External imbalances and the governance of the eurozone

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The plight of the eurozone is far from being over. The economic growth of this area has been barely above zero in 2014 and debt deflation is increasingly a daunting worry for policy-makers. Such a dénouement would be as risky as the menace of a financial meltdown of a few years ago.

This fact is pretty relevant for the world economy too since the European Union holds a large chunk of the global GDP and of world trade. President of the ECB Mario Draghi's assertion in August 2011 that whatever it takes will be done in order to save the common currency, seems to have produced a wonder until now. But the exit from deep troubles is still to be made. There is a widely shared view that the design of the euro area was flawed institutionally and policy-wise. This reality has been amply illustrated by a crisis that cannot be ascribed exclusively to budget profligacy in several member states and the extent of wrongdoing in finance. The institutional flaws of the euro area combine with a less fortunate crisis management exercise in explaining its very difficult current state.

Recent years have brought to the fore a salient feature of the eurozone and of the global economy: the current account surplus of Germany, with an ensuing debate on its impact on neighbouring economies. This surplus was c. 7% of its GDP in 2013 (which was slightly higher than in 2012 according to IFIs and the European Commission data[1]) and the figure for this year is seemingly nearby; at about 200 billion euros, it was the largest in the world[2]. Germany is a formidable export machine, maybe the best performing in the global economy in view of the range of and the value added contained by its manufactured goods. The criticism some analysts make as to what underlies this performance, such as suppressed wages[3], can give food for thought, but cannot obfuscate a formidable capacity to generate exports.

Is this surplus a problem? Does it matter for the level of aggregate demand in the eurozone and further, in the global economy? Especially now, when there is such a marked inability to grow in the largest economies of the euro area and debt deflation is a real threat. A response to how much this surplus matters can be given in broad terms, or by looking at the euro area in particular.

A global perspective

A surplus has a corresponding deficit among partners; an accounting identity operates here. If surpluses and corresponding deficits would vary cyclically, alternating in the external accounts of trading partners, high imbalances would be avoided over time. Otherwise, the very functioning of trade and the funding of deficits would be put under strain. The exchange rate is a key tool in the adjustment of imbalances. Floating, or adjustable exchange rates (as were predicated by the Bretton Woods arrangements) are meant, together with monetary and fiscal instruments, to enhance the correction of large external imbalances. One has to make a distinction between real and nominal exchange rates, with the former considering price movements.

A legitimate question arises: why large imbalances appear and what lies behind their persistence despite corrective mechanisms? Likely answers are: a country can undertake a massive effort at paying back debts over a period of time; a country benefits on a stellar constellation of circumstances that make it excel in innovation, industrial prowess, the constant rejuvenation of its competitive advantages; the trading partners do not have the room, at least for a while, to undertake a corrective action of their deficits. It goes without saying that being a constant creditor does not make sense for a surplus country unless this status extracts other benefits, not necessarily of a commercial nature. But which country would accept to make a permanent transfer of resources to the rest of the world via a trade surplus?

It could be the case of a 'hegemon', which could be endowed with a remarkable and unmatched economic and technological power and which could be interested in maintaining an international order that suits its interests. Such a situation brings the discussion in the realm of geopolitics. The US could be seen under this light after the end of the Second World War, when a dollar hunger prevailed and the Marshall Plan was part and parcel of the strategy of reordering the post-war western world and containing the communist bloc. Later on, nonetheless, the US delinked its currency form gold and had to resort to its printing press in order to fund large military operations abroad. And closer to our times, its external balance has turned negative. The exploitation of shale gas and the prospects for the US of becoming an energy net exporter may turn its external balance positive again eventually.

The case of paying back debts would involve not condoning an appreciation of the own currency as a means to bolster exports and contain imports. Trading partners could tolerate such a policy conduct when there is a mutual interest in settling debt matters. Excellence in innovation, in creating competitive advantages, puts pressure on trading partners,

which may be forced to try to devalue their own currencies as a policy response. Structural reforms which should enhance productivity gains may also be a venue for keeping up with competitive pressures. When trading partners do not have policy room for correcting massive imbalances, they are likely to go through painful balance of payments crises. This is not an uncommon occurrence around the world.

