GROUP OF TWENTY

EURO AREA IMBALANCES

Annex to Umbrella Report for G-20 Mutual Assessment Process

Prepared by Staff of the

INTERNATIONAL MONETARY FUND*

*Does not necessarily reflect the views of the IMF Executive Board.

ANNEX 2: EURO AREA IMBALANCES[1]

SUMMARY

Large euro area imbalances have resulted in vulnerabilities exposed by the current crisis. While capital flows across the monetary union were part of convergence and anticipated, key imbalances resulted to a large extent from overly optimistic expectations, mispricing of risks, inadequate adjustment to shocks, insufficient oversight or governance in recent years as well as cyclical factors. Fundamentally, there was no effective constraint on borrowing in good times and no effective crisis management mechanism in place for bad times. With monetary policy and the exchange rate responding to area-wide conditions, adjustment to country-specific shocks proved inadequate.

Imbalances have declined with the crisis and steps have been taken to reduce them further. Current account balances of deficit economies improved beyond that implied by standard cyclical effects. Many factors that contributed to the imbalances are not present anymore. Also, several steps have been taken to reduce external and fiscal imbalances further, such as fiscal and structural adjustment in the program countries, initiatives to improve competitiveness in the periphery, and strengthened economic and budgetary governance. Narrowing intra-area imbalances will require significant relative price adjustment, while it is important to avoid deflation in deficit countries in the periphery pursuing internal devaluation.

Efforts on several fronts are still needed to build a stronger monetary union. Specifically: (i) moving toward a *pan-euro-area financial stability framework*, which inter alia implies centralized powers in banking supervision and resolution, and common deposit insurance; (ii) *stronger fiscal integration*, including national fiscal rules, as envisaged by the Fiscal Compact, complemented by fiscal risk sharing to ensure that economic dislocation in one country does not develop into a costly fiscal and financial crisis for the entire region; (iii) *structural reform* to strengthen competitiveness and improve the ability to adjust to shocks, including by a wage-setting mechanism that is more responsive to firm-level economic conditions, reducing labor market duality and in general barriers to hiring and firing, and lowering barriers to domestic and foreign competitions in product markets. There is growing awareness among European policy makers to move along these lines and active efforts are underway to build the necessary consensus.

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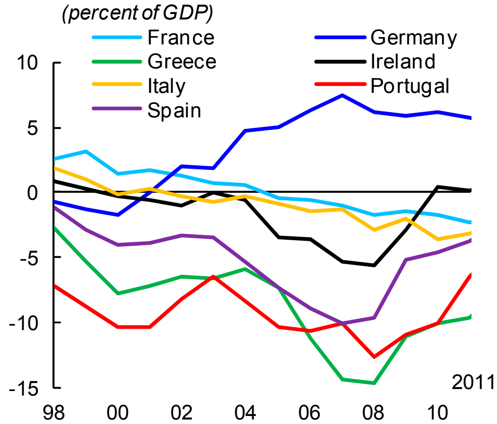
I. EVOLUTION AND OUTLOOK OF IMBALANCES[2]

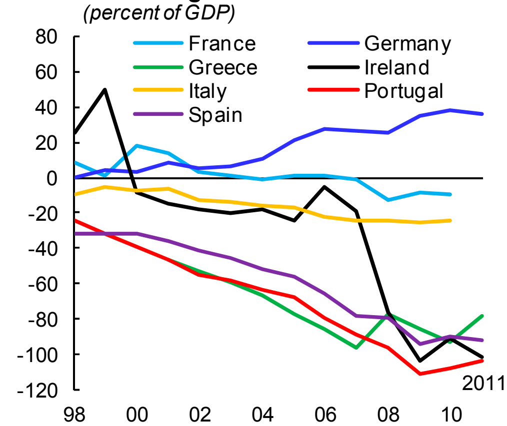
1. **External and fiscal imbalances in the euro area widened in the decade prior to the crisis, and fiscal balances deteriorated further during the crisis**. Intra-euro area external imbalances widened by about 4 percent of the euro area GDP during 1999–2007, with the current account balances of surplus and deficit countries each widening by about 2 percent of the euro area GDP. As a result, net foreign asset positions of the member countries have diverged significantly. Fiscal accounts did not strengthen sufficiently or even worsened in several members prior to the crisis despite generally favorable conditions and lower borrowing costs for most under the Economic and Monetary Union (EMU)—and deteriorated across the board during the crisis. With respect to the area's fiscal governance framework, the Stability and Growth Pact (SGP) limits on public debt and deficits did not prove binding.

