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## **CORRECTING EXCESSIVE EXTERNAL IMBALANCES IN EURO AREA ECONOMIES**

**Summary:** This paper provides an analysis of correcting external imbalances in euro area economies in the post-crisis era. Rebalancing process is examined from the perspective of both surplus and deficit countries and covers extra- and intra-euro zone trade relations. This article revealed that the burden of correcting external imbalances was incurred by “deficit countries” which after being severely hit by a sudden stop of capital inflows in 2008 and then by a recession, abruptly reduced their current account deficits mainly via income channel and ‘internal devaluation’. Considering big asymmetry in costs of adjustment within euro area countries it has to be admitted that new regulations on correcting macroeconomic imbalances are important part of the EU governance reforms, however they may be ineffective as they are relatively arbitrary and difficult to execute. Another finding is that rebalancing in euro zone members were strongly oriented towards trade with the third countries. This observation may have ambiguous consequences in the long-term.

**Keywords:** Euro area, external imbalances, international trade, current account, global financial crisis.

**JEL classification:** F13, F15, F53

### **Introduction**

According to conventional theories, three main factors driving international trade are related to output/demand levels, competitiveness and barriers to foreign trade. Modern approach to international trade models underlines organization of production structures based on global value chains and financial integration which

influence significantly exporters and importers behaviour<sup>1</sup>. The later ones revealed to be very important in spreading financial economic turmoil of 2009 among euro area countries. Understanding the reasons behind external imbalances is not the aim of this paper, however it is useful for studying adjustment processes. The objective of this article is to compare processes of correcting external imbalances among euro area economies. Adjustments starting in the aftermath of the last financial crisis resulted in a significant progress, however they have not been completed. Rebalancing is examined from the perspective of external and intra-euro zone trade relations and focuses both on countries with persistent external deficits and surpluses. This approach is in line with the European Union's post-crisis regulations on monitoring and correcting macroeconomic imbalances, which require reduction of current accounts deficits, as well as excessive external surpluses. The following questions are analysed: i) whether rebalancing was symmetrically spread among deficit and surplus economies; ii) which channel: export or import dominated in adjustment processes, iii) whether correction of current account imbalances was due to intra-euro trade or trade with the third countries; iv) how a structure of current accounts changed during rebalancing process?

This paper is organized as follows. Section 1 presents a review of the literature on arguments for and against correcting external imbalances. The evolution of external imbalances in euro area countries is presented in Section 2. Section 3 focuses on correcting mechanisms in deficit and surplus countries. The last section concludes with implication of perspectives of sustainability of current account rebalancing in monetary union countries.

## **1. Arguments for and against rebalancing external imbalances in monetary union economies**

Accumulation of external imbalances in euro zone economies have not seemed to bear serious economic consequences until the outbreak of the crisis in 2008. Thus, the question arises when current account imbalances become problematic for monetary union. Some economists admitted [Blanchard, Giavazzi 2002] that asymmetry in current accounts among euro zone countries was a natural effect of real convergence process, as low-income countries need higher investment to catch-up richer economies. This explanation of external imbalances has a background in neoclassical economy and corresponds to the hypothesis of bal-

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<sup>1</sup> See for e.g. Chen, Milesi-Ferretti, Tressel (2012), Lane (2013), Hobza, Zeugner (2014).

ance of payments stages. According to it poorer countries with low saving rate and relatively high yield on investments absorb capital from rich economies, which have positive saving-investment gap. This reasoning assumes beneficial effects of current account imbalances, as they can reflect efficient allocation of resources and rational decisions on inter-temporal substitution of consumption. Moreover, according to traditional classical theory all countries gain from free trade, thus correcting mechanism is a permanent feature of open market economy with flexible prices. This approach has its origins in David Hume's price-specie-flow mechanism or David Ricardo's theory of comparative advantages.