There could also be a case when a country keeps its currency undervalued steadily by betting that, in such a way, competitive advantages would be created via tradable oriented resource reallocation and intensive assimilation of new technologies (as an outcome of export expansion)[4]. In this case, short term income losses (due to currency undervaluation) are accepted for the sake of greater benefits over the longer term which result from dynamic productivity gains. Not a few Asian countries pegged their currencies to the USD in order to grow economically through export expansion. And they were quite successful.

One has to say that such a strategy demands very intensive assimilation of knowhow and steady upgrading of own exports. Asian countries' temptation to keep their currencies undervalued was boosted by the crisis of 1997/98; they realized that the international regime is quite destabilizing because of large and volatile, speculative capital flows and that it pays to build up foreign exchange reserves, that there is premium on holding large reserves as a means to fend off adverse shocks[5].

This said, however, there are limits to how much emerging economies can mitigate the pains of massive capital in- and outflows. Even wisely calibrated capital controls can be of little help when big central banks do not heed the externalities their operations create in the world economy. This is what Helene Rey has in mind when saying that the 'impossible trilemma'[6] is essentially a 'dilemma' in small economies, under the circumstances of volatile capital flows[7].

When a country is heavily export-oriented (as Germany is) the propensity to use net exports as a vehicle to stimulate domestic economic activity is pretty high – especially when recession is spreading around, as it has been the case in most of the industrialized world after the current crisis erupted. A big problem with such behaviour is that it invites 'beggar thy neighbour policies', namely, policies that harm partners reciprocally.

The reason is simple: partners would try to replicate the same conduct, and a destructive race to the bottom would take place. A caveat needs to be made however in this regard. Countries are not similar in economic terms and, therefore, their response tools are not similarly effective. The countries that hold more technological power are also stronger commercially, and they are likely to win more, or to lose less, from a currency/trade war. Germany, the Netherlands, Austria, Denmark, Sweden, are European economies that belong to this category; for both big firms and highly specialized SMEs which are active in niche markets.

The bottom line is that currency and trade wars, however carefully waged they are, are doubled edged; it is better to avoid them. This is the rationale behind the search, during history, of trade and currency agreements, which should foster international economic exchanges. International institutions and analysts remark that Germany's large external surplus (out of which above 70% is obtained outside the euro area currently) damps global aggregate demand in a period of much subdued economic activity in Europe[8].

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For its part, German officials retort that their country's public debt has grown to above 80% of GDP in an ageing society, that its strategic objective is to balance the books, which sounds fine prima facie. This choice shows up inevitably in external accounts (since domestic saving is considerably higher than domestic investment[9]) and impacts economic activity across borders. A central policy issue is how to reconcile over-indebtedness, which limits the appetite of many firms and families to borrow, with the need to bolster aggregate demand in order to fend off debt deflation. This is a huge conundrum for policy-makers who are sailing in uncharted territory and resorting to unconventional means.

A European perspective

A big problem in the euro area is that for economies that are less competitive and register trade imbalances on a recurrent basis two key tools for correcting external imbalances are no longer available – the exchange rate and own monetary policy. At the surface, the euro area seems not to have a problem in this respect since creditor countries' surpluses more than compensates other member states' deficits. As a matter of fact, the euro area has a surplus vis-à-vis the rest of the world[10]. But the single currency area is hardly a genuine monetary union, which should temper worries about external imbalances among member states. The reason is that the euro area is lacking proper fiscal underpinnings, which should take care of asymmetric shocks.

Daniel Gros notices that The Netherlands, Norway, Sweden, Switzerland, also have substantial external surpluses[11]; he talks about a 'Teutonic' cluster, whose economies have been running trade surpluses for years now. But Norway is not a EU member state, and is a big oil exporter, while Sweden and Switzerland are not in the euro area. Moreover, the latter country has put a ceiling on its currency of 1.20 to the euro, which suggests a mercantilist stance. Not to mention that the sheer size of Germany's economy after reunification puts it in its own league and creates a peculiar situation for the effectiveness of one size fits all policies in the euro area.