Current Account Balance
(percent of GDP)



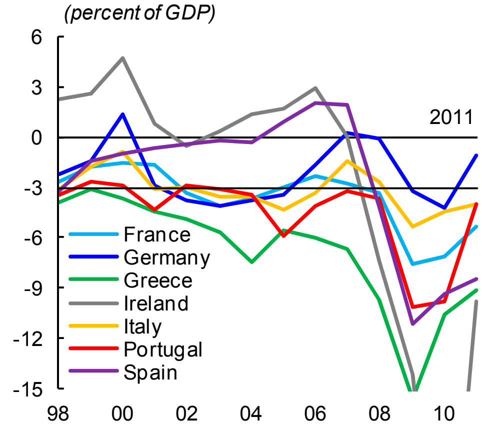
Source: IMF, *World Economic Outlook*.

Net Foreign Asset Position
(percent of GDP)



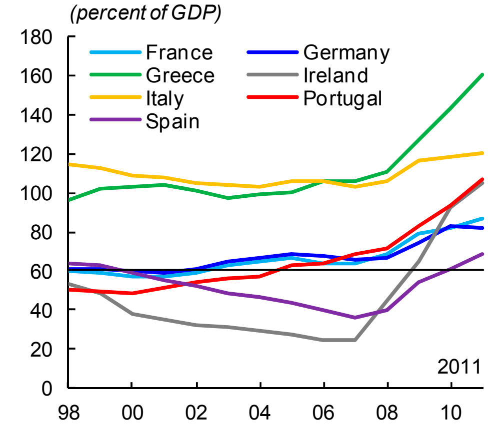
Source: Haver Analytics.

General Govenment Balance
(percent of GDP)



Source: IMF, *World Economic Outlook*.

General Govenment Debt
(percent of GDP)

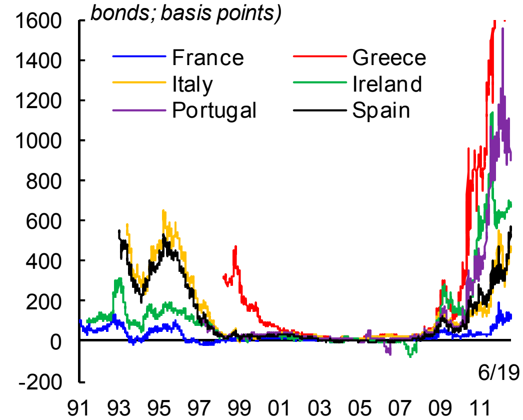


Source: IMF, *World Economic Outlook*.

[2] The analysis on euro area imbalances draws in part on Jaumotte et al., 2012, "Making EMU Work", forthcoming IMF Staff Discussion Note.

2. **Initially, growing imbalances did *not* cause much concern given diverse starting points of members, while the euro area as a whole remained close to balance externally**. High borrowing on the part of lower income members was thought to be benign and natural in anticipation of efficiency gains and income convergence from joining monetary union. With the elimination of exchange rate risk, country risk premia also essentially vanished—providing easy private funding conditions for external deficits. The spreads on sovereign bonds virtually disappeared, indicating that markets viewed all euro area governments as equally creditworthy—or expected weaker members to be bailed out by stronger members as part of the EMU. However, during the global crisis, the convergence in spreads unraveled. Several economies—characterized by large current account deficits and/or weak fiscal positions—have come under intense market pressure, with spillovers felt in the rest of the euro area and beyond.

