CHATHAM HOUSE briefing paper

Intra-European Imbalances: the Need for a Positive-sum-game Approach

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Summary points

- Over the first 10 years of the euro Southern Europe has suffered a massive loss of competitiveness and built up large current account deficits *vis-à-vis* the North. For many years, very little attention was paid to these imbalances. The global financial crisis, however, has put an end to the easy financing of these deficits and has revealed many weaknesses in the euro architecture.
- Current account imbalances derived both from structural microeconomic factors (Germany's successful production restructuring) and from the asymmetric macroeconomic effects of the European Monetary Union or single currency on creditor and debtor countries.
- The official policy, however, is that this adjustment should be entirely one-sided. Domestic spending must fall on debtor countries, with no offsetting expansionary policy in the creditors. As a consequence, growth has suffered and recession has hit all peripheral countries.
- The present zero-sum-game approach is risky for the stability of the euro area. The right approach must combine more symmetrical macroeconomic fiscal adjustment with microeconomic policy measures aimed at encouraging productivity increases.
- Cooperation and policy coordination are needed to avoid the present 'beggar thy neighbour' situation. In this regard, the new European Governance Framework could fruitfully be further integrated and more effectively used than it has been so far.

Introduction

Until the outbreak of the global financial crisis, there was wide divergence among the current account balances and the competitive positions of individual EU member countries, whereas the euro area as a whole had remained relatively close to external balance. By removing exchange rate risk, the introduction of the euro encouraged massive capital flows to, and large current account deficits in, the Southern European countries (Greece, Italy, Portugal and Spain). Meanwhile, there have been spectacular current account surpluses in Nordic countries, and Germany had a surplus of 6% of GDP in 2011 (Figure 1). External imbalances also reflected steadily widening gaps in competitive positions in the two groups of countries (Figure 2).

For many years, however, national authorities and European institutions paid very little attention to these imbalances. The assumption was that changes in competitiveness and current accounts are not necessarily bad in a monetary union.

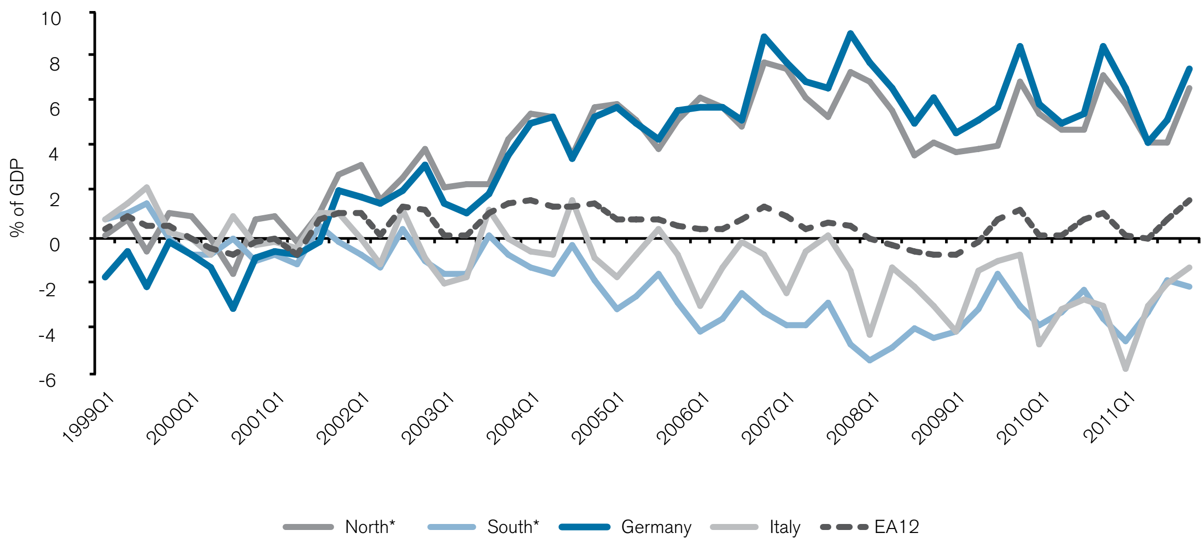
For instance, catching-up countries have strong investment requirements that call for inflows of foreign capital and therefore current account deficits. Furthermore, increased integration of capital markets is likely to result in large current account deficits and, in such a context, deficit countries do not need measures to reduce their imbalances.

