SOME THOUGHTS ON CURRENT ACCOUNT IMBALANCES WITHIN THE EURO AREA

Speech delivered by Jacques de Larosière during the EURO 50 Conference, Brussels, 5 June 2019

1. The present situation is characterized by large current account surpluses in some countries of the Union, and by an increasing global surplus for the Euro area as a whole.

In 2017, the Euro area had reached a current account surplus of 3,5% of its GDP (0,6% of world GDP), i.e. the equivalent of the US current deficit ***(see Chart 1)***.

From now on, the countries that used to account for very large current account surpluses – China and Japan – only represent, each, less than 50% of the combined surplus of Germany and the Netherlands (the latter countries experiencing current surplus of, respectively, 8% and 9,8% of their GDP in 2017).

Moreover, the current account surplus of the Euro area has increased over the last years, in large part because of the economic adjustment by the peripheral countries.

The following table shows that - with the exception of France and Greece - almost all the usual deficit countries of the Union have now regained a current account surplus.

Table1 Evolution of current account positions of some countries of the Euro area

Current balances as a % of GDP	2010	2017	2018
Germany	+ 5,6%	+ 8%	+ 7,4%
Netherlands	+ 3,4%	+ 10,5%	+ 9,8%
France	- 0,8%	- 0,6%	- 0,6%
Italy	- 3,4%	+ 2,8%	+ 2,6%
Spain	- 3,9%	+ 1,8%	+ 0,8%
Portugal	- 10,1%	+ 0,5%	- 0,6%
Greece	- 11,4%	- 2,4%	- 3,4%
Ireland	- 1,2%	+ 8,5%	+ 10%
Euro area	- 0,1%	+ 3,5%	+ 3%

Source: IMF – World Economic Outlook April 2019.

2. How can one explain such an evolution ?

2.1. World macro-economic factors

a) The strong propensity to consume in the US

This is a traditional feature of the international monetary system.

It has been recently boosted by the Trump Administration fiscal policy, which has added fiscal stimulus to the US domestic demand, and, therefore, contributed to increase the country's current account deficit.

b) The fact that the Euro area has gradually emerged as one of the largest sources of world savings

The *Chart 1* illustrates this major macro-economic trend.

2.2. Country specific factors

One can underline the growing specialization of manufactured exports from high current account surplus countries like Germany and the Netherlands.

In a monetary area in which levels of competitiveness are inevitably heterogeneous, the stronger countries in terms of industrial tradition, low production costs, high capital and sound macro-management, tend to become more and more efficient.

Indeed, the average rate of the common currency (given the impossible currency adjustments inherent to the existence of the monetary area) is the result of the market views on the global competitiveness of the area. Therefore, countries with low costs and high competitiveness, like Germany, take advantage from the average valuation of the Euro.

It has been calculated that the "German Euro" is undervalued by 15% to 20% (in real effective exchange rate), in relation to the peripheral countries of the Euro area[1].

This phenomenon is, by definition, boosting German exports and compounding present disparities in terms of current accounts.

2.3. Lastly, the substantial adjustment realized, since the crisis, by peripheral countries has increased the global surplus of the Euro area

The following table shows the magnitude of the adjustment: cost reduction and compression of domestic demand have changed current accounts.

	Adjustment (in points of GDP) from 2010 to 2017-18
Spain went from a current deficit of - 3,9% / GDP in 2010 to a surplus of + 1,3% in 2017-18 (average)	5,2
Portugal went from a current deficit of - 10% / GDP in 2010 to balance in 2017-18	10
Italy went from a current deficit of - 3,4% / GDP in 2010 to a surplus of + 2,7% in 2017-18	6,1
Greece went from a current deficit of - 11,4% / GDP in 2010 to a deficit of - 2,9% in 2017-18	8,5
Ireland went from a current deficit of - 1,2% / GDP in 2010 to a surplus of + 9,2% in 2017-18	10,4

[1] See CEPII letter February 2018: « The unpleasant arithmetic of Eurozone imbalances » by Guillaume Gaulier and Vincent Picard.

The considerable improvement in those peripheral current accounts can be explained by three major factors[2]:

- Firstly, the compression of domestic demand (result of fiscal discipline) and, thus, of imports;
- To a lesser degree, cost reductions have helped exports to become more competitive;
- The reduction (except in Greece), of "protected" sectors (services not subject to competition) versus manufactured exports.