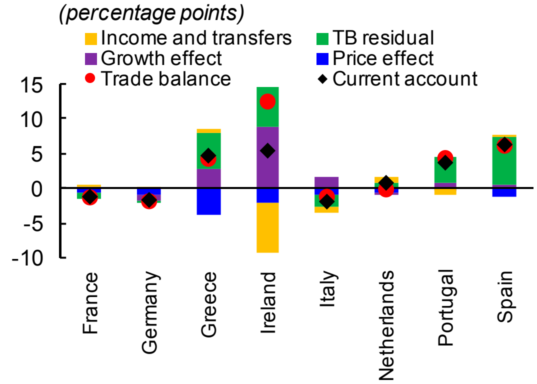
Government Bond Spreads
(10-year yield spreads over German bonds; basis points)



Source: Bloomberg, L.P.

3. **The global financial crisis has triggered a noticeable narrowing of external imbalances**. As world trade collapsed, current account balances of deficit economies improved substantially—well in excess of what would have been expected given the fall in output based on standard trade elasticities (i.e., "residual" changes are large), despite a significant increase in interest costs on their external debt.[3] Substantial demand compression following the collapse of credit, asset and housing booms and a decline in confidence in periphery economies, reinforced by fiscal consolidation, played an important role in this wrenching adjustment. Many of the factors identified below as contributing to the imbalances—such as excessive optimism and easy financial conditions begetting consumption and construction booms—are out of the picture now. Hence, much of the adjustment observed so far is likely to be lasting.

Decomposition of Changes in the Ratio of Current Account Balance to GDP from 2007 to 2011
(percentage points)

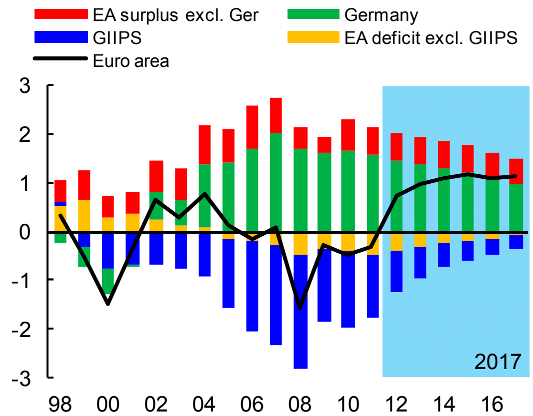


Sources: IMF, *Globall Economic Environment;* and IMF, *World Economic Outlook.*

[3] At the same time, the existence of the monetary union—with common payment mechanism and central bank lending facilities—helped avoid an even more abrupt adjustment.

4. **Several steps have been taken to reduce external and fiscal imbalances further**. Going forward, EU/IMF programs with Greece, Ireland and Portugal envisage substantial fiscal and structural adjustment. Initiatives to improve competitiveness and boost jobs and growth in the periphery have been announced. Economic and budgetary governance has been strengthened in a series of legislative acts, directives, and treaties. At the same time, the difficulty of regaining competitiveness in the context of a monetary union should not be underestimated, particularly given the low tradable base in the southern economies. Moreover, for deficit economies requiring relative price adjustment to help narrow imbalances, it will be important to avoid deflation in the periphery alongside the needed internal devaluation.

Euro Area Current Account Balance
(percent of euro area GDP)



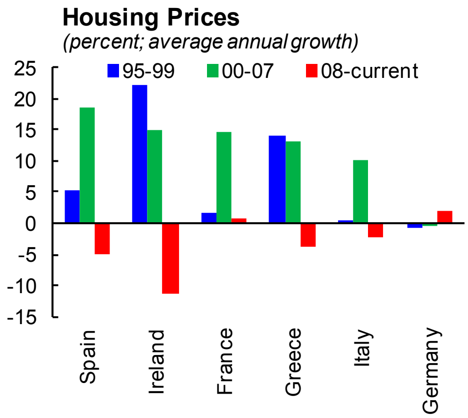
Source: IMF, *World Economic Outlook*.