Early studies of external imbalances in the European Monetary Union (EMU) supported this comforting explanation (Blanchard and Giavazzi, 2002). Furthermore, large current account deficits in the euro area have been easily financed for many years by net (private) capital flows from surplus countries that bought the assets of deficit countries, including debt obligations. There was a sharp increase in cross-border banking flows, as the deepening of financial integration led banks (notably in the core countries, Germany and France) to search for profitable investment in high-growth countries. Thus lending to the private sector and investment in overvalued assets – namely construction – continued apace.

In other words, the banks of the core countries heavily financed the excess demand in the peripheral countries, thus promoting the accumulation of large macroeconomic imbalances within the eurozone.

The global financial crisis in 2008–09, however, put an end to this easy financing and revealed many weaknesses in the euro architecture. Private funding of imbalances dried up and the system of euro area

Figure 1: Current account imbalances in the euro area



Source: Eurostat

* North: Austria, Belgium, Finland, Germany, Luxembourg, Netherlands. South: France, Greece, Ireland, Italy, Portugal , Spain.

central banks had to replace the banking sector as a key source of funding of current account imbalances and private capital movements. This massive intervention was to a certain extent successful, but the cost was a dramatic increase of budget deficits and sovereign debts in deficit countries (de Cecco, 2012). These imbalances translated into higher public debt, as a result of either a sharp drop in revenues or the transformation of private debt into public debt.

In the years after the crisis, highly indebted European countries with large external deficits experienced the highest sovereign bond yield spreads. Current imbalances were placed at the heart of the eurozone crisis. The over-reliance on external borrowing made financing the increased public debt more difficult; and European banks ended up holding a high proportion of their public debt. As a result, the euro system has become exposed to the twin related risks of sovereign and bank defaults. High public deficits and debts are much more an effect than a cause of the eurozone crisis.

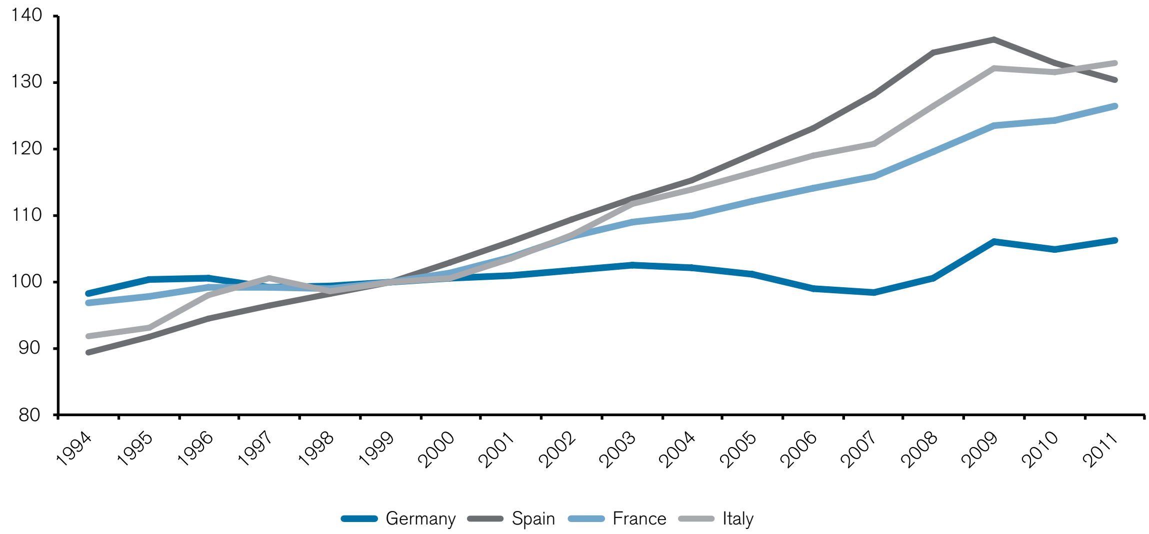
The fact is that the imbalances in the first 10 years of the euro were not the temporary outcome of an overall European economic convergence process, as early studies have argued. In contrast to some previous optimistic assumptions, this paper argues that the large current account deficits/surpluses which characterized that decade cannot be sustained for long and should be reversed. Unless the economies of Europe are brought into better balance, the region could get stuck in a low-growth pattern that could make the debt crisis harder to resolve and threaten the future of the entire EMU. In effect, because of trade and financial spillovers across member states, large macroeconomic imbalances may also hinder the functioning of EMU and affect confidence in the euro.