In the recent literature, we can find both arguments for and against benign neglect approach towards current accounts imbalances. Obstfeld in his article from 2012 tried answering a question „whether current account still matter?”. He briefly summarised a discussion in the literature on the importance of current account balance, pointing two lines of attack. The first group of arguments assumes that in the world of highly integrated financial markets countries can diversify their risks, thus external imbalances does not pose a problem. This reasoning is in line with so called „Lawson doctrine” according to which external deficit originating in private-sector behaviour should be of no concern. Another argumentation maintains that the stability impact of net current account is small compared to financial flows, so the role of net current account on a country's net external wealth is diminished by capital gains and losses on increasing foreign asset and liability positions.

It should be noticed, that economic theory also gives arguments for importance of current account pointing out drawbacks of persistent external imbalances, as both current account deficits and surpluses may generate macroeconomic risks and costs. National income identity shows that, current account deficit is reflected in negative national saving-investment gap, whereas current account surplus is due to higher saving than investment. Moreover, a current account surplus implies net lending from the country to the rest of the world (positive net position), and a trade deficit implies that a country must be borrowing from abroad (negative net position). The first situation emerges the risk of yields from foreign assets, whereas the second one relates to default of the debtor country. In monetary union economies external imbalances appear to be harmless because of free flows of trade and capital, as well as elimination of exchange rate risk. However, as the last crisis revealed, even euro zone members had problems, either with paying their debts (deficit countries) or executing their claims (surplus countries).

As external imbalances raise macroeconomic risks and challenges, authorities prefer avoiding excessive disequilibria. This logic has been reflected in the new EU regulations: Regulation 1176/2011 on the prevention and correction of macroeconomic imbalances and Regulation 1174/2011 on enforcement measures to correct excessive macroeconomic imbalances in the euro area. With reference to external imbalances, the new regulations specify the following indicators with upper and lower thresholds (European Commission, 2012):

- 3 year backward moving average of the current account balance as percent of GDP, with thresholds of +6% and -4%,
- net international investment position as percent of GDP, with a threshold of -35%,
- 5 years percentage change of export market shares measured in values, with a threshold of -6%,
- 3 years percentage change in nominal unit labour cost, with thresholds of +9% for euro area countries and +12% for non-euro area countries,
- 3 years percentage change of the real effective exchange rates based on HICP/CPI deflators, relative to 41 other industrial countries, with thresholds of -/+5% for euro area countries and -/+11% for non-euro area countries.

It is worth to add, that the composition of the scoreboard indicators may evolve over time and the indicative thresholds for the indicators serve as alert levels but the crossing of one or more indicative thresholds need not necessarily imply that macroeconomic imbalances are emerging, as economic policy-making should take into account interlinks between macroeconomic variables (Recital 14 of the Reg. 1176/2011). This gives space for arbitrary and thus, weakens the effectiveness of new regulations.

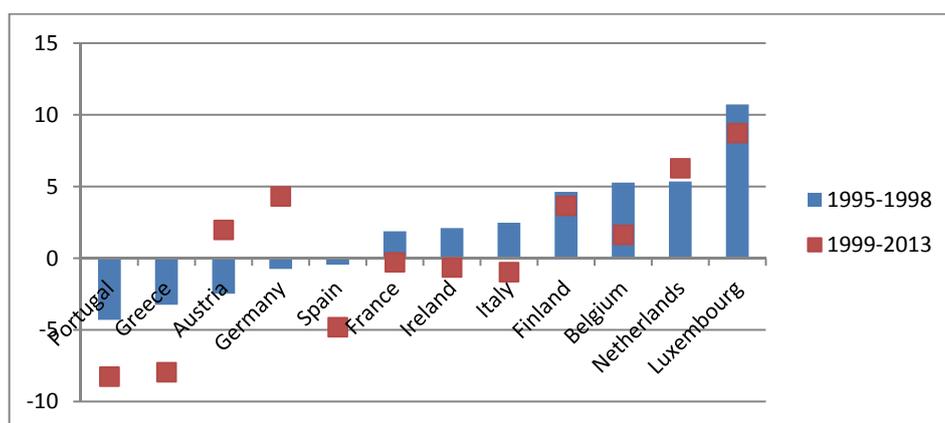
## **2. The scale and evolution of external imbalances in euro zone economies**

