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Euro area rebalancing: a symmetric response and easier monetary policy could facilitate the process

- Structural reforms, wage cuts and a sharp contraction in domestic demand have led to a recoup of lost competitiveness and a reduction of external imbalances of periphery euro area members.

- A symmetric response from surplus countries could facilitate the slow and painful rebalancing process. In Germany, tight labor market conditions should be allowed to operate freely on the determination of employees' compensation, while initiatives could be taken to boost domestic demand. Both developments would support exports of periphery members.

- Centralized bank supervision by the ECB could accelerate the return of private capital to weak members as it will leave little room for national authorities to be captured by local special interests, thus contributing to a sound European banking sector.

- Within its supervisory duties, the ECB may differentiate its monetary policy between the euro area countries in order to facilitate capital channeled into productive uses and control more effectively capital flows that feed domestic distortions.

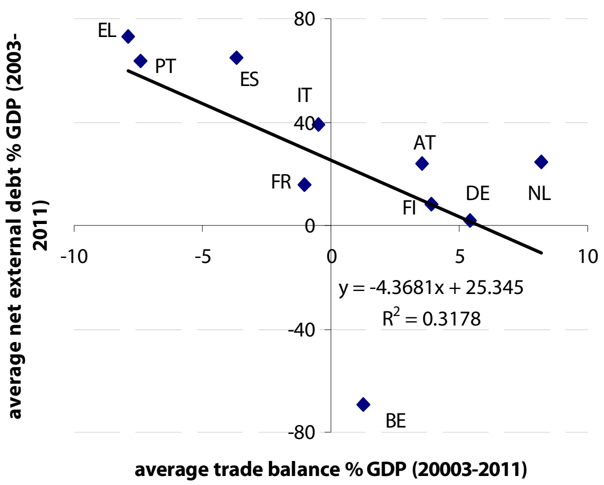
The sovereign debt crisis has unveiled fiscal and external imbalances of euro area periphery members, putting an abrupt end to markets' complacency about the ability of these countries to service their debts. While triggered by markets' distrust on the sustainability of Greek public finances, the crisis soon engulfed members with relatively prudent fiscal fundamentals but low competitiveness and large current account deficits. Indeed, a growing literature suggests that the external imbalances burdening the periphery euro area members are primary drivers of the crisis, just as well as fiscal laxity[1].

Excesses in domestic demand, along with a leisurely approach in liberalizing rigid labor and product markets have led to price increases and unit labor costs hikes, which resulted in asymmetric shocks in terms of competitiveness between core and periphery euro area members. These imbalances are clearly captured in current account deficits of periphery members. Consumption of imported goods facilitated by cheap borrowing on the one hand, and reduced exports growth due to competitiveness losses, on the other hand, have led to large trade deficits. Meanwhile, constrained wage growth in Germany boosted its current account surplus, bringing it in sharp contrast to the respective measure of the periphery.

The flip side of protracted current account deficits was the build-up of large external debt positions (Figure 1). The removal of currency risk in the advent of the euro and the financial integration has caused a "downhill" flow of cheap capital from core countries in the North to the less advanced Southern Europe. Such flows were encouraged by an anticipated virtuous procedure of economic convergence.

[1] See Alessandrini, P, et al. (2012), "External imbalances and financial fragility in the Eurozone", MoFiR working paper No. 66.

Figure 1



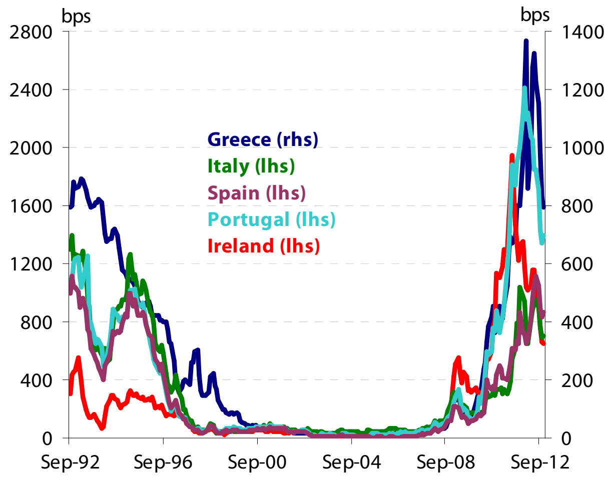
Source: Eurostat

As these countries offered higher rates of return and stronger growth prospects, investment would increase and saving would decline, both leading to current account deficits[2].