In order to design the appropriate governance and policy mix, it is important to make the right diagnosis of the nature of these intra-European imbalances. Failure to do so may lead to an inappropriate policy structure.

The peculiar functioning of EMU

The first significant explanation is macroeconomic and relates to the peculiar functioning of EMU. It should be noted that the euro and EMU had a fundamental role in the increase of the German trade surplus through their effect on creditor and debtor countries (Allsopp and Vines, 2010; Tilford and White, 2011; Krugman, 2012; Guerrieri and Esposito, 2012). The removal of exchange-rate risk inside the eurozone

Figure 2: Index of labour cost per product unit (1990=100)



Source: Ameco

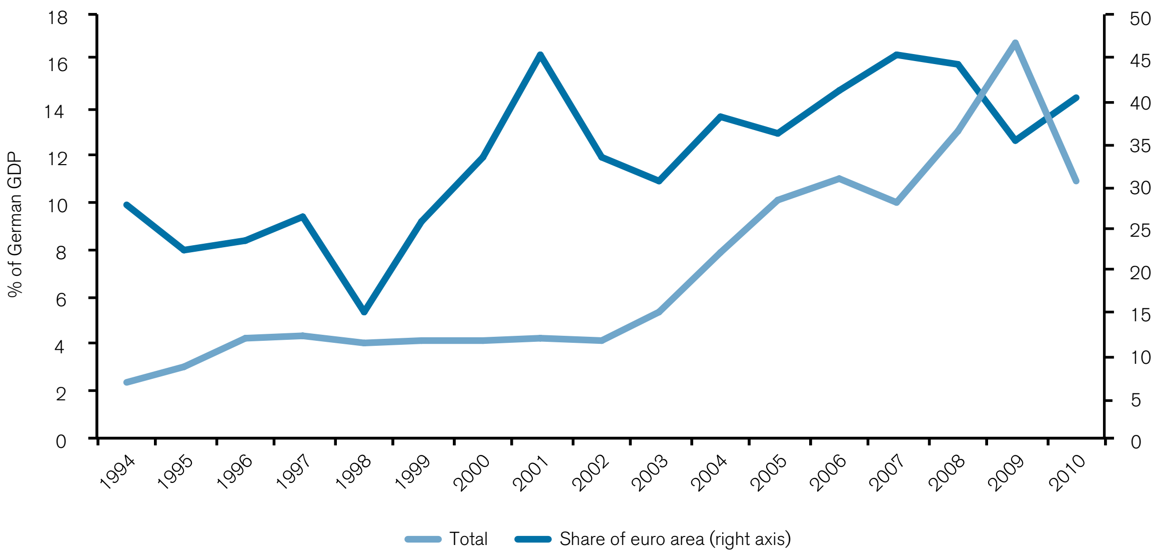
encouraged massive sums of capital to flow from the 'core' countries to countries in the 'periphery' (Greece, Italy, Portugal, and Spain), and households, firms and governments in the southern countries to spend more than they earned. The excessive demand boom in the peripheral countries, fuelled by private/public consumption and residential investment spending, led to persistent inflation and unit labour cost differentials, loss of competitiveness, and asset price inflation – notably in the housing market – in the countries that had to converge towards the euro area average. And it led to an explosion of current-account deficits in the southern countries. Meanwhile, Nordic countries – notably Germany, as noted above – ran spectacular current account surpluses.

The contribution of the eurozone to Germany's net exports increased from 25% in the first half of the 1990s to over 40% in the years before the global financial crisis (Figure 3). The proportion of Germany's trade surplus with the eurozone has since fallen, but not by much. It is still on course to be around 5% of GDP in 2011, while Europe as a whole will account for over three-quarters of the overall surplus.

Surplus and deficit euro member countries are mirror images of each other (Figure 1). In current account deficit countries, large capital inflows led to an unsustainable accumulation of household and corporate debt, aggravated by their inappropriate fiscal policy response. In other member states, meanwhile – as in the case of Germany – large current account surpluses reflected falling relative costs (due in part to outsourcing) and incomes, leading to structural weaknesses in domestic demand. Since the crisis, the financing burden of these imbalances has mostly fallen on the European Central Bank (ECB) and official assistance programmes, as private financing from the surplus countries has dried up. At the same time, the supply side did not catch up with the demand side because of structural competitive differences across euro member states.