II. CONTEXT AND DRIVING FORCES OF IMBALANCES

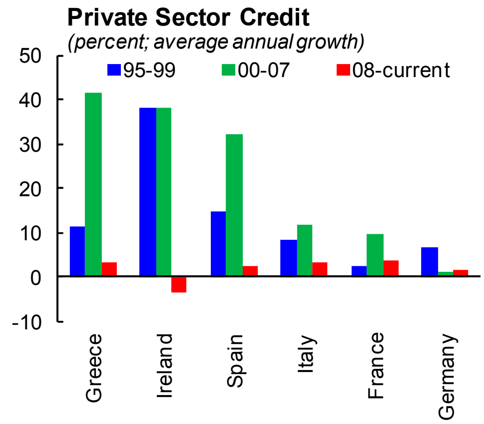
5. **The euro area included countries with diverse income levels and economic structures**. The more salient differences were in income levels, labor market institutions, industrial specialization, and financial development. Differences in product specialization were felt not only in the high-level division into services, industry, construction and agriculture, but more in specialization within those broad areas. For example, financial services played a prominent role in some members, while some others had large tourism sectors.

6. **The advent of the euro gave rise to anticipation of integration and convergence**. Income and productivity levels differed considerably across members at the inception of the monetary union. Optimistic expectations of faster catch-up generated consumption and housing booms in several countries, facilitated by easy financial conditions. The resulting current account deficits led to accumulation of foreign liabilities, even though the capacity to service those obligations was not growing commensurately.

7. **As interest rates converged, domestic demand, housing and credit boomed in the periphery**. In the context of significant trade and financial integration between members since the inception of the euro, the compression of the risk premium represented a dramatic improvement in borrowing conditions for economies with large deficits and made it easy for them to finance fiscal and external imbalances. Construction activity expanded significantly, particularly in Spain. Housing prices soared in many euro area economies, including in some core members, like France—but Germany was a notable exception. Stock markets experienced a bull run between early-2003 and mid-2007, with indices rising on average considerably more in deficit than in surplus economies. At the same time, leverage in the financial system increased throughout the euro area.

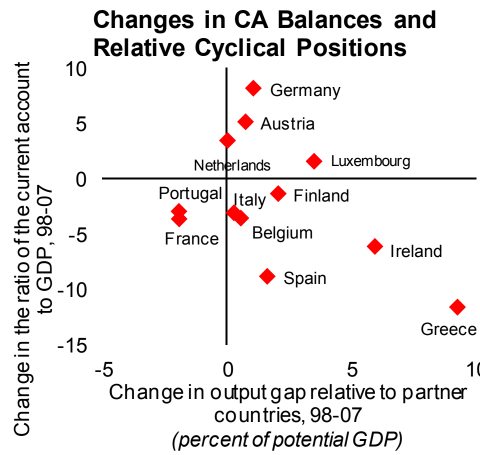


Sources: Bank for International Settlements (BIS); and Organization for Economic Cooperation and Development.



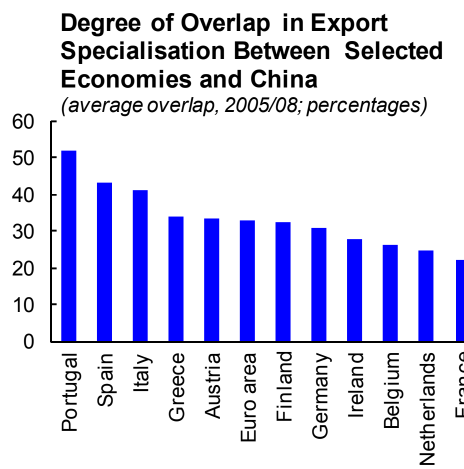
Sources: IMF, *International Financial Statistics;* and IMF staff estimates.

8. **Divergent cyclical positions also contributed to the accumulation of external imbalances**. Growth rates differed considerably in the euro area during the upswing—both in absolute terms and relative to potential—and faster-growing countries tended to accumulate larger current account deficits, reflecting demand expansion in excess of productive capacity.