To analyse a process of current account rebalancing in euro zone economies, the EMU countries have been selected into two groups: external surplus and external deficit countries<sup>2</sup>. The division refers to a criterion used by the ECB

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<sup>2</sup> The composition of euro zone member states based on 'old' members is helpful for explaining some common stylised facts on the boom period observed up to the onset of the global economic and financial crisis and adjustments processes running from 2009. Cyprus, Malta, Slovakia, Slovenia and Estonia are relatively new euro zone members as they joined the euro area relatively shortly before or during the crisis, so they are not included over the whole period studied and therefore are not considered.

[2012] and was based on average current account balance of euro area economies over the period 1999-2013. Due to the above-mentioned criterion the group of deficit countries includes: Greece, Spain, Portugal, Ireland, Italy and France, whereas Austria, Germany, Belgium, Netherlands, Finland and Luxembourg belong to the external surplus group. This grouping is very similar to classification presented by the European Commission which identified the EU economies affected or may be at risk of being affected by external imbalances [European Commission, 2013].



**Fig. 1.** Average current account balance in euro zone member economies prior and after creation of the EMU (as percentage of GDP)

Sources: Eurostat database [www 1].

Until establishing in 1999 the Economic and Monetary Union the divergences in balance of payments positions of euro area economies had been substantial but not as excessive as in the first decade of XIX century. Figure 1 shows that prior the time of euro accession Greece and Portugal's current account deficits were the largest in euro area (yearly average over the period 1995-1998 amounted to -3.3% and -4.3% of GDP, respectively), whereas Luxembourg, Netherlands, Belgium and Finland registered the highest external surpluses. Over the first decade of the EMU, current account deficits deteriorated in the biggest debtor countries<sup>3</sup>. It is interesting that since 1999 two countries (Germany and Austria) have changed their positions from deficit to persistent surplus, whereas three others (France, Italy and Ireland) which before 1999 had positive current account balances, registered deficits over the years of the EMU

<sup>3</sup> As a deficit in the current account indicates that a country earns less than it spends, a deficit country needs to borrow abroad to pay for its imports.

operation. In the case of Germany an average net current account in 1999-2013 was around 5% of GDP, and over the years 2010-2013 it reached 7% – the level regarded as excessive<sup>4</sup>. Table 1 shows more detailed information about the scale and duration of external imbalances in euro area.

**Table 1.** Duration of current account imbalances in euro zone economies

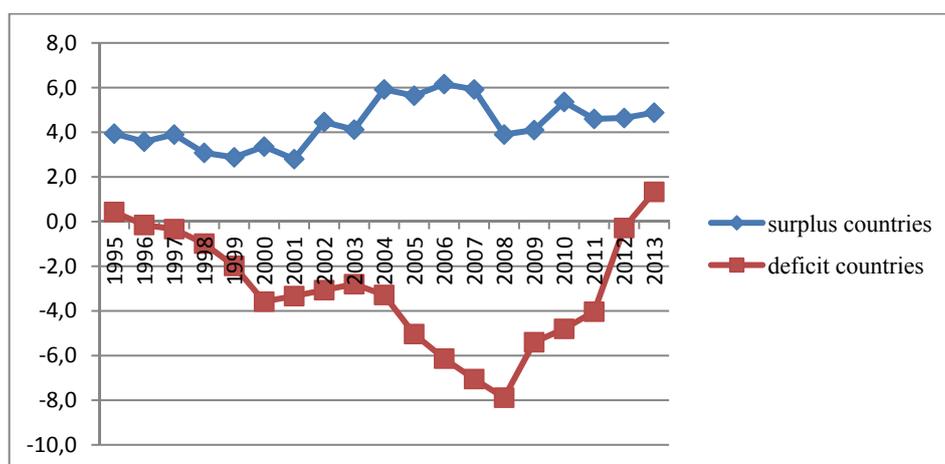
		Number of years of CA surplus 1999-2013	Excessive CA surplus (> 6% GDP, if yes – number of years)
<b>Surplus countries</b>	Belgium	10	No
	Germany	13	Yes (7Y)
	Luxembourg	14	Yes (12Y)
	Netherlands	14	Yes (8Y)
	Austria	12	No
	Finland	11	Yes (4Y)
<b>Deficit countries</b>		Number of years of CA surplus 1999-2013	Excessive CA deficit (< -4% GDP, if yes – number of years)
	Ireland	8	Yes (2Y)
	Greece	13	Yes (12Y)
	Spain	13	Yes (12Y)
	France	11	No
	Italy	8	No
	Portugal	13	Yes (12Y)