3. Why is such a situation problematic?

At first glance, one could look at these imbalances within the Euro area as a rather normal situation:

- They are the manifestation of economic disparities that are not uncommon in monetary zones (in the USA one can also observe sizeable current account imbalances between different states);
- These imbalances allow "net importing countries" to take advantage of low import prices which thus improve their purchasing power;
- Deficits can be "virtuous" in so far as they allow "southern" countries to attract foreign capital in productive sectors, hence contributing to strengthen, over time, productivity, potential growth and the balance of payments;
- Such imbalances are normally financed by offsetting capital movements: surplus savings of the North moving to the South (we will see, however, that this rebalancing is thwarted in Europe).

On a more general plane, one could argue that if the financial international system is sufficiently open and integrated to allow massive transborder flows of savings, some countries could accumulate, for long periods of time, current account deficits without being compelled to adjust[3].

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But that is not enough to deal adequately with the issue.

Here are a few additional thoughts.

a) <u>Even in an environment of free capital movements, the need to adjust does not disappear</u>

Empirical observation shows that the working of the principle of balance of payments financiability (cited above) depends on the solvency of countries that are net importers of capital. If a country runs for a long time an "unsustainable" current account deficit (ie a deficit that does not allow, in the future, to contain at an acceptable level its ratio: net external debt / GDP), such a country will inevitably see its "solvency" disputed by the markets, and thus will have to adjust its current account by stimulating domestic savings. It goes without saying that the more "virtuous" are the deficits (ie caused by productive investments generating future cashflows) the less the solvency constraint will manifest itself.

b) <u>In fact, the massive current account deficits of the periphery up to 2009 had not been « virtuous » in terms of their contribution to the catching up process of their productive sector</u>

These deficits were essentially caused by a very strong growth in domestic demand which intensified during the years 2000-2009 because of different factors:

- Excessive expansion of credit (especially in the real estate sector);
- Fiscal stimulus (that led to large budgetary deficits);
- And a growth in wage costs well above that of "core" European countries.

The expansion of unit labor costs has triggered a "demand shock" in the sectors that were sheltered from international competition (notably the construction bubble). This fostered current account deficits through higher imports (Ireland, Greece, Spain). The overheating was concentrated in the sheltered sectors which had grown more rapidly than the tradable ones. The result was a relative shrinking of unprotected sectors, a significant over-indebtedness of the sheltered parts of the economy as well as a massive current account deterioration. Eventually, markets reacted to those external deficits and imposed much higher spreads after 2009.

c) <u>The current surpluses of Germany, and of the whole Euro area, are the manifestation of large underlying imbalances</u>

When the IMF had still some authority in this field, and when free capital flows were less powerful than today, current imbalances exceeding 4 to 5% of GDP, were considered as "fundamental", and called for a rapid correction in a context of protracted and deep imbalances: growing distorsions between countries and solvency issues eventually threaten the survival of the system and require adjustment.

d) <u>In older days, a significant undervaluation of the currency of a country running a high current account surplus would have triggered immediate reaction from the IMF</u>

The co-existence of undervalued currencies and large current account surpluses can create, or increase, competitive advantages and thus introduce distorsions in the working of international trade. This reminds us of the "beggar thy neighbor policies" of the 30's.

No system (and even the present "non-system") can tolerate such exchange rate distorsions for a long time.

e) <u>It might be objected that the situation has completely changed and that the existence of the Euro area renders obsolete any consideration related to a national « virtual » currency of any member of the Union</u>

[2] See Joaquim Oliveira Martins and Dominique Plihon: « Déséquilibres des balances des paiements de la zone Euro. Où en est-on ? ».

[3] See Joaquim Oliveira Martins and Dominique Plihon: « L'impact des transferts internationaux sur les déséquilibres extérieurs » - Banque de France Economie et Statistiques Année 1990.

In such a perspective, the only current balance to be considered is the one of the entire Monetary area. And at 3-3,5% of GDP, the Euro area surplus is well below alarming levels.

But such an argument does not seem convincing. While there is a Monetary Union with one single currency, it is also true that the different nations remain responsible for their own balance of payments.

Indeed, the "no bail out" clause of the Maastricht Treaty calls on each member country to correct unsustainable positions. So, if some members of the Euro area were to reach extreme imbalances (surpluses or deficits), it would be up to them to adjust[4].

It is so true that those members of the Euro area that had experienced massive (and unsustainable in the long run) current account deficits during the years 2000, were forced (under the pressure of the crisis and of high market spreads), to regain equilibrium after 2009-2010, by taking strong adjustment measures ("internal devaluations").