In short, the story is that the introduction of the euro favoured the emergence of large intra-area macroeconomic imbalances that were unsustainable, and that the eurozone has no adequate mechanism to manage. It is because deficit countries spend more than they earn that countries with external surpluses, such as Germany, can do the reverse. The intra-area imbalances are thus the effect of the zero-sum game that is implicit in any currency union and should be managed by an effective governance framework. It is

Figure 3: The German trade balance and the role of the eurozone



Source: Author's elaborations on CEPII-Chelem database.

very difficult, then, for Germany to be a model for all other euro countries simultaneously, and even more so since there seems to be little room to shift euro imbalances to the rest of the world. In the past, the eurozone had balanced trade with the rest of world, although Germany, for example, ran a large trade surplus against the rest of the eurozone. It would be very difficult for future adjustment to transform the eurozone as a whole from a region with balanced trade with the rest of the world into another trade-surplus and export-led growth area like East Asia. That would make it even more difficult to stabilize and promote growth in the world economy as a whole. It follows that the need to balance trade within the eurozone should take place within the EMU area, at least to make it compatible with the new overall global equilibrium.

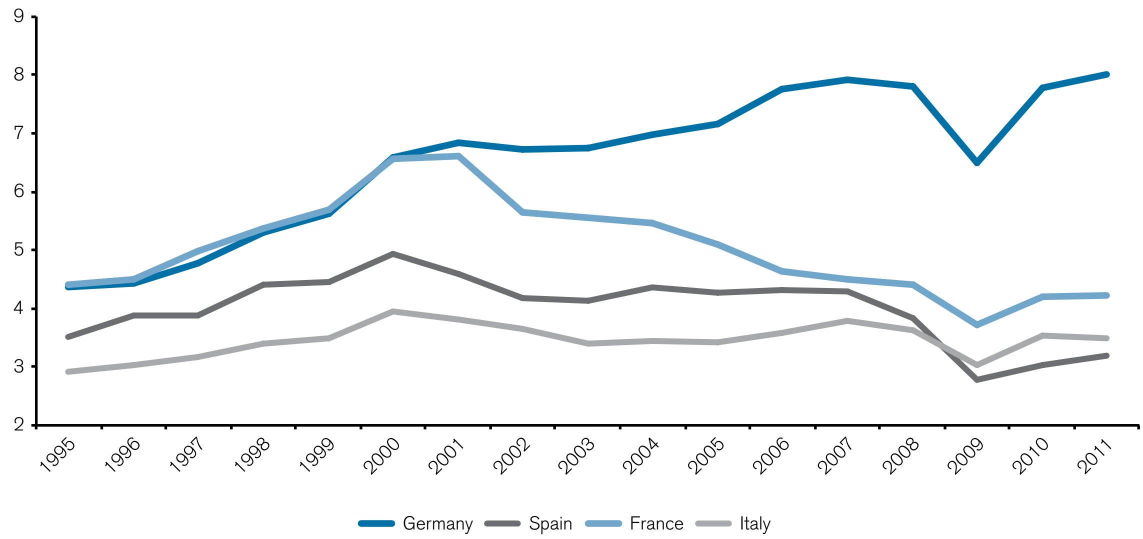
Imbalances and the international reorganization of German firms

To this primary explanation of intra-euro area imbalances one could add a second story that is fundamentally microeconomic. It is related to the international reorganization of the German production system over the last 15 years. Outsourcing to Eastern Europe has been a central part of this restructuring, partly as a result of the kind of industrial output that Germany produces.

In the past 15 years the world economy has undergone profound changes characterized by the rise of new emerging areas and countries. The most advanced economies have tried to respond more or less rapidly and more or less effectively. A very synthetic indicator of these different adaptive capacities is the extent to which an economy is affected by international trade, measured by the average of the share of exports and imports in GDP. In the case of Germany and other major euro member countries such as France, Italy and Spain a huge gap has opened between them over the last decade. The German economy has almost doubled its degree of openness (from 19% to 38%) whereas the other countries over the same period have registered only a modest increase. The divergent trends appear even more surprising since by the mid-1990s the four countries started from a very similar position (Guerrieri and Esposito, 2012).

Furthermore Germany has not only strengthened its leading-country role in exports but has significantly increased the flow of imported goods. The import content of German exports has gone up by about ten percentage points to more than 20% in the past decade. German firms of all sizes have spread themselves abroad,

Figure 4: Index of overall international fragmentation of production: degree of openness in trade of parts and components



Source: Author's elaborations on data from Ameco, Comext.

in search not only of new markets but also of cheaper production inputs (parts and components), in order to reorganize their activities by increasing international fragmentation and outsourcing of production. An indication of this process is the degree of trade in 'outsourced' and related goods, – that is, intermediate goods, and more specifically parts and components traded across different stages in the supply chain (Figure 4).