Sources: Author's elaboration based on Eurostat database [www 1].

It is easy to notice that scale and duration of current account imbalances imply big asymmetry within euro area which has been accumulating in the first decade of its functioning. Figure 2 shows the net effect of rebalancing in the two groups of the studied economies. Deficit countries significantly reduced their imbalances over the period 2009-2013, whereas the surplus countries strengthened their current account positions.

The abrupt correction of external deficits required strong adjustments. This suggest a hypothesis that the main burden of current account rebalancing has been carried by the deficit economies. The following section presents the process of correcting external imbalances via different adjustment channels and verifies the above-formulated hypothesis.

<sup>4</sup> According to Macroeconomic Imbalances Procedure the threshold indicators for current account balance have been established at +6% (maximum surplus) and -4% (maximum deficit), calculated as 3 year backward moving average of the current account balance as percent of GDP.



**Fig. 2.** Evolution of net current accounts in deficit and surplus economies of the euro zone (percentage of GDP)

Sources: Author's calculations based on data from Eurostat [www 1].

### 3. Mechanisms of current account rebalancing in the euro area economies

Rebalancing processes can be as a result of free market forces, as well as policy makers action. For monetary union members the crucial issue is whether particular country's external imbalance was due to outside or intra-monetary union transactions. Firstly, common currency eliminates nominal exchange rate changes among monetary union, therefore neither market adjustments (depreciation or appreciation) nor policymakers' intervention (devaluation or revaluation) can change the nominal exchange rate among the eurozone members. Secondly, a fundamental difference between adjustment processes of euro area economies vis-à-vis intra and extra-euro area concerns trade policy. Functioning in a common market eliminates using individual trade policy to rebalancing particular countries imbalances, so the option of protecting domestic agents is either a common EU policy or "murky protectionism" [Evenett, 2012].

Table 2 compares external balances of the euro zone countries in 2008 and averages in 2012-13. As data on current account balances vis-a-vis euro area partners are not available, geographical breakdown refers to trade balances of goods and services.

**Table 2.** Intra-euro zone trade balances and net current accounts in 2008 and average in 2012-2013 (percentage of GDP)

		Trade balance					Current account balance		correcting
		total		intra-euro area			2008	2012-2013	
		2008	2012-2013	2008	2012-2013	correcting			
<b>Surplus countries</b>	Belgium	-1,8	-0,5	-2,1	-5,3	No	-1,3	-1,9	Yes
	Germany	6,2	6,1	3,3	1,3	Yes	6,2	7,5	No
	Luxembourg	41,2	38,9	17,1	13,0	Yes	5,4	5,5	No
	Netherlands	8,5	9,6	12,8	15,9	No	4,3	10,2	No
	Austria	4,8	3,0	0,1	-0,1	Yes	4,9	2,6	Yes
	Finland	4,0	-0,2	-1,7	-3,5	No	2,6	-1,3	Yes
<b>Deficit countries</b>	Italy	-0,7	1,9	-0,6	-0,6	No	-2,9	0,4	Yes
	Greece	-11,5	-1,3	-5,9	-0,1	Yes	-14,9	-0,9	Yes
	Spain	-5,5	1,9	-3,9*	-1,3*	Yes	-9,6	-0,2	Yes
	France	-2,2	-1,6	-3,3	-3,5	No	-1,7	-1,8	No
	Portugal	-9,5	0,8	-6,9	-2,2	Yes	-12,6	-0,8	Yes
	Ireland	9,0*	24,1	12,8	11,3	Yes	-5,6	5,4	Yes