The result of all this is that permanent surpluses, when they reach "fundamental" levels especially when they are not accompanied by "virtuous" deficits in neighboring countries, call for a "symmetric adjustment" ("internal reevaluations") which is always required by any international monetary system.

One can add that the lack of trust between member states, caused by macro-economic divergencies in the years 2000-2009, as well as by the fragmentation of the Banking Union ("ringfencing") explains that "Northern" countries are not inclined to invest their surpluses in the South and thus to facilitate the financing of external imbalances in the Union. The paradox of the Euro area is that large savings surpluses are invested outside the Union!

f) <u>The international importance of this issue is particularly significant</u>

We have stressed above that fundamental imbalances based on misaligned exchange rates are a major problem for any international monetary system.

If Germany had not been a member of the Euro area:

- The massive surplus of savings over investment in that country,
- as well as the strong world-wide demand for riskless German Treasury instruments,

would have resulted in a significant appreciation of the DM on the markets.

If that strength of the "virtual" DM does not trigger a corresponding upward movement of the Euro, it is because other countries of the area are considered by the market as rather weak (structural problems, lagging growth, poor competitiveness, high public debt …).

This "viscosity" of the Euro can only compound the German competitiveness issue.

But this "undervaluation" of the "notional DM" raises an international issue. The USA will probably not remain passive spectators if the situation were to last. Protectionist reactions against Europe are to be feared, and are already announced.

That is another reason to start dealing with the issue.

g) <u>A surplus of savings in relation to investment can be a real problem</u>[5]

Let us consider the situation of Germany.

Chart 2 shows how this country has developed a very significant current account surplus since the early 2000's.

This surplus has obviously strengthened the financial foreign position of Germany, but it also displays problematic aspects.

Indeed, a surplus of savings can either reflect an abnormally high level of savings or a lack of investment. In fact, both factors are at play in the case of Germany.

Chart 3 shows that the level of German savings (29% of GDP) exceeds that of the majority of other countries of the Union (around 24%).

This results in a considerable reliance of the German economic growth rate on exports. Exports represent 50% of German GDP against 32% for the other members of the Union ***(see Chart 4)***.

But there is also a weakness in German investment.

Chart 5 shows that the investment rate in Germany (21% of GDP) is particularly modest when compared to other members of the Union (around 24%).

In this respect, ***Charts 6 and 7*** show that public investment is weak in Germany, which is also the case of total corporate investment (12,5% of GDP against 14% for the other European countries of the Euro area).

This is a source of difficult problems for the future potential economic growth rate of Germany while demography is declining.

We have to understand the demographic argument.

It is generally observed that a rapidly ageing country like Germany has a tendency to consume less and to save more in order to prepare for retirement. Later on, when retirement takes place, households dis-save in order to offset their lower income after retirement.

But that does not mean that the surplus of savings should necessarily be:

- Extreme (8% pf GDP);
- Almost entirely invested outside of the Euro area;
- And accompanied by a significant deficit of domestic infrastructures.

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[4] Even in an integrated financial market, the need for adjustment does not disappear. Market benevolence will eventually depend on "fiscal solvency" of defined countries (including USA). See J de Larosière: « The demise of the Bretton Woods system explains much of our current financial vulnerabilities » - London School of Economics January, 31st 2019.

[5] This paragraph draws heavily on Patrick Artus Flash Economie - NATIXIS, 18 March 2019.

h) A word on franco-german balances: structural issues do matter

We have seen above that France is continuously running a current account deficit ***(see Table 1)***.

In France - as compared to Germany – the industrial base has been disproportionally hit by the opening of trade to emerging markets.

The manufacturing sector has significantly weakened and only represents 10% of GDP, half the European average, and much less when compared to Germany.

The result is twofold:

- Vis-à-vis Germany, there has been a "conjonctural" shock: more domestic demand driven growth in France, and more export driven growth in Germany. This has led to a deterioration of the bilateral French balance with Germany;
- But there has also – and more fundamentally – been a "structural shock", because the French manufacturing base has shrunk in comparison with that of Germany, as a result of structural competitive problems (small margins, too high taxes and social contributions).

Therefore the "rebalancing" between the two countries cannot be achieved by a classical "fine tuning" of the policy mix. Any fiscal stimulus engaged by France to increase growth will, predominantly, push up imports (because of the lack of a proper industrial base) instead of French production.

The current imbalance between the two countries is bound to continue to deteriorate in terms of the French deficit with Germany, except if France were to engage in a true «supply side» set of structural reforms.