Sources: IMF, *Global Economic Environment;* and IMF, *World Economic Outlook.*

9. **External shocks affected euro area economies differently, as global trade and specialization proceeded**. Paramount among them was the rapid growth of emerging Asia, particularly China, and its increasing role in international trade. Many periphery economies lost market share to low-cost competition, while Germany benefited from growing external demand for capital goods from these same trading partners.[4] In a somewhat similar fashion, German manufacturing firms were at the forefront of establishing assembly lines in neighboring Central European economies, taking advantage of relatively cheap, skilled labor and rapidly growing productivity. Many of those assembled goods were sold to other euro area economies, worsening their trade deficits with Emerging Europe (as well as overall deficits).



Source: Mauro, Forster, and Lima (2010).

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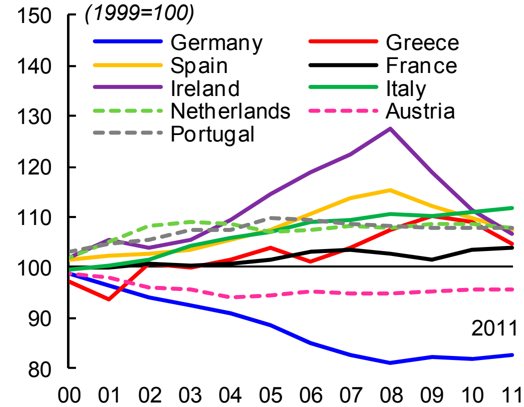
[4] Chen, R., G-M. Milesi-Ferretti, and T. Tressel, 2012. *External Imbalances in the Euro Area*, forthcoming IMF Working Paper.

10. **Competitive positions diverged considerably, reflecting disparate wage and price developments—partly due to underlying structural factors**. Booming domestic demand kept inflation considerably above the euro area average in several members, even though the productivity gap declined only slowly. As a result, unit labor costs rose substantially in those economies, while Germany experienced a dramatic decline in its relative unit labor costs thanks to wage moderation.[5] In contrast, rigidities in wage and price setting in the periphery kept inflation relatively high on a persistent basis.

Relative Unit Labor Cost, Against EMU Partners
(1999=100)



Source: European Commission.

11. **Adjustment to asymmetric shocks was insufficient, partly as mechanisms were not well developed**. Country-specific shocks or common shocks that affected countries unevenly because of structural differences could not be offset by area-wide monetary policy or exchange-rate movements. The alternative mechanisms for dealing with asymmetric shocks were not sufficiently developed. Prices and wages did not react to developments in external competitiveness—in fact, external deficit countries persistently ran higher inflation than surplus economies. Even where a domestic demand boom had weakened (e.g., in Portugal before its entry into EMU), wage and price growth remained above the euro-area average. Labor mobility across borders remained low.

III. ROLE OF POLICIES AND FRAMEWORKS

12. **Many failed to use good times to build up needed fiscal space**. In high-debt economies, the public debt-to-GDP ratio continued to rise (Greece) or declined only slowly (Italy), despite debt servicing relief coming from much lower interest rates. Asset booms made fiscal positions appear sounder than they were. In some booming economies (e.g., Ireland and Spain), debt ratios declined, but given the extent to which ample fiscal revenues had been linked to unsustainable asset market developments, structural balances remained fundamentally weak. That weakness was unmasked by the crisis. In addition, Spain and particularly Ireland had allowed their banks to overextend credit, necessitating costly public bailouts when the crisis hit. In Portugal, growth was sluggish after its entry into the euro area following an earlier credit boom, while fiscal balances were generally weak.

[5] Of course, differential movements in relative ULC indices do not by themselves allow one to distinguish between divergence and convergence in the *level* of competitiveness. However, given concurrent developments in the trade balances, one can be fairly confident that the competitiveness gap between Germany and southern euro area economies increased over the course of the 2000s.