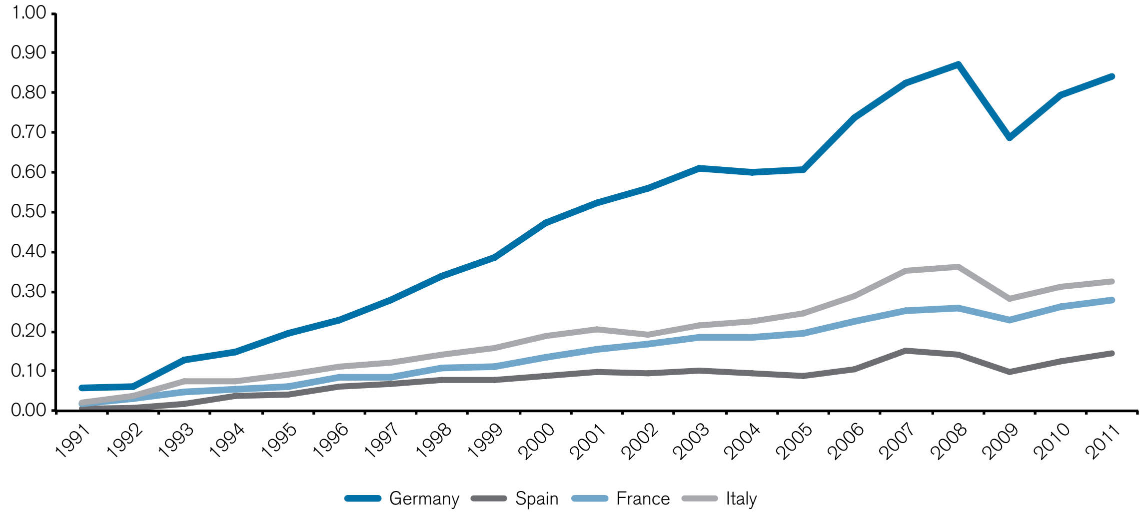
This international fragmentation of production is evident in the evolution over the past decade of German trade relations with, in particular, Central and East European economies. Germany increased its economic integration with some of the latter – especially Poland, Slovakia, the Czech Republic and Hungary – by a strong growth in trade flows in intermediate products and components, both of which are at the root of the international fragmentation of production implemented in the second half of the 1990s (Figure 5). Taking advantage of the close geographical location of these countries and the availability of their cheap skilled workforce, many German companies have moved parts and stages of their production processes to Eastern Europe. Poland, the Czech Republic, Slovakia and Hungary, in particular, have thus become key suppliers of the German economy and firms in recent years, notably for parts and intermediate goods, in many cases replacing the previous suppliers from Italy and other countries in southern Europe.

Many studies suggest that German companies have significantly cut their labour costs by shifting production of some parts and components abroad (Geishecker and Gorg, 2008; Geishecker et al., 2010; Hansen, 2010; Marin, 2010a). The reduction of labour costs thus obtained is just as relevant as that resulting from wage moderation (Marin, 2010b). Significant gains – sometimes of more than 20% – in the productivity of firms have also been derived from outsourcing (Hansen, 2010; Marin, 2010a).

German firms seem to have been taking full advantage of the phase of globalization that covered the period from the late 1990s until the financial crisis. On the supply side, as shown above, they benefited from the advantages of increased international fragmentation of production, which strengthening their competitiveness. Furthermore on the demand side, they have fully exploited the new demand for goods and services from emerging countries.

As shown in Figure 6, German firms appear to have exported to emerging markets much more than those from Italy and other European competitors. For

Figure 5: Index of international fragmentation of production: degree of openness in trade of parts and components with Eastern Europe



Source: Author's elaborations on data from Ameco, Comext databases.

instance, China has become by far the biggest market for a number of German consumer and investment goods, ranging from cars to industrial machinery. The share of China in German trade has grown from just over 2% in 2000 to over 6% in 2010. It is now similar to the share of the United States on the total German exports that has, by contrast, decreased from 10.5% to 6.5% during the same period (Comext database, author's elaborations). The reduction of costs deriving from the creation of such an international production system has been coupled with wage restraint and has thus enhanced the competitiveness of German firms. The competitiveness of the German economy has also improved through its increasing trade surplus with respect to the European peripheral countries that were unable to establish similar international production systems.