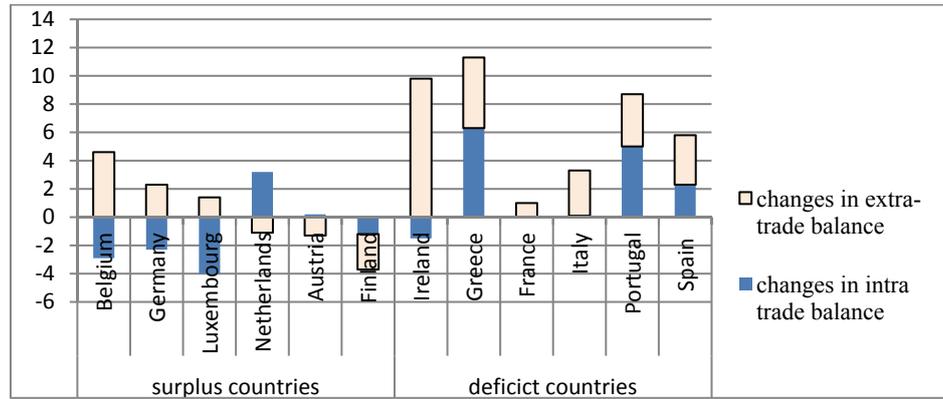
\* For Ireland data for 2009, for Spain data of intra-euro trade balance in 2008 covers only trade in goods.

Source: Data from Eurostat [www 1].

Shortly prior global financial crisis, all deficit countries<sup>5</sup> recorded a large trade deficits both with their euro zone partners, and with the third countries<sup>6</sup>. In the surplus countries, a vast majority recorded surpluses with intra- and extra-euro area trade partners. This implied a need of symmetrical engagement into rebalancing process. The net effects of rebalancing vis-à-vis partners from euro area and the rest of the world are presented in figure 3. Except Netherlands, surplus countries reduced their net trade positions vis-a-vis euro partners and then offset it with the third countries. In the case of deficit countries, the scale of rebalancing was more spectacular.

<sup>5</sup> Except Ireland, which current account deficit was due to incomes, not trade in goods and services.

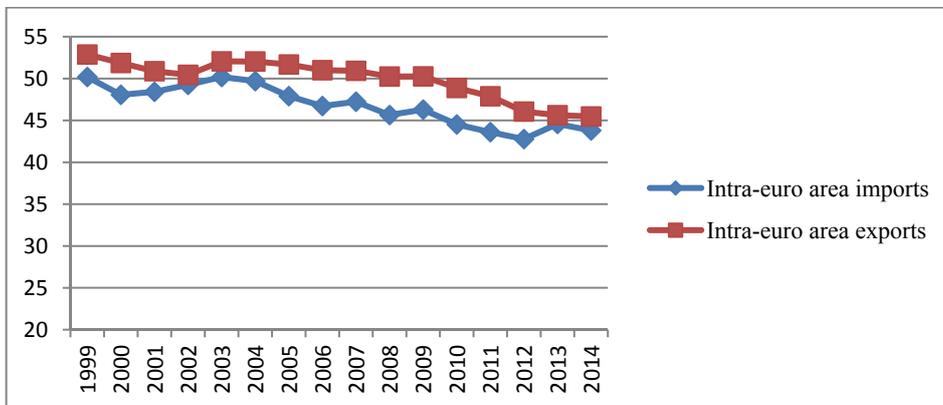
<sup>6</sup> Only France compensated its intra-euro deficit in outside euro zone trade.



**Fig. 3.** Changes in extra and intra-euro area trade balances between 2008-2013, percentage points of GDP

Source: Own elaboration on the basis on data from Eurostat [www 1].