Once the euro area crisis erupted, bond yields differed increasingly among member states, investors fleeing the paper of afflicted issuers and favouring more and more German bonds. These differentials came down again only following the start of the ECB's special operations. Eventually, the ECB decided to act as a de facto lender of last resort, although its statutes would not allow such a function. But is it surprising that such a task should be in the mandate of the ECB in a monetary union, be it an incomplete one?

In the last couple of years, internal devaluation, via drastic cuts of incomes (wages) did take place in various member states (Ireland, Greece, Spain, and Portugal). And this has helped the substantial reduction of external imbalances. But this method puts economic and social structures under enormous strain. It is hard to assume that internal devaluation can be the main tool for correcting imbalances in the euro area. And if structural reforms, which are time consuming, do not raise economic growth rates soon enough, so that the burden of private and public debts be mitigated, a backlash can ensue. Debt deflation has already turned into a major threat for the euro area. Inflation has come down constantly in recent years, at 0.3% annually in November 2014 for the whole area; several countries (Slovenia, Spain) already witness deflation.

Higher public debts and very large private debts, high levels of non-performing loans in banks' balance-sheets ask for a wider range of correction mechanisms, including, arguably, debt restructuring. Bailing in schemes are part of new means of dealing with high indebtedness and trying to protect taxpayers' money. The attempt to sever the link between banks balance-sheets and sovereign debt has not succeeded so far and it may be a futile endeavour if the objectives are not realistic. For, however damaged the reputation of some member states may be, banks would likely continue to place sovereign debt among preferred assets. A stark fact is that the only taxation power rests with governments. And it is still too early to think that the Banking Union can be the definitive solution to euro area's troubles.

What impedes a new design of the euro area when it comes to its governance and institutions? First, it is arguably a train of thought regarding the roots of the crisis, which puts emphasis on public indebtedness. But this is in contrast with the cases of Spain, Ireland and other countries where it is private borrowing that has brought about the bigger troubles. And if one accepts it, then a legitimate question relates to what central banks and other regulators and supervisors did in restraining the growth of private debt. How did commercial banks assess the risks incurred by funding rising private indebtedness in the countries which ended up with large external imbalances? Not least, the suboptimal character of the single currency area combined with markets' myopia in causing failures of all sorts. Therefore, a proper analysis of the causes of this crisis needs to be much more nuanced in order to build adequate policy responses, corrective measures.

The one-sided adjustment of large imbalances, which may involve unavoidable austerity, is not sufficient and can engender pernicious effects; further sinking economies into recession and debt deflation are among such effects. It is very much true that public mood among citizens in creditor countries should not be underestimated. There are also legal and constitutional reasons which do play an important role in this equation. But the crucial explanation lies with the interpretation of the root causes of this crisis. There is over-indebtedness of public and private sectors in most of the EU countries, which, clearly, restrains credit demand. But the way the eurozone does function is no less important.

The Banking Union is an attempt to reorder things, address and redress the flaws of the Monetary Union and, consequently, find a way out of the mess. There is undeniable progress scored until now with the creation of the Single Supervisor Mechanism, the setting up of national resolution schemes. However, much more needs to be done. The joint Resolution Fund, which is meant to help recapitalize banks, or help wind them down in an orderly fashion, is much to small (55 billion euro) as compared to banks' balance-sheets, and its coming into being is far-fetched – in 2024. And deposit insurance schemes remain national. What matters in the end is what member states are willing to stake together. Which means that, for the foreseeable future, countries will have to use, basically, their own resources. The ECB will be around to intervene as a lender of last resort, and its operations could be critical to forestall things getting out of control. But is it sufficient for the longer term?

The description of the euro area sketched above suggests that the focus on external imbalances needs a broader framework for analysis. The German external surplus mirrors exceptional industrial and trade capabilities, the capacity of a social and institutional model to mobilize internal resources for change, to undertake adjustment under duress (as it did happen after reunification and during Chancellor Schroeder's mandate). But the way the euro area has been functioning from its start made the euro operate as an undervalued DM (which bolsters exports and discourages imports, creates jobs, etc) and an overvalued escudo, drachma and peseta.

