Current Account Imbalances and the Euro Crisis

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NERO Meeting – 19 June 2017
Preliminary observations (I):
With the introduction of the single currency, huge increase in current account imbalances

Figure 1: External Balances vis-à-vis All Trading Partners in EMU’s Northern and Southern Economies (1980 – 2014)

Note: Northern economies = Austria, Belgium, Finland, France, Germany and the Netherlands
Southern economies = Greece, Ireland, Italy, Portugal and Spain
No external lending data for Greece before 1995

Source: Johnston and Reagan (2016)
Preliminary observations (II):
With the Eurocrisis, some decrease in current account imbalances

Figure 2: Balance of Payments Current Account (% of GDP, IMF forecasts)

Source: Financial Times, 2013, “The dramatic adjustment in Eurozone Trade Imbalances”
Outline

(I) Varieties of Capitalism approach in a pre-crisis context

(II) Additional explanations for current account imbalances

(III) Adjustment since the Euro crisis
I - Varieties of Capitalism approach in a pre-crisis context

• Varieties of Capitalism theory: 4 ideal-type models
  • Coordinated Market economies (CME)
  • Liberal Market economies (LME)
  • Mixed Market economies (MME)
  • Dependent Market economies (DME)

• Main argument: capital flows and current account imbalances between the North and South of the EMU are due to different national institutional frameworks between CMEs and MMEs
CMEs: export-led growth model and low-inflation prone

• high levels of wage coordination that limit unit labor cost increases → inflation limited

• sophisticated systems of vocational training, collaborative research and development and incremental innovation

→ competition on both quality and price

• Price competitiveness → real exchange rate comparative advantage

• Strong preference for savings → limited effectiveness of counter cyclical policies
MMEs: demand-led growth model and high-inflation prone

• Similar characteristics to CMEs but to a much lower level
• Weaker institutional infrastructure, low wage bargaining coordination:
  • E.g. Fight between trade unions for the allegiance of the workforce; lack of regularity in social pacts; employer associations are less institutionalized
• In this institutional context, vocational training is also harder to implement → workforce is less skilled, continuous innovation is more difficult
• Need of expansionary macroeconomic policies -> tend to increase inflation
What role for the single currency?

• The introduction of the single currency removed two decisive adjustment tools between MMEs and CMEs:

1. National central banks
   Limited capacity of the ECB compared to national central banks to deliver inflation convergence between diverse EMU countries
   -> accumulation of inflation differentials year on year between North and South
   -> persistent divergence in the real exchange rate

2. Currency devaluations
What role for the single currency?

• Implications:
  • Relative inflation became the only variable in the real exchange rate identity
  • -> CMEs (low-inflation prone) have a comparative advantage in the real exchange rate
  • Structural competitiveness differentials between North and South and Persistent imbalances in current account and external lending between the two growth models within the EMU -> divergence in speculative behaviors on the financial markets between CMEs and MMEs
  • Export-led CMEs: current account surplus; Demand-led MMEs: current account deficits
What link between current account imbalances and the Euro crisis?

- Observation: no current account surplus countries were exposed to a sovereign debt crisis, while the Southern economies (except Italy) required a bail-out program (Baldwin and Gros, 2015)

- Balance-of-payments surpluses building up in CMEs $\rightarrow$ large capital flows sent to Southern member states by Northern banks (with a strong EU bias – Gros, 2012)

- In a “beggar-thy-neighbor” approach, current account balances reach a zero-sum game $\rightarrow$ for surplus countries to hold a trade surplus, they must lend capital to deficit countries via the capital account

- This + confidence generated by the formation of the EMU $\rightarrow$ cheap credit $\rightarrow$ expansion of domestic demand (no matter the policy decided by government) $\rightarrow$ inflation $\rightarrow$ ULC and prices even higher $\rightarrow$ persistent real exchange rate differentials

- Low nominal interest rates and access to cheap credit fueled consumption and real-estate booms
What link between current account imbalances and the Euro crisis?