However, steadily stagnation of European economies and high level of dependence on trade within euro area constituted factors constraining rebalancing deficits via export channel, thus import channel dominated. This suggests that rebalancing process compounded with changes in geographical structure of trade, which started to be more oriented towards the third countries. In fact, the net effect of external adjustments has been reflected in reductions of shares of intra-euro area trade in total trade of the analysed economies.



**Fig. 4.** Shares of intra-trade of the euro area economies (as percentage of total exports and imports)

Sources: Author's elaboration on the base of Eurostat database [www 1].

Figure 4 presents evolution of the shares of intra-trade of the euro zone countries. At the beginning of the EMU the average share of intra-trade in euro area countries' exports was 53% and in imports 50%. Over the period 1999-2014 the euro area countries reduced their intra-trade relations, both in imports and exports<sup>7</sup>, respectively to 44% and 45%<sup>8</sup>. The consequences of looser trade linkages within the euro area are ambiguous. On one hand, high level of trade integration is expected to reduce potential costs of monetary union, as it reduces probability that asymmetric shocks occur<sup>9</sup>. On the other hand, increasing trade cooperation with the third countries, accompanied with positive or balanced net trade positions, demonstrates comparative advantages and strengthens the EU position in the world economy.

The analysis of real exchange rates (REERs) is helpful in assessing costs of external rebalancing. Figure 5 shows evolution of real exchange rates calculated for euro zone economies against 37 industrial countries and against euro zone partners. Both indicators are deflated with unit labor cost. The averages levels of REERs against 37 countries show that prior the crisis REERs appreciated in the two studied groups of countries. However, REERs calculated against euro area trading partners for the surplus countries, have been depreciating from 2001 to 2008. This can explain a big accumulation of current account imbalances among euro area economies over the first decade of EMU. After 2009 a rebalancing process has been supported by real depreciation in deficit countries, and real appreciation in the group of surplus countries, however the scale of REER adjustments in deficit countries was much bigger.

Figure 6 gives explanation of REER changes and highlights that the burden of rebalancing was not symmetrically distributed among euro area economies. Adjustments in deficit countries have occurred via real exchange rate depreciation due to drastic costs and price reduction („internal devaluation”). According to classical macroeconomic models lower prices can be achieved only when production is below its potential and rate of unemployment is above its natural level. Another theoretical base for explaining distribution of costs of external imbalances refers to national income identity. Reduction in the current account deficit must correspond to either increase in saving, which means a decrease in spending, or to lower investment. Such rebalancing produces a „bad equilib-

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<sup>7</sup> The exception is Ireland, which between 1999-2013 has increased its share of imports from the EU.

<sup>8</sup> Not only shares of intra-euro area trade, but also shares of intra-EU trade have been reducing in total exports and imports of the euro area countries.

<sup>9</sup> This approach is known as the European Commission view about the relation between economic integration and the occurrence of asymmetric shocks, was presented in the European Commission Report „One market, One money” in 1990.

rium” – achieved by stagnation (Skidelsky, 2014). Thus, for deficit countries adjustment mechanisms pose a dilemma: rebalancing current account or to stimulate growth.

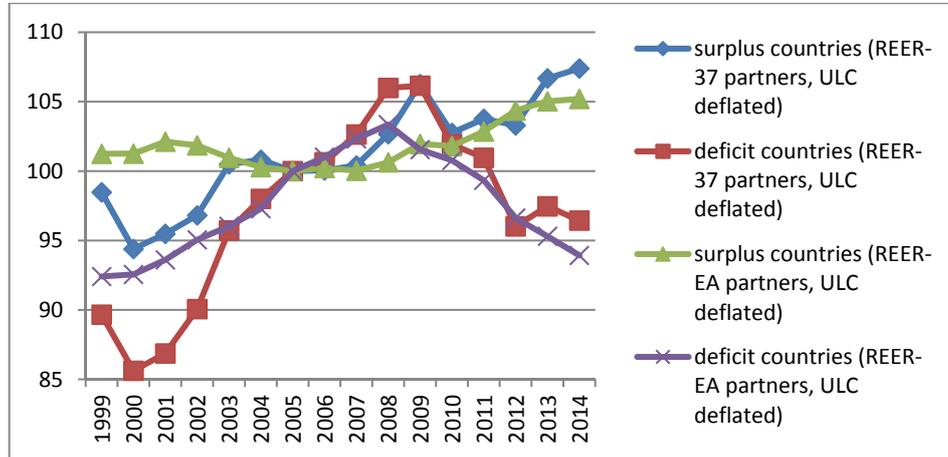


Fig. 5. Real effective exchange rates, annual data, Index 2005=100

Source: Author’s own elaboration based on Eurostat database [www 1].

