financial stability are usually specific to a limited number of countries. This implies that an institution like the ESRB will have to call for action at the national level, including country specific differences in the application of financial market regulation. This conflicts of course with the aim of establishing a ‘single rule book’, or in general the aim of establishing a ‘level playing field’ within the internal market. Institutionally, the conflict is thus between the ECB/ESRB and the Commission.

4. Concluding remarks

During the first decade after the start of EMU, the euro area and more broadly the global economy experienced an unprecedented credit boom. The expansion of credit was particularly robust in the Southern countries. The difficulties these countries are now experiencing are the consequence of a 'sudden stop' in the private capital flows they became accustomed to receiving during the boom years.

In this Policy Brief, we argue that the expansion in domestic demand financed by the capital inflows was the main reason behind the loss of competitiveness in the Southern euro area countries.

Uncontrolled demand expansion based on credit inflows is the main source of the current imbalances. Alas, years of accumulation of flows have generated a large stock problem, mostly debt, which has to be corrected. For the correction to happen, the main effort has to come inevitably from individual countries. European Institutions, i.e. the European Commission, the ECB and the ESRB, can only affect the process marginally. The Commission can provide member states with guidance on how to achieve the re-balance and cope with its effects on the real economy. The ESRB can contribute to the mitigation of systemic risk within the financial sphere arising from macroeconomic developments. Last but not least, the ECB can contribute to contain financial instability and avert disruptions in the financial sector.

Given the heterogeneity of the crisis within the euro area and the country specificities, the main risk is that a conflict emerges between internal market rules and the need for measures adapted to individual countries.

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