Adjustments have taken place in the last couple of years and, Spain, for instance, shows an external surplus this year. But these corrections have taken place primarily via a drastic compression of internal demand in those economies and not by a surge of net exports. This is also shown by the level of unemployment. Moreover, the new governance structure in the euro area/the EU, for monitoring imbalances (the European Semester, the Fiscal Pact, the Excessive Deficit Procedure, etc), be it useful, is quite complicated and cumbersome to implement[12].

More important is that the policy mix in the euro area has not matched expectations. And data is quite revealing in this respect. In 2014, the euro area has been coming close to a new recessionary phase. Quite worrisome is that Germany, which is its economic locomotive, has been slowing down. The sanctions on Russia have probably taken its toll, but more is at work in explaining the inability of the single currency area to recover. And economic stagnation is liable to foment social strain further, continue to fuel the rise of extremist political groups. Not least, the very survival of the European project could be tested. This is the broad picture under which the thrust of current policies in the euro area have to be judged.

If the euro area had not existed the German surplus would have pushed the DM toward steady appreciation, as it constantly did during the decades of German economic miracle, after the Second World War. The same would have happened with the Dutch and, maybe, other currencies. But now, the fracture between the North and the South in the euro area can have very deleterious effects unless its institutions and governance policies change. Recent years' internal devaluation in Ireland, Spain, Portugal, and Greece have diminished their external imbalances dramatically. But does it change the essence of the problem? Are such adjustments the path to follow in the future for whichever member state gets into trouble? Is such a process sustainable socially and politically? Because one has to consider that economies do not have the same capacity to absorb shocks.

The unemployment rates are quite ominous: in Germany it is below 6%, in Austria similarly, while it is above 20% in Spain and Greece; in these latter countries external imbalances have been internalized via internal devaluation. A union that does not have

tools to combat asymmetric shocks is prone to go from one crisis to another. This dramatic situation prompts the EC officials to demand symmetric adjustments in the euro area, which is a diplomatic language of saying that the countries which have fiscal space should buttress aggregate demand at the euro area level. A fiscal capacity, as suggested also by the president of the European Council, Herman van Rompuy, does make sense in a monetary union.

Conclusion

The euro area needs a new design and policy arrangements which should fit a genuine monetary union. The way it does function now resembles more the gold standard regime of the interwar period and this should be quite alarming, for we know what that international policy regime contributed to. The talk about a looming economic stagnation ('secular stagnation', as Larry Summers put it)[13] in Europe is motivated by a very serious situation, ominous data. Unconventional monetary policies aimed at breaking the deadlock of the transmission mechanism need to be combined with bold public investment policies which should prop up aggregate demand at the euro area level and enhance chances for longer term recovery.

Such a fiscal-monetary policy mix at the euro area level would make it easier for Italy and France to advance with structural reforms while pursuing their fiscal consolidation programs more firmly. More stimulus at the euro area level must be accompanied by structural reforms as a senior partner. What the new head of the European Commission, Jean Claude Juncker, has announced is a public investment program of several hundred billion euros is a major step forward that can give some hope.

However, it is not clear how much of it is going to be actual new money, or it will mostly provide public incentives and guaranties in order to entice private investment. Mario Monti, a former Prime Minister of Italy and European Commissioner, rightly points out that, when funding is so cheap and basic infrastructure is in dire state, it is more than justified to undertake investment via public borrowing[14].

The EIB could be the conduit for funding such a program, which would be of much assistance in those economies that meet biting fiscal constraints. The involvement of the private sector in the whole investment scheme would help pursue good projects. At the same time, symmetric adjustments need to become a rule of the game in the euro area, which brings external imbalances and their connection with national policies to the fore.