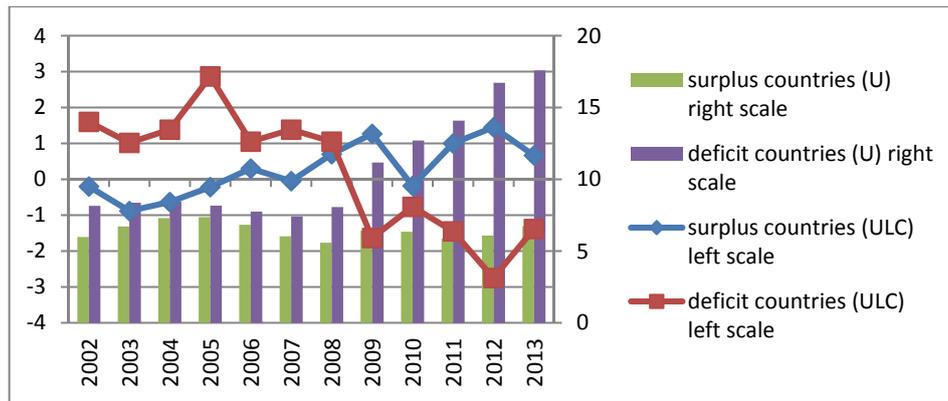
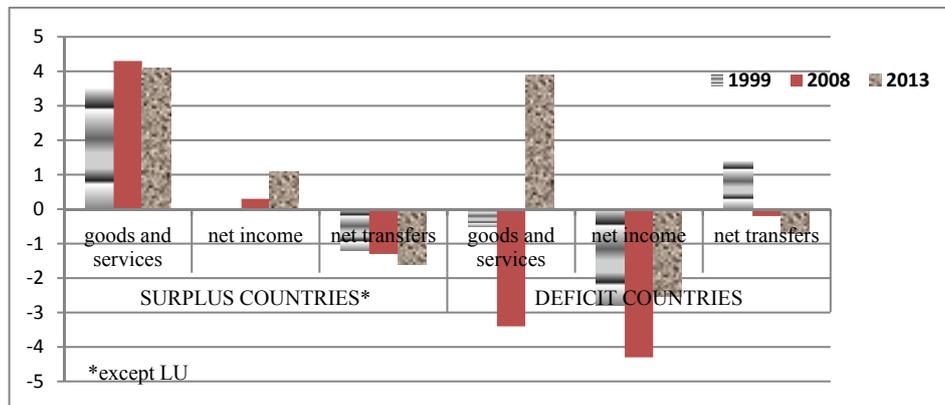


Fig. 6. Changes in unit labour costs and rates of unemployment in euro area economies (as percentages)

Source: Author’s calculations based on data from Eurostat database [www 1].

Figure 6 shows that since 2009, deficit countries have significantly reduced unit labour costs (ULC), but at a cost of dramatic increase in unemployment. This implies that austerity measures had to be introduced by debtor countries in

labour markets and public finance<sup>10</sup>. In contrast, in surplus countries ULC have raised moderately and unemployment has been relatively low. The above-mentioned difference can be related to supply-side factors (e.g. labour market elasticity) which determine the capacity to absorb shocks.



**Fig. 7.** Composition of net current accounts in euro area economies (as percentage of GDP)

Source: Author's calculations based Eurostat database [www 1].