13. **Financial oversight was lacking—as was market discipline**. With a common currency and undifferentiated interest rates, there was no appreciable market or policy pressure on deficit members losing external competitiveness. Easy access to credit continued despite persistent budget and external deficits and deteriorating net foreign assets positions. Market assessment of convergence prospects may have been overly optimistic. Relatedly, investors failed to see that fiscal positions in several countries were distorted by unsustainable asset booms. In addition, moral hazard may have been a factor given possible perceptions that, despite the absence of explicit arrangements, a government or a large financial institution would not be allowed to fail. As a result, easy credit from core country banks enabled wider deficits in the periphery.[6] Rapid credit expansion was also due to the loosening of underwriting standards and the lack of systemic oversight at the national level. This was compounded by poor quality of bank capital; the varied application of risk weights, and high leverage embedded in instruments in ways that were not transparent. Financial sector supervisors and sometimes even banks failed to understand where risks were located.

14. **While financial integration proceeded rapidly in key areas, the institutional framework lagged behind**. Fast integration of wholesale and bond markets provided ample financing to the private and public sectors of the periphery countries. However, despite growing financial linkages between countries, regulation and supervision remained under national purview with limited cross-border frameworks (e.g., memoranda of understanding). With respect to fiscal governance, the SGP limits on government deficits and debt were not stringently enforced, with their enforcement undermined by the fact that on occasion it was the largest and most influential members that exceeded the limits. Institutional reasons for SGP's relatively weak bite included the absence of an operational benchmark for the debt criterion, the absence of a procedure for addressing imbalances, and the absence of a credible enforcement mechanism.

15. **The weakness of EMU's institutional framework was particularly manifest during the crisis**. Area-wide financial stability risks—given the degree of integration and leverage—had been underestimated. Once the sustainability of fiscal and external positions of several member countries had been called into question, response mechanisms had to be improvised. There was no formal *ex ante* arrangement for fiscal risk sharing that would allow stronger members to support weaker ones. The ECB was explicitly prohibited from playing the role of a lender of last resort to governments directly in any significant way. Increases in deposit insurance required difficult coordination to prevent bank runs, while maintaining a level playing field. Resolution of troubled financial institutions with large cross-border activities posed serious challenges. Moreover, nationally-based supervision permitted strong linkages between sovereigns and banks to develop.

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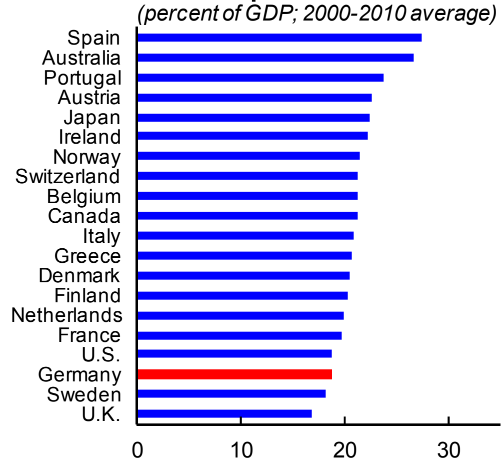
[6] As mentioned in the IMF's *Sustainability Report* on Germany (http://www.imf.org/external/np/country/2011/mapgermany.pdf), deeper issues with the business model of publicly-owned German *Landesbanken* may have made them particularly susceptible to such investments.

16. **Finally, persistently large current account surpluses—while not posing sustainability concerns—also need some policy attention**. In Germany, several proximate reasons were identified for large and persistent surpluses, including *favorable product specialization* helping Germany benefit from a cyclical upswing in global demand while being relatively insulated from low-cost competition from emerging Asian producers; *moderate wage growth* helping it maintain competitiveness; *fiscal consolidation* in the mid-2000s; *high household and corporate saving* and *low private investment*.[7] These factors reflected a combination of deeper causes, such as an overhang from the reunification boom; doubts about the durability of the expansion; uncertainty about income prospects arising as a result of labor market and pension reforms; unfavorable demographics; and certain financial sector distortions. It should be noted that the reasons for Germany's high saving and low investment rates are not fully understood. Given that the euro area is open to external trade, one cannot assert that German surpluses directly "caused" deficits in the periphery. Strong trade surpluses in Germany were largely *not* driven by intra-area trade balances. At the same time, stronger domestic demand in Germany would be beneficial both for the country itself and for its trading partners.