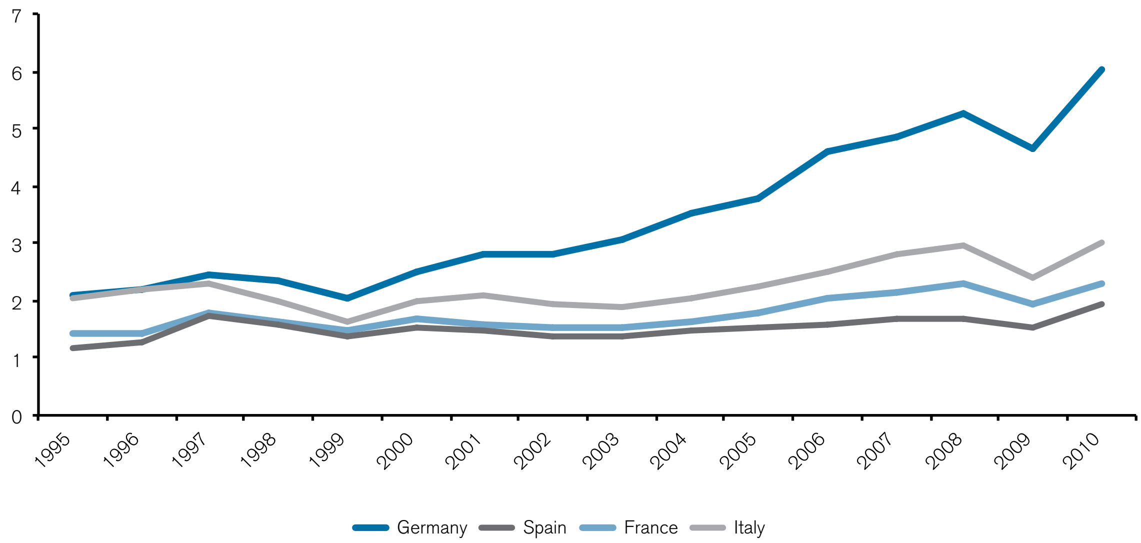
The virtues and vices of the German model

Germany has proved more capable than other euro member countries of exploiting the opportunities provided by globalization. Indeed German industry provides an answer to one of the most difficult economic issues facing the developed world: how to maintain manufacturing competitiveness against low-cost emerging economies. In this regard Germany is the EU's benchmark, the competitive model that other member countries urgently need to emulate.

But it could be misleading to look at Germany's strong external performance only through the prism of the country's restructuring and so-called 'competitiveness'. As already shown, Germany's large trade and current-account surpluses are as much a reflection of the peculiar European macroeconomic environment linked to the functioning of EMU up to the financial crisis. The two above narratives – microeconomic and macroeconomic – are complementary in assessing the determining factors of current imbalances in the eurozone. Both create a picture of a European crisis which was exacerbated by the emergence of sovereign risk and currency risk in the periphery, coupled with austerity as a response to these risks. Over the past decade unsustainable macroeconomic imbalances derived – as explained in the previous paragraphs – both from structural competitive factors (different countries' restructuring and outsourcing of production) and from the effects of EMU on creditor and debtor countries (sharing a common currency).

A smooth adjustment of this diverging intra-euro area competitiveness and of macroeconomic imbalances is

Figure 6: Exports towards emerging economies (% of GDP)



Source: Author's elaborations on data from Ameco, Comext databases.

vital for the future of the euro. If it does not take place, or at a fast enough pace, coexistence between the North and South is bound to be increasingly difficult, eventually undermining the stability and functioning of EMU in the medium to long term. So far, however, national authorities and European institutions, including the ECB, have paid little attention to these imbalances.

The predominant approach has been that the adjustment should be entirely on the side of the debtor countries. The resulting prescription was fiscal austerity and economic reforms. According to this approach, since the crisis does not stem from the eurozone system itself, but from the behaviour of individual, peripheral deficit countries within it, the adjustment should be entirely centred on the highly indebted countries. Fiscal austerity measures have thus been introduced and diffused everywhere in the eurozone, from Greece with its unique fiscal problems to countries such as Spain and Ireland, which have banking but not fiscal crises. The deficit countries are required to improve competitiveness and save more to pay down their debts, without an offsetting decline in saving and expansionary policy in the surplus countries such as Germany. The belief is that budgetary adjustment in these countries could restore fiscal sustainability, bring down interest rates and restore their competitiveness, without the creditor countries having to change their policy (Guerrieri, 2012).