The net effect of correcting external imbalances can be reflected in changes in composition of current account balance (Figure 7). In surplus countries shares of income increased significantly reflecting their stronger international investment position. In deficit countries the most relevant change contributing to current account rebalancing was a large improvement in balance of trade of goods and services. Moreover, negative net income was reduced comparing to the level of 2008, however in 2013 it amounted to 2.5% of GDP reflecting negative net international investment position of deficit countries.

## Conclusions

Current account adjustments in euro area economies have started in the aftermath of the global crisis 2009. Deficit countries significantly reduced their current account imbalances over the period 2010-2014, whereas the major surplus countries still register excessive current account surpluses. Rebalancing

<sup>10</sup> Some deficit countries, like Spain and Ireland have reformed their labour markets (supply-side adjustments) and being under the pressure of excessive deficit procedure, they also have consolidated public finance. More about labour market reforms in the euro zone countries in the aftermath of the last financial crisis in ECB [2012].

process based on one-sided adjustments carried by deficit countries implied asymmetry of cost distribution, which was reflected in changes of labour costs and rates of unemployment. Thus, correcting external imbalances by deficit countries poses a dilemma: to stimulate growth or to re-establish external equilibrium. Considering the asymmetry in costs of rebalancing, the new EU regulations on the prevention and correction of macroeconomic imbalances introduced in 2011, seem to be a good institutional innovation, because they require reduction of excessive current account deficits and surpluses. It should be notice, however, that they do not take in account whether external imbalance refers to intra- or extra-euro area partners. Moreover, the new regulations leave a space for arbitrary interpretation of macroeconomic excessive imbalances, so they may aware inefficient.

Rebalancing process was reflected in significant adjustments in both intra- and extra-euro area trade relations. Due to extending stagnation of euro zone economies, rebalancing within euro area had cyclical character and went mainly via reduction of import. Moreover, relatively higher growth outside the euro area and REER depreciation (especially in deficit countries) contributed to correcting current accounts also via export channel. The consequence was a significant reduction of intra-euro trade. This tendency may emerge ambiguous effects because, on one hand, weaker intra-euro zone trade relations reduce business cycle synchronisation and make individual economies more vulnerable to asymmetric shocks. On the other hand, closer trade with the third countries in exports demonstrates sustaining comparative advantages and strengthens European countries position in the world economy. The last reasoning seems to be supported by the fact, that not only surplus countries compensated losses in intra-euro area trade with extra-euro area trade partners, but also deficit countries managed to increase their net exports to the third countries. It can be concluded that the orientation on trade with the third countries should constitute a part of export-led growth strategy and be supported by a common EU trade policy.

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## KORYGOWANIE NADMIERNYCH NIERÓWNOWAG ZEWNĘTRZNYCH W GOSPODARKACH KRAJÓW STREFY EURO

**Streszczenie:** Artykuł przedstawia analizę procesu korygowania nierównowag zewnętrznych w gospodarkach strefy euro po ostatnim kryzysie finansowym. W badaniu uwzględniono dostosowania w krajach z nadmiernymi deficytami, jak i nadwyżkami na rachunkach obrotów bieżących oraz relacje wewnątrz strefy euro i poza nią. Wnioski wskazują, że ciężar dostosowań poniosły głównie kraje „deficytowe”, które doświadczając w 2008 roku nagłego zatrzymania dopływu kapitału, a później recesji, szybko zredukowały nierównowagi zewnętrzne, głównie przez kanał dochodowy oraz wewnętrzną dewaluację. Uwzględniając asymetrię rozkładu kosztów dostosowań, należy przyznać, że nowe regulacje UE dotyczące nadmiernych nierównowag makroekonomicznych są ważnym elementem reform instytucjonalnych, jednak z racji ich arbitralności mogą okazać się nieskuteczne. Inny wniosek dotyczy wzrostu znaczenia krajów spoza strefy euro w procesie korygowania nierównowag zewnętrznych. Tendencja ta oznacza niejednoznaczne skutki dla krajów EMU.

**Słowa kluczowe:** strefa euro, nierównowagi zewnętrzne, handel zagraniczny, rachunek obrotów bieżących, globalny kryzys finansowy.