4. What to do?

One could be tempted to tell the peripheral countries something on the following lines:

« You have not yet lowered your costs sufficiently. If it is true that the "German Euro" is undervalued by 15 to 20%, it is your duty to intensify your efforts and to further reduce your costs by approximately 20% (for example, you could achieve this objective by keeping for 10years your yearly inflation at a level of 2 percentage points less than in Germany) ».

Such a recommendation was perhaps justified in the years when the costs in the South (notably wages) were increasing much faster than in the North, and when Southern current accounts were showing large deficits.

But today such a prescription does not seem warranted:

- As we have already seen, almost all countries of the South have regained balance or even surplus in their current accounts (in part because of efforts made to moderate labor costs). Thus, in terms of flux (capital movements) the situation has normalized;
- Would it be logical to impose on these countries 10 more years of austerity so that they can match exactly the German level of costs ? such a policy would only increase the surplus of the Euro area and depress the periphery. That is where we have to avoid fundamental mistakes.

I am not saying that peripheral countries should stop adjusting.

On the contrary, I believe they have to intensify their structural reforms.

And we should not forget that the outstanding amounts of their debt are the result of years of deviations[6]. Those accumulated amounts will have eventually to be reduced to more normal levels. But this can only be achieved in a long-term framework lest one would provoke too significant a slowering of domestic demand that would endanger growth, which - after all - is the key to financial normalization.

In any case, it would not seem justifiable to ask such peripheral countries to be the only ones to adjust and to suffer 10 more years of internal devaluations, just to align their costs and their indebtedness on those of countries running "fundamental surpluses"[7] who would thus be exempted – without reason – from any corrective action and whose savings model cannot (and should not) be replicated elsewhere.

The effort should be shared. If not, populism could prevail.

As a result of this reflexion, it seems that the countries that have accumulated large current account surpluses should also take their part in the rebalancing of the current account of the Euro area. A few possible avenues can be suggested:

- A commitment to increase infrastructure investments in Germany (expenditures that have been delayed for too long)[8];
- An agreement on a more equitable balance of responsibilities and financial duties regarding defense and security in Europe;
- The rapid enforcement of financial solidarity in the context of the Banking Union.

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[6] One should note that imbalances in terms of outstanding debt should not be dealt with on the same scale of adjustment as for flow imbalances. Indeed, the "repair" of ongoing deficits reassures the market. But in an environment of low interest rates, one can justify a much longer time horizon for outstanding debt.

[7] See article CEPII already mentioned: « Current account imbalances in the Euro area. Where do we stand ? ". Just a quote: « Given the low inflationary environment in Europe, the fall in relative costs in the non-tradable sector could increase a deflationary risk ».

[8] The German budgetary surpluses have brought back the outstanding public debt of that country to 60% of its GDP (Maastricht norm).

Conclusion

We all know that in a Monetary Union, national economic policies have an impact on the other members as well as on the Union as a whole.

This is the reason why coordination of macro-economic policies is on the essence.

It is honest to recognize that such coordination has failed until the explosion of the sovereign debt crisis of 2009-2010.

In the wake of the crisis, the "Macroeconomic Imbalance Procedure" (MIP) was established alongside other reforms.

During the ten first years after the creation of the MIP[9], the Union has identified a large number of countries as affected by such large imbalances.

But we must also note that the Union has never suggested to trigger the corrective clauses contained in the MIP.

The objective is not to criticize surplus countries but to show that present growing imbalances are the symptom of underlying problems and that prolonged inaction can lead to an impasse or to serious tensions.

It would be a mistake to believe that such imbalances can last for ever and that capital markets will always be there to finance them ***(see Chart 8)***.

Let us not forget the solvency (and liquidity) constraint that limits access to financial markets as we always rediscover whenever a crisis breaks out.

And let us not forget either the constraint on the external acceptability of massive and durable surpluses (***see Chart 8)***.

In fact, in a monetary zone that has chosen to deal with balance of payments on a national plane, the existence of large current account imbalances within the Euro area raises a serious challenge in terms of macro-economic adjustments.

We should not remain passive while facing this situation.

In this regard, the present absence of any initiative under the excessive structural imbalance procedure seems difficult to justify.

The survival of the Eurozone calls for more symmetrical adjustments, which could, in turn, strengthen confidence and growth.

Obviously, the issue raised in these pages is all the more difficult to handle that capital flows within the Union are, in fact, blocked.