However, such expectations proved to be too optimistic. To a great extent, the capital inflows were used to finance excessive increases in private consumption and housing construction activity. Moreover, strong increases in domestic demand and wage hikes in the non-tradable sector in periphery economies beyond what productivity gains would justify, led to higher inflation and, consequently, to lower real interest rates[3]. The latter supported local appetite for borrowing, financed by capital inflows. Thus, a negative feedback loop between inflation, labor costs and capital inflows emerged, sustained by foreign markets' willingness to provide liquidity that absorbed the asymmetric shocks. With respect to policymakers, abundant liquidity allowed a laxity in addressing growing structural vulnerabilities which led to slow or even negative growth in productivity[4], higher unit labor costs and further loss of competitiveness.

Although external imbalances were growing, financial market agents remained unalarmed, as they perceived that imbalances in the balance of payments of each member country were irrelevant. The elimination of divergence in government bond spreads over bunds (Figure 2) is illustrative of markets perception that not only sovereign defaults were an unlikely event but also that rising external debt positions was not a worrisome development. However, the outbreak of the sovereign debt crisis pointed out that the euro-zone countries were not financially as integrated as a country's regions, while it revealed the institutional weaknesses of the European Union to address incidents of crisis. As private investors came to realize the consequences of the absence of a transfer union to complement the monetary union, they shunned periphery members, leading to sudden stops in capital flows. Investors have even doubted Greece's ability to preserve its membership in the currency union. To prevent a total collapse of the financial markets, the ECB stepped in by providing unlimited amounts of cheap liquidity to banks, partially compensating for the loss of private funds.

Figure 2
10-yr spreads over bunds



Source: Eurostat

Unwidning of external imbalances is underway

Under markets' unremitting pressure and not having the option of currency depreciation, periphery members had to embark on internal devaluation and long delayed structural reforms aiming at productivity gains in order to recover lost competitiveness and unwind external imbalances. Wage cuts, labor market reforms and excess supply of labor have resulted in a significant decline of unit labor costs (Figure 3) in all periphery members, with the notable exception of Italy, where the measure is projected to keep rising in 2013. In addition, current account deficits have shrunk materially in Greece, Portugal and Spain, leading to a narrowing of the gap between surplus and deficit countries

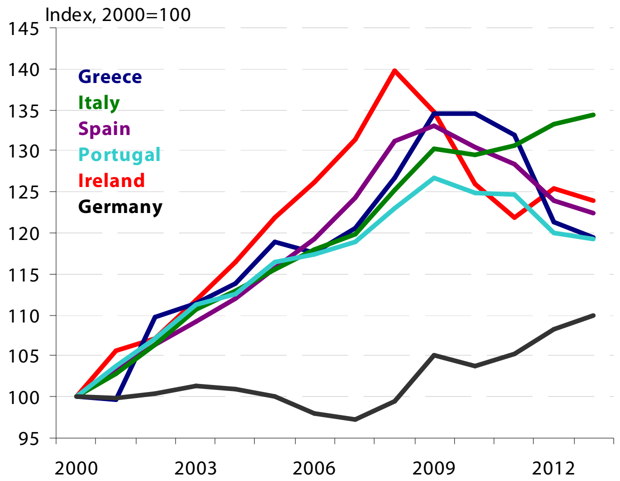
[2] See Blanchard, Olivier and Francesco Giavazzi (2002), "Current Account Deficits in the Euro Area: The End of the Feldstein-Horioka Puzzle," Brookings Papers on Economic Activity 2, pp.148-186.

[3] The average real interest rate (GDP deflated) of government benchmark bond of 10 years in the period from 2000 to 2008 for Ireland, Spain, Italy and Portugal was 1.46%, as opposed to 2.57% for the group of Germany, France, the Netherlands, Austria and Finland.

[4] Total factor productivity in Portugal and Italy increased on average by a meagre 0.085% and 0.17%, respectively, on a year-on-year basis in the period from 2000 to 2007, compared to 0.88% in Germany. In Spain, it even contracted by an average rate of -0.16%. In contrast, the average annual total factor productivity in Greece was 1.96%, almost as much as in Sweden and Finland.

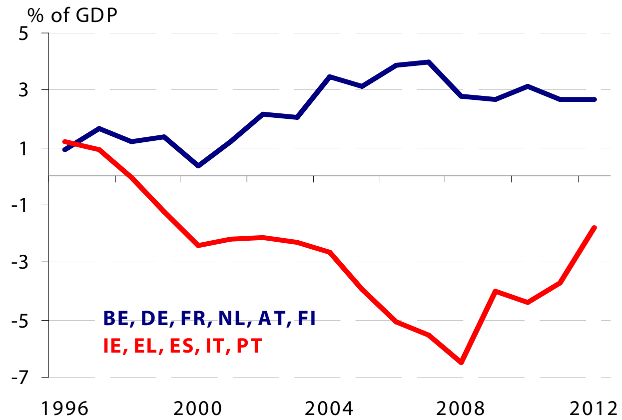
(Figure 4). Ireland has returned to positive territory since 2010, taking advantage of a strong export base and a rebound of the global economy. Current account corrections reflect decreases of trade deficits in Greece, Spain and Portugal where a sharp contraction of domestic demand has led to large drops of imports. In Greece, the decline of imports in goods and services accounts for most of the correction observed in its trade balance between 2008 and 2012, reflecting the country's small export sector (Figure 5). At the same time, it implies a potential for substantial improvement from the side of exports. In contrast to Greece, improvements in Italy's and Ireland's trade balances are almost entirely attributed to a rise in exports, as the former benefits from a large diversified export sector, while the latter takes advantage of large high-tech exports.