• Capital flows from Northern to Southern economies
  • channeled into non-tradable sectors in the South → cannot generate export surplus
  • Fueled investment bubbles and caused consumption boom not supported by an increased productivity

• During crisis: doubt for the solvency of the States due to persistent imbalances -> this can fuel divergence in speculation on financial markets between North and South

• Speculation also increased by high savings in Germany, high dissaving in Spain for example

• Implication: Hall (2014), Johnston et al. (2014)
  • the North should stop demanding Southern member states to copy the capitalist model of the North
  • Recommendation of wages increases in the North to give more leeway to the South
How relevant is all this?

• Johnston et al. (2014) using a panel analysis:
  • Significant correlation between export decline and increasing differentials between manufacturing and public sector wage growth
  • Weak governance institutions have a more negative impact on exports inside rather than outside a monetary union

• Piton (2014):
  • countries which current account worsened most are those where unit labor costs increased the most as well
  • But no significant correlation between unit labor costs and exports

• Gaulier and Vicard (2012): increase in imbalances due to asymmetric demand shock and not to competitiveness shock through trade
  • Exports uncorrelated to current account balances and ULC
  • Imports correlated to current account balances
  • Domestic demand correlated to both current account balances and ULC
II- Additional explanations for current account imbalances

• Globalization process and rise of new players
  • Asymmetric trade development with countries outside the euro area, integration with Central and Eastern European countries in the context of GVC (Esposito, 2017)
  • Increased competition from China
  • Factors that contribute in reducing intra-EMU trade and increasing imbalances, but still linked to competitiveness differentials within the EMU

• Financial deregulation
• European financial integration
  • reduced risk-premium due to increased confidence, role of financial transactions in transmitting negative shocks across countries, incentives for the development of asset bubbles
• Connection between fiscal and current account deficits:
  • Keynesian income mechanism: budget deficits stimulate domestic demand and hence income generation, which leads to import pull
  • Neoclassic price mechanism: budget deficits \(\rightarrow\) rise in prices and wages \(\rightarrow\) real exchange rate appreciation \(\rightarrow\) worsening of the external balance
  • This suggests that causation runs from budget deficits to current account deficits
(S - I) $\equiv$ (X - M) + (G - T)

**Eurozone sectoral financial balances**

Private sector balances (as a % of GDP)

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Capital inflow* (as a % of GDP)

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Fiscal balances (as a % of GDP)

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**Creditors countries (NL, GE, BE, FI, AT)**

(S-I) > 0: financial surplus of the private sector
(X - M) > 0: current account surplus (= net capital outflow)

Unsure for (G-T) (balanced budget or deficit/surplus)

**Debtors countries (GR, ES, PT, EE)**

(S-I) < 0: financial deficit of the private sector
(X - M) < 0: current account deficit (= net capital inflow)

Unsure for (G-T) (balanced budget or deficit/surplus)

→ Strong correlation between private sector financial balance and current account balance
III- Adjustment since the Euro crisis

- Adjustment through budget balance
III- Adjustment since the Euro crisis

• Gavyn Davies (Financial Times, 2013): imbalances within the Eurozone have gone down because of a recession in Southern countries
  • Labor costs have decreased since the crisis in peripheric countries, but the gap with Germany has not:
• Germany’s real exchange rate is now about 20% lower than it was in 1999
• The reason for lower imbalance since the Euro crisis is not structural reform or wage disinflation but the impact of austerity program
• Huge unemployment in the South

But, were Southern countries to stop austerity to lower unemployment, it would increase demand and there would be a return to high trade deficits

→ Trade-off between high unemployment and high imbalances

Source: Gavyn Davies (Financial Times, 2013)
Conclusion: What I will research...

• Study of the post-crisis and adjustment period to find some clues as to what caused current account imbalances

• I notably intend to look at structural reforms both at the national and the European levels

• Guiding question: Which countries have adjusted? Is it temporary?