If capital emanating from surplus countries were channeled towards deficit (but adjusting) countries, the situation would be different:

- In the short term, we would see an increase in the level of investment in Europe;
- In a longer term perspective, it has been calculated that the European growth potential could increase by 0,3 percentage points a year[10].

In other words: « If the Eurozone were a true currency area, Germany's excess savings would be less of a problem, as they would finance investments in the rest of the Eurozone and would not weaken the zone's growth » (Patrick Artus).

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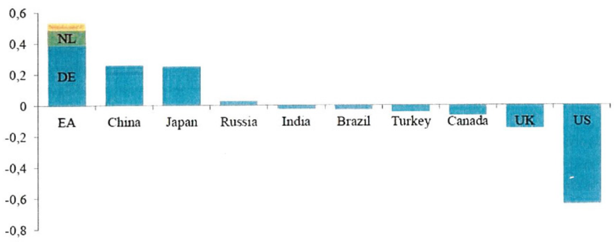
[9] This procedure now encompasses - as it should - the current account imbalances. But the decision discarding the procedure as long as current surpluses are not more than 6% of GDP during two years in a row, seems questionable.

[10] The « loss » of investments emanating from the leak outside of the Union of surplus capital amounts leads to a reduction of 1 percentage point in the accumulation of capital per year (therefore, given the 0,3 elasticity of GDP/capital), potential growth would be reduced yearly by 0,3% per year.

ANNEX

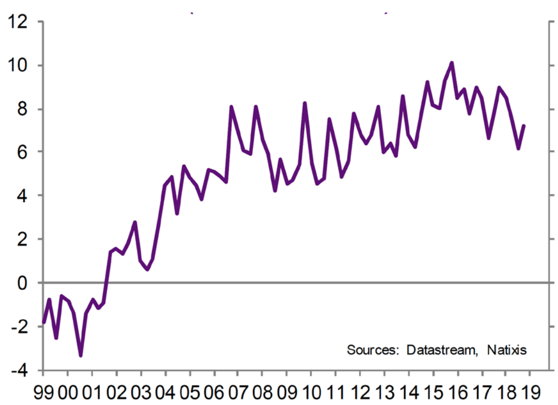
Chart 1 The current account in 2016 as percentage of global GDP



Source: Calculations based on IMF Data Mappe

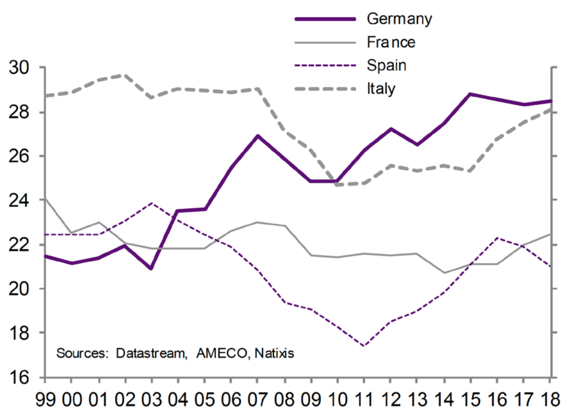
The European current surplus dominates world imbalances

Chart 2 Germany: current account (as % of GDP nominal)



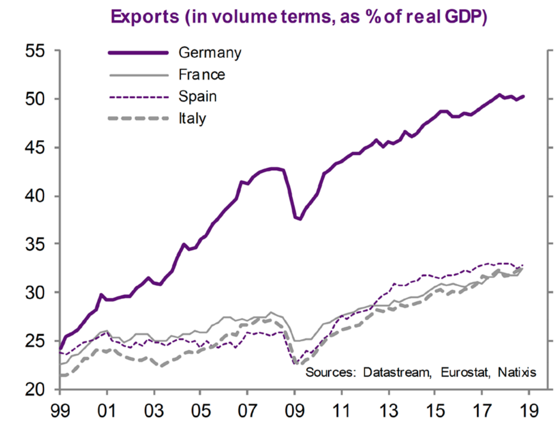
Germany: A massive surplus of savings over investment

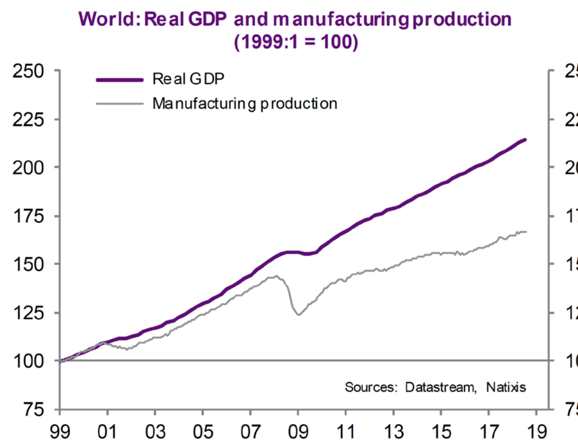
Chart 3 Savings rates (as a % of nominal GDP)