Gross Capital Formation
(percent of GDP; 2000-2010 average)

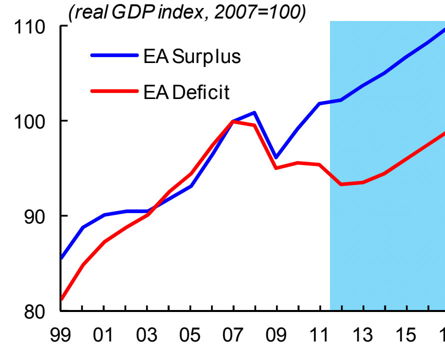


Source: IMF, *World Economic Outlook*.

IV. HOW TO BUILD A STRONGER UNION

17. **The euro area faces the challenge of simultaneously dealing with the crisis and laying the foundation for a stronger and more resilient union**. In the near term, resolving the euro area crisis will require, among other things, a combination of measured fiscal adjustment with ample liquidity support and financing for banks from the ECB and, if necessary, from official creditors. Requisite steps in the near term are discussed in Annex I. To anchor these crisis management efforts, however, further action over time is also needed to lend clarity and confidence in the future of a healthy and resilient EMU by addressing deeper-seated issues.

Euro Area: Growth and Recovery from the Crisis 1/
(real GDP index, 2007=100)



Source: IMF staff estimates.
1/ Euro area external surplus countries: Austria, Belgium, Finland, Germany, Luxembourg, and Netherlands.
Euro area external deficit countries: Greece, Ireland, Italy, Portugal, and Spain.

18. **While some compression in imbalances has already occurred, deeper fundamental adjustment is**

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[7] Ibid.

still also required. With the crisis, considerable current account adjustment has primarily reflected painful demand compression in deficit economies, alongside the fall in output. This shift relative to the pre-crisis trend in the periphery is likely to persist (see graph). Further improvement in imbalances depends on a restoration, over time, of underlying competitiveness in current account deficit economies through a combination of wage adjustment and accelerated productivity growth, both of which require structural reform. It is important to avoid deflation in deficit economies as part of the relative price adjustment process—a responsibility for the ECB consistent with its price stability mandate. Stronger demand from surplus countries would support a further narrowing of the imbalances. Inflation in surplus countries could be temporarily higher relative to deficit economies to help restore the latter's wage and price competitiveness without jeopardizing area-wide inflation objectives.

19. **Efforts on several fronts are needed to build a better functioning monetary union**:

- *Moving toward a pan-euro-area financial stability framework*. The monetary union will function effectively only if the financial system is well integrated, which inter alia implies centralized powers in banking supervision and resolution, and common deposit insurance.

- *Stronger fiscal integration*. Stronger national fiscal rules, as envisaged by the Fiscal Compact, and greater national coordination of fiscal policies will help maintain fiscal sustainability—provided stringent enforcement. But rules need to be carefully designed and implemented, complemented by fiscal risk sharing to ensure that economic dislocation in one country does not develop into a costly fiscal and financial crisis for the entire region.

- *Institutional monitoring and constraints on excessive imbalances*. The European Union's new Macroeconomic Imbalances Procedure is a useful step in extending surveillance over national policies beyond the fiscal realm. For the framework to be effective in containing problem imbalances, proper diagnosis and *enforcement* will be essential.

- *Structural reform to strengthen competitiveness and improve the ability to adjust to shocks*. The collective bargaining process should be made more responsive to firm-level economic conditions. Public wage restraint would not only facilitate fiscal adjustment, but also help contain economy-wide wage growth. Differences in employment protection for different categories of workers should be reduced, and in general barriers to hiring and firing should be lowered. Better targeted social safety nets would provide more efficient protection for vulnerable groups. In product markets, barriers to domestic and foreign competitions should be reduced.