But if most eurozone governments cut spending at the same time, the deflationary effect on GDP is further magnified. Fiscal austerity in individual European countries has thus resulted in excessively tight macroeconomic policy for the euro region as a whole. A slow-down in one country reduces demand for exports in others. As a consequence, growth has suffered and recession has hit all peripheral countries. Together with Europe's inability to handle the problems in Greece, this contributed to weakening market confidence and creditworthiness in many countries, notably Spain and Italy. The decline in sovereign bond prices of highly indebted countries has exposed banks' undercapitalization. As a result, the banking crisis and sovereign debt crisis have so far been interacting with each other in a perverse direction. It is thus very clear that fiscal austerity, whether alone or combined with the new fiscal compact approach, will not solve the crisis and adjust intra-eurozone imbalances.

It follows that the huge challenge today is to make management of the crisis compatible with adjustment of the existing intra-euro area imbalances. The present zero-sum-game austerity approach is very risky for the stability of the euro area and the current no-coordination option could lead to a 'beggar thy neighbour' situation. Austerity measures and/or indefinite financing of them are not the solution. The former will exacerbate recessionary trends in the eurozone, while the latter will create economic and politically unsustainable tensions among countries.

Internal rebalancing as a cooperative positive-sum game

A smooth adjustment of intra-euro area macroeconomic imbalances requires a positive-sum-game policy approach in Europe. Policy coordination of some kind is needed. In other words, convergence and adjustment do not happen automatically in EMU, but need to be policy-driven. This requires agreement on well-identified economic policy priorities at both EU and member-state level, taking full account of the different positions of the members in terms of growth, external imbalances and competitiveness.

New policy priorities are thus required in the eurozone that put more emphasis on cooperative games in convergence and competitiveness. The diagnosis sketched in the previous sections shows the complex and systemic nature of the eurozone crisis. It is due as much to excess bank leverage and poor risk management in the core countries as to excess expenditure and lost competitiveness in the periphery. The adjustment process in the South is affected by economic conditions in the North. New policy and governance priorities are thus required in the eurozone that put more emphasis on cooperative games in convergence and competitiveness.

Addressing intra-area imbalances requires two well-known measures. First, there must be a real depreciation on the part of the debtors and a real appreciation on the part of the creditors – that is, wages and prices in the deficit countries must fall relative to those in Germany. Second, as already pointed out, it requires a redistribution of spending, with the debtors spending less and the creditors more. As to the first adjustment, the competitive gap and the excess of private and sovereign debts require, first of all, fiscal adjustments (austerity) and structural reforms in the highly indebted peripheral countries. There is no doubt, in the light of the competitive trends discussed above, that southern European countries would be well advised to take supply-side and microeconomic reforms more seriously than they did in the past. This would increase their productivity and living standards would rise over the medium to longer run. But given the very low growth and inflation of the eurozone at the aggregate level, there is a risk that real exchange-rate adjustment will take place mainly through deflation in the deficit countries, which would raise their debt burden relative to GDP. Excessive fiscal adjustment and deflation can thus ultimately be self-defeating and make the reforms to improve the southern European countries' competitiveness impossible to implement.

To succeed, these adjustment processes in the periphery need enough time and adequate macroeconomic context at the European level. That is why the second adjustment mechanism (symmetric burdens of adjustment) is crucial as well.

Countries with current imbalances will have to demonstrate how they intend to close them, with the onus being as much on those running trade surpluses as on those with deficits. In effect, the pace of fiscal adjustment and policies of countries in the North have major implications for those in the South. The more the former expand overall spending, the less difficult it is for the latter to carry out the necessary adjustment and close the competitiveness gap. Surplus economies have much to gain from a rebalancing. Furthermore, since the required adjustments need time to work through, the eurozone as a whole requires sufficient liquidity to support the adjustment process, and this must be provided to the area as a whole by the ECB and/or European stability mechanism (the EFSF-ESM). It is true that no successful rebalancing can take place without a sustained implementation by the peripheral countries of budgetary adjustments and structural reforms, but it is also evident that the euro area should contribute too.

This requires agreeing on well-identified economic policy priorities at both EU and member-state level, taking full account of the different positions of the members in terms of growth, external imbalances and competitiveness. From this perspective the new European economic governance (the so-called six-pack and European semester) has taken the right direction by seeking to extend and complement the EU's existing focus on fiscal surveillance with a macroeconomic monitoring mechanism focusing on member countries' external position and international competitiveness above and beyond budget deficits. The extension of a monitoring system similar to those governing national budgets, to the surveillance of macroeconomic imbalances with special consideration for the state of member countries' external accounts, is a very positive development. It is also very important that structural reforms aimed at boosting economies' competitiveness and growth potential be considered a top priority on the policy agenda.