Figure 3
Nominal Unit Labor Costs



Source: Eurostat

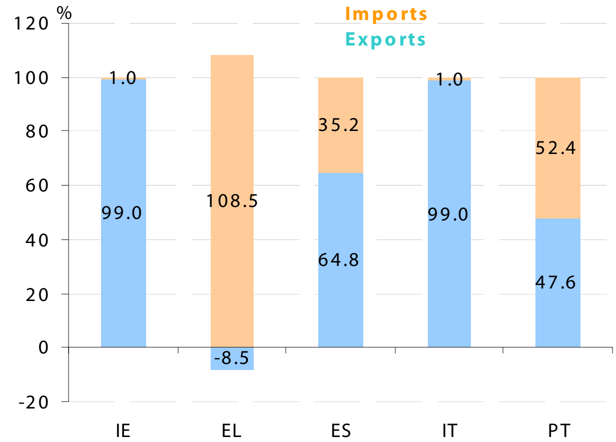
Figure 4
Current account balances of deficit and surplus countries



Note: Cummulative current account data of each group are GDP weighted
Source: IMF

Looking ahead, further progress in unwinding external imbalances is expected on the backdrop of declining real exchange rates, fiscal adjustment and widespread structural reforms in labor and product markets in deficit countries. Yet, the aforementioned unwinding of excessive imbalances has come at a very high cost for their societies. Extensive retrenchment in public spending, heavy taxation, wage cuts, large job shedding in sectors that experienced bubbles and lack of confidence have led to a dramatic shrinkage of domestic demand. As a result, unemployment has reached record highs in all periphery countries, while prospects are particularly grim for the youth. While the reduction of domestic demand is an unavoidable part of the adjustment process, peripheral countries need to adjust their current accounts through increasing exports, as persistent decline in imports implies protracted austerity that is socially untenable. In the period ahead, periphery members need to work

Figure 5
Contribution of imports and exports of goods and services in trade balance correction between 2008-2012

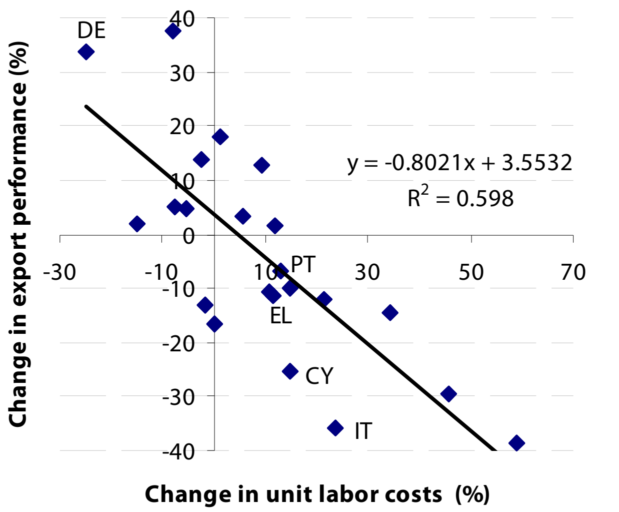


Source: Ameco

more to achieve a transfer of resources from the non- tradable to the tradable sector that would assist them to permanently unwind their external imbalances. The latter constitutes a pre-condition for the return of foreign investors to periphery countries and lower risk premia. To this end, more far-reaching labor and product market reforms are essential to boost productivity, expand export activity and reduce the large unemployment slack.

To illustrate the significance of a recoup in comptetitiveness, we depict in Figure 6 the relationship between export performance and unit labor costs. The data suggests that for each percentage unit of increase in unit labor costs exports share drops by 0.8 percentage units. Countries that have kept unit labor costs in check have managed to either maintain or increase their exports shares. Thus, the chart underscores the importance of structural reforms aiming at increasing competitiveness, in periphery countries' efforts to orient their economy towards exports. Although labor costs is not the only factor influencing export performance, reducing unit labor costs may be of particular importance in countries like Greece and Portugal, where labor intensive sectors play a significant role in total exports.

Figure 6
Change in ULCs and export performance between 1995 and 2011.