Germany: an unusually high level of savings

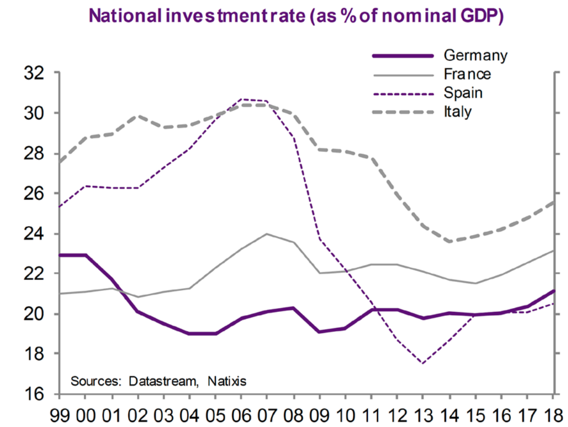
Chart 4 Exports





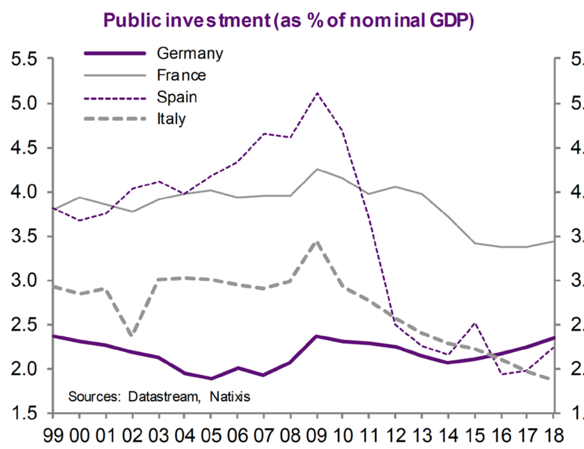
Germany: dependent on exports

Chart 5 Investment rates (as a % of nominal GDP)



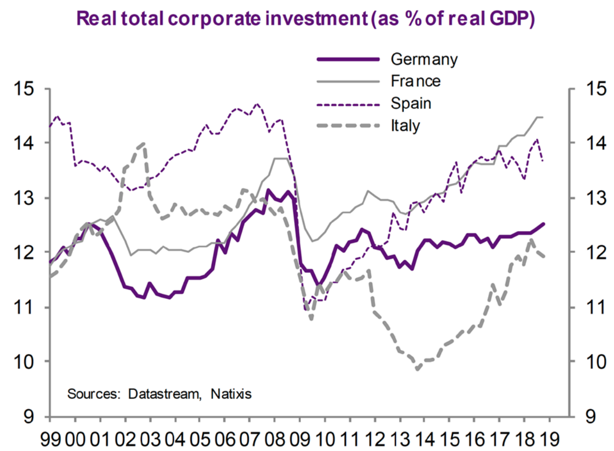
Germany: weak level of investment

Chart 6



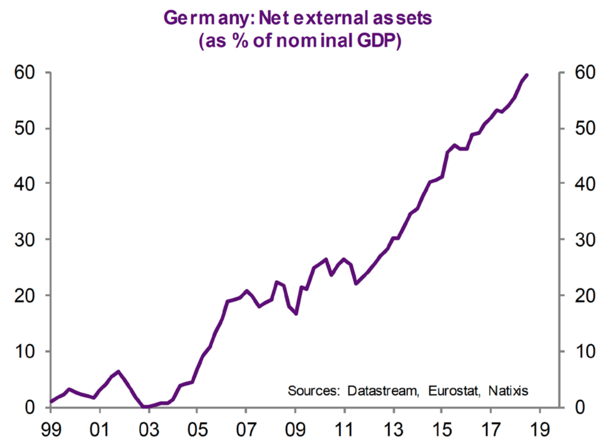
Germany: weakness of public investment

Chart 7 Corporate total investments (% of volume GDP)



Germany: weakness of total investment

Chart 8 Germany: net foreigner assets (as % of nominal GDP)



In spite of the accumulation of net foreign assets, Germany does not experience an appreciation of its exchange rate because of the Euro.