Having said this, the new European economic governance devotes insufficient attention to policies capable of favouring these economic adjustments. The emerging framework remains weak in parts and incomplete in others. The new governance measures can be represented in many ways as a box of tools, some new and others reconditioned, which are potentially very useful for reinforcing economic coherence and policy coordination in the euro area – a set of tools that can be used in various ways, producing different results and impacts. It is like an economic model characterized by multiple equilibria, which can offer more solutions at the macro level, depending on how these measures are formulated. In this regard, neither the European Commission nor the European Council, despite their expanded jurisdiction and strengthened mandate, has been able to put in place procedures and policy instruments that work. These are not details, but key elements that can affect the ability to cope with the current crisis, on the one hand, and to offer a stable future growth path throughout Europe and the euro area, on the other. Central to the new mandate must be a new fiscal regime based on a symmetric imbalances procedure as outlined above. In its *Annual Growth Survey 2012*, the Commission had advocated 'pursuing differentiated growth-friendly fiscal consolidation' and had encouraged countries with strong budgetary positions to let their budgetary policy play 'their counter-cyclical and stabilizing role, as long as medium-term fiscal sustainability is not put at risk' (EU Commission, 2012).

But in its recently published first *Alert Mechanism Report*, which is the initial step in the new procedures for the prevention and correction of macroeconomic imbalances, the Commission devoted much of its limited space to the contribution that a reduction of the large and sustained current account surpluses of Germany and other northern countries may make to eurozone growth and adjustment. In other words, the European Commission's support for synchronized fiscal austerity shows that it has no intention of ensuring that the new excessive imbalances procedures are symmetric. Big trade surpluses will thus remain a powerful drag on economic activity in the eurozone and put a big obstacle in the way of the needed adjustments between member states.

Conclusion

Intra-European imbalances are due to a loss of competitiveness in the entire eurozone's periphery, stemming from both microeconomic and macroeconomic factors. A smooth adjustment of intra-euro area divergences in competitiveness and macroeconomic imbalances is key to the solution of the eurozone crisis and, more generally, to the successful and sustainable functioning of EMU in the long term. The policy of the eurozone group, however, is that this adjustment should be entirely one-sided and must fall on the debtors. This would be a recipe for prolonged recession and stagnation in Europe. Even as structural reforms are implemented, reforms pay off only in the long run, but slow or no growth in the short to medium term tends to heighten social and political risks.

Cooperation and policy coordination of some kind are needed to avoid this kind of 'beggar thy neighbour' situation. To avoid further recessionary trends in the eurozone and the potential for a major euro crisis, it is thus crucial that European policy-makers modify their policy strategy. In this respect, it is widely agreed that solving the current crisis in Europe will require immediate action of three kinds: recapitalization of European banks, strengthening of the European Stabilization Funds (EFSF-ESM) to manage liquidity and contagion effects, and a much closer fiscal integration. In addition, it is essential that member states put in place an ambitious and comprehensive policy response geared at speeding up and improving intra-euro area adjustment mechanisms. The present zero-sum-game approach will be very risky for the stability of the euro area.

Reasonable macroeconomic fiscal adjustment needs to be combined with microeconomic policy measures aimed at encouraging productivity increases (to narrow price and non-price-competitive gaps across member states). Symmetrical adjustment is crucial: increases in savings and exports in eurozone deficit countries need to be offset by equal increases in spending and imports in surplus ones. Peripheral Europe cannot possibly succeed in reducing its borrowing substantially unless surplus countries such as Germany pursue policies that allow their surpluses to contract.

Now, since the current deficits and surplus of the euro area countries are both a demand-driven and a supply-driven phenomenon, coordination of economic policies will require monitoring of both national demand (fiscal) and supply policies. It is important to emphasize the key difference between supply and demand (fiscal) policy coordination. While supply factors depend more closely on domestic structures and national policies autonomously formulated by individual countries, in the highly interdependent euro system the growth of effective demand is more closely dependent on the coordination of fiscal policies in the overall European context. New policy priorities are thus required in the eurozone that put more emphasis on cooperation in convergence and competitiveness. In this regard, the new European governance framework could fruitfully be further integrated and more effectively used than in the past.

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