Ottmar Issing, formerly Chief Economist at the ECB, sounds commonsensical when he portrays Germany's macroeconomic situation on its own. Nonetheless, what may look optimal at a national level may not be optimal for the euro area as a whole[15]. And this is arguably the crux of the matter right now. The president of the Bundesbank, Jens Weidemann is right to emphasize the principle of 'individual responsibility', as it is enshrined in the Maastricht framework, and which means that 'sovereign, banks and investors bear the consequences of their decisions'[16]. Structural reforms fit the logic of individual responsibility fully. But, however responsible national policies may be, a union still asks for a lender of last resort and tools for dealing with asymmetric shocks. All eyes are on Germany to take the lead when it comes to better policy coordination in the euro area.

External imbalances in the euro area are a facet of the challenges the management of the euro area crisis is encountering. These challenges are compounded by the need to continue reforming finance and repair banks' balance-sheets without undercutting the efforts to enhance economic recovery. Unless the governance of the euro area improves considerably what Olivier Blanchard calls 'dark corners' will likely engulf it[17]. To paraphrase Mario Draghi, whatever is needed to avoid debt deflation should be made. ■

The views expressed in this article are to be seen as his own.

1. See also "Macroeconomic imbalances: Germany 2014", European Economy, Occasional paper 174, European Commission, Brussels, March 2014
2. The German current account surplus has gone up since the inception of the eurozone in 2001 and its level held above 6% of GDP since 2006.
3 Philippe Legrain, "Germany's economic mirage", Project Syndicate, 23 September, 2014
4. Robert Wade, Alice Amsden, Lance Taylor are among those who have emphasized the role of exchange rate policies in fostering competitive advantages in several Asian economies. Dani Rodrik is also known for highlighting 'non-conventional', including industrial policies, as a means to foster competitive advantages. These policies were at odds with the so called 'Washington consensus' which extolled the virtues of speedy trade and financial liberalization.
5. For an analytical presentation of the destabilizing function of volatile capital flows see also Joseph Stiglitz's "Contagion, liberalization and the optimal structure of globalization", Journal of Globalization and Development, vol.1, 2, 2010, pp. 1-44
6. Which says that autonomous monetary policy, free capital flows and a stable exchange rate cannot operate simultaneously.
7. Helene Rey, "Dilemma not Trilemma: The Global Financial Cycle and Monetary Policy Independence", Global Dimensions of Unconventional Monetary Policy, proceedings of the 2013 symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole28-30 August, pp.285-335
8. China's external surplus has been declining from c. 10% of its GDP in 2007 to about 2% currently. This may reflect an attempt to rely more on domestic consumption in supporting its growth rate.
9. Domestic investment has come down in Germany to c. 17% of GDP lately (from an average of 21% of GDP during the past decade/Eurostat data).
10. In 2014 the current surplus of the euro area has been running at c. 3% of its cumulated GDP. And one finds here an explanation for the high level of the euro against the USD in the last couple of years, though a drastic correction has occurred during 2014 – to below 1.25 to 1USD in late November from above 1.34 in the first half of 2014.
11. Daniel Gros, "The German Scapegoat", Business Standard, 24 December, 2013
12. Germany's external surplus in 2013 would have had to trigger a procedure for dealing with an excessive imbalance – as according to the EU rules. Although one could argue that the German surplus with the rest of the euro area is considerably below 6% of its GDP.
13. Larry Summers resuscitated Alvin Hansen's concept of 1938 in order to underline structural trends that may have diminished the growth potential of industrialized economies ("Crises Yesterday and Today", speech at the IMF 14th Jacques Polka annual research conference, November 2014
14. Mario Monti, "We saved the euro from the markets, now save it from the governments", Financial Times, 9 October, 2014. Monti's argument resonates with Larry Summers' piece in the same financial daily: "Why public investment really is a free lunch", 7 October this year.
15. Otmar Issing, "Blame Berlin for bad policies, but not for its reluctance to spend more", Financial Times, 24 October 2014.
16. Jens Weidemann, "Reforms for recovery and resilience", speech at the Bank of Latvia Economic Conference, 17 October 2014
17. Olivier Blanchard, "Where danger lurks", Voxeu, 3 October 2014