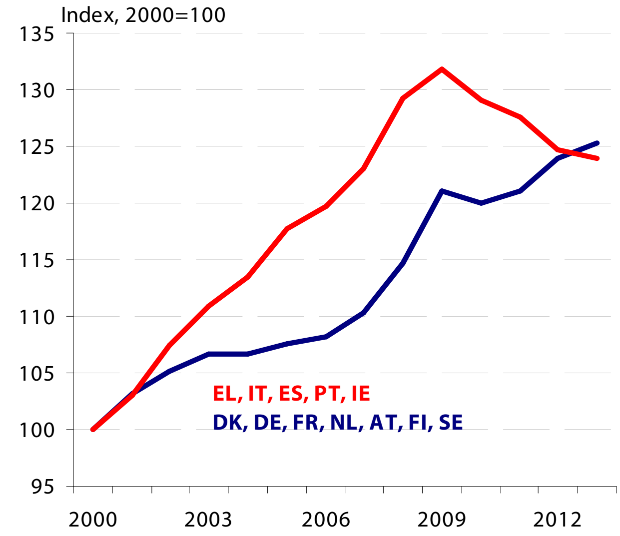


Note: Exports performance is measured as exports of goods and services at 2005 prices relative to 36 industrial countries (series code OXGSQ). Unit labor costs are relative to 36 industrial countries (series code PLCDQ)
Source: Ameco

A symmetric response in surplus countries and easier monetary policy could facilitate the process of rebalancing

As is evident from Figure 4, the adjustment of current account imbalances has so far been unilateral, mostly attributed to correction in deficit countries. Yet, a symmetric response in surplus countries would facilitate the slow and painful process of re-orienting the peripheral economies away from non-tradables towards exports. A rebalancing of the surplus economies towards non-tradables would support private consumption and boost wages. Both developments would benefit imports from the periphery. Current account surpluses and tight labor market conditions should be allowed to operate freely on the determination of employees' compensation. In an encouraging note, wage adjustment between surplus and deficit countries is already in progress, as nominal unit labor costs rise in the former and contract in the latter (Figure 7). Recent significant wage increases in Germany are right steps towards a more balanced German current account vis-à-vis the rest of the euro area. In addition, favorable financial conditions, a buoyant housing sector and the absence of a significant fiscal adjustment may encourage German private expenditures. That said, expectations should remain modest as there does not seem to be political will for a material reorientation of the German economy towards non-tradables.

Figure 7
Nominal unit labor costs in core and periphery euro area members



Source: Eurostat

Accommodative monetary policy can reduce the difficulties that deficit countries are facing as they struggle to regain competitiveness within the context of a monetary union. In addition to its generous liquidity provision measures and initiatives to eliminate redenomination risks, in our view, the ECB should allow expectations for a weaker euro and send markets signals of tolerating inflation rates higher than 2%. To do so, the ECB could adopt the Fed's practices of providing future guidance on its policy rate or even tie its monetary policy on hard real economy indicators, such as the unemployment rate. A weaker euro would support competitiveness of struggling countries, as a significant portion of their total exports is directed to non euro area countries[5]. Higher inflation would provide them double service, as it would improve their debt sustainability outlook, while it would increase pressure for higher compensation in surplus countries (in contrast to frozen or even negative wage growth in deficit countries).

[5] Extra-euro area exports of goods of Greece, Italy, Spain, Portugal and Ireland represent 58.2%, 55.6% 43.4%, 35% and 55.6% of total exports. (Average figures from 2007 to 2011 based on IMF DOTS data).

Recent initiatives in creating a banking union featuring a centralized supervisory mechanism and a single resolution framework backed by a common resolution fund could accelerate the return of private capital to periphery members. A reversal of capital flows from the North back to the South is a requisite to finance export activities, reduce non-labor related costs, boost investment and productivity and thus, maximize the benefit of structural reforms and wage cuts. Conferment of supervisory and resolution duties on the ECB could facilitate the return of private investors to weak members mainly due to two reasons. First, it will contribute to the creation of a sound and reliable European banking system supervised by a credible institution, leaving little room for national regulators being captured by local special interests. Second, centralized supervision will allow the ESM to recapitalize directly banks, thus reducing the impact of sovereign woes on banks' vulnerabilities and vise versa. Hence, a banking union could contribute to the re-integration of the now fragmented European financial sector, this time on sounder foundations.

Within its supervisory duties, the ECB may impose country specific rules and restrictions on a country's banking system to differentiate the cost of money so as to take into account a country's imbalances and idiosyncratic risks. This way, the ECB may facilitate the financial flows channeled into productive sectors of the economy whereas hinder capital flows that feed domestic distortions (e.g. capital oriented to sectors where there is growing evidence of bubble formation). This is a task that market forces failed to perform during the last decade. As an example, the ECB could levy a higher rate in its refinancing operations on a country's banks that exhibits inflation persistently above the euro area average (complemented by an economic reading) or amend its collateral risk policy by applying higher haircut on bonds issued by sovereigns with weaker fundamentals.

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