

II.2. External rebalancing in the euro area: progress made and what remains to be ⁽⁵⁶⁾

Euro area countries with high current account deficits before the start of the crisis have now achieved balanced positions or even surpluses. This reflects substantial external rebalancing. The question is whether this is sufficient and the answer depends on whether levels of external indebtedness are sound. The analysis in this section shows that countries such as Estonia, Latvia and Slovakia corrected their current account positions early on in the crisis. At the same time, they have a level of indebtedness that does not pose sustainability risks for their economies and/or is slowly declining. Countries such as Spain and Portugal have stabilised their external positions and have current account surpluses that are helping to reduce their external indebtedness at a moderate pace. Nevertheless, their levels of indebtedness are high and require current account surpluses to continue. More efforts are required of Cyprus and, in particular, Greece if they are to improve their current account positions and reduce their indebtedness. In general, the process of external rebalancing is not finished, as there is still a need to address high stocks of debt. Moreover, the ability to achieve that is surrounded by significant risks that relate predominantly to persistently lower-than-expected inflation and growth.

External rebalancing — how far have we got?

An earlier contribution to the *Quarterly Report on the Euro Area* ⁽⁵⁷⁾ concluded that a number of countries in the euro area needed to do more to improve their external positions. Substantial progress has since been made in most euro area countries in this respect, but the adjustment remains asymmetric, with surplus countries further increasing their surpluses.

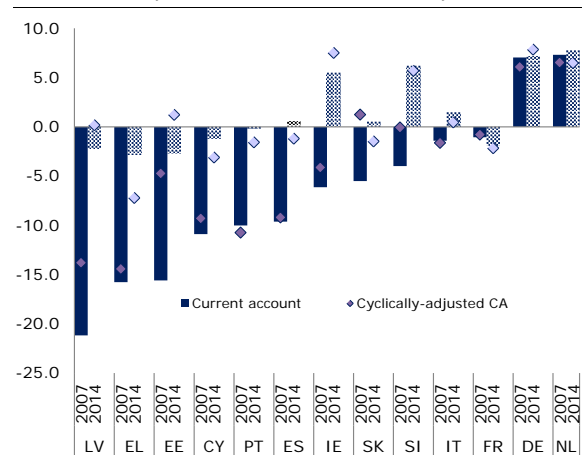
In this section, we revisit and update the assessment of external sustainability. We focus mostly on a small number of countries in the euro area, namely those that have been characterised as

vulnerable in recent years (Cyprus, Greece, Spain, Ireland, Portugal and Slovenia). These countries have managed to improve their current account positions substantially. At the same time, their levels of external indebtedness remain high (except for Slovenia) and in any case, mostly composed of debt liabilities. Both the level of debt and its composition can pose considerable risks in terms of sustainability. ⁽⁵⁸⁾

For comparison purposes, the analysis also occasionally includes those euro area Member States that accumulated large current account deficits in the pre-crisis years but closed these deficits earlier in the crisis, i.e. by 2010 (Estonia, Latvia and Slovakia). The external indebtedness of these countries has stabilised at levels of no more than 60% of GDP and, importantly, this debt is in its most part foreign direct investment (FDI) rather than debt liabilities. As a result, the underlying risk is shared between the countries concerned and their creditors.

For reference, the section also includes some data for the euro area's two main creditor ⁽⁵⁹⁾ countries (the Netherlands and Germany) and the two remaining large Member States (Italy and France).

Graph II.2.1: **Actual and cyclically-adjusted current account levels**
(2007 and 2014, % of GDP)



Source: European Commission calculations

Current account balances in the countries that faced large current account deficits prior to the crisis have now improved substantially (see Graph II.2.1). By 2014, all countries recorded

⁽⁵⁶⁾ Section prepared by Alexander Hobza and Maria Demertzis.

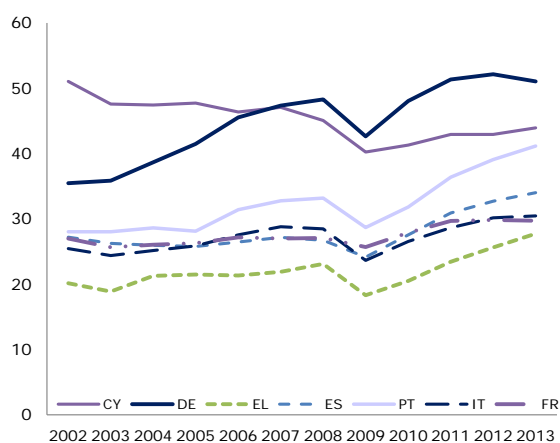
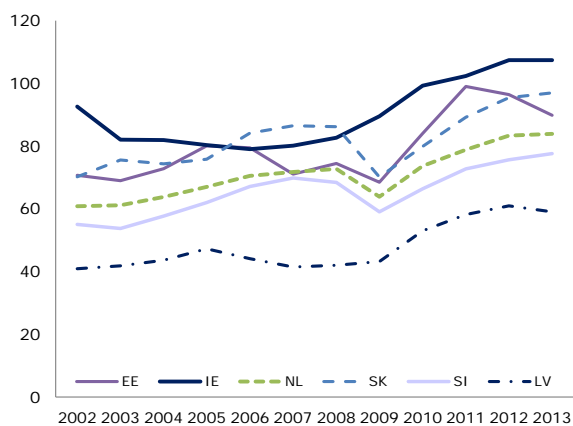
⁽⁵⁷⁾ D'Auria, F., J. in't Veld, R. Kuenzel, (2012): 'The dynamics of international investment positions', *Quarterly Report on the Euro Area*, Volume 11, No 3.

⁽⁵⁸⁾ 'Sustainability' will be discussed in the last section in greater detail.

⁽⁵⁹⁾ Creditors in the sense of having a positive net international investment position.

surpluses or very small deficits.⁽⁶⁰⁾ As to the nature of the adjustment, previous analyses indicate that much of this correction has been non-cyclical.⁽⁶¹⁾

Graph II.2.2: **Exports of goods and services**
(2002-2013, % of GDP)



Source: Eurostat

This implies that improvements in the position in the business cycle are unlikely to lead to current account positions similar to those witnessed prior to the crisis.⁽⁶²⁾

The adjustment to the current accounts is the result of both a reduction in imports as well as an

⁽⁶⁰⁾ Preliminary data on the latest positions indicate that Spain has reverted back to deficit, at least temporarily. This is primarily due to changing external market conditions that have adversely affected exports.

⁽⁶¹⁾ European Commission, 2014: ‘The cyclical component of current-account balances’, *Winter Forecast*, Box 1.3 (and more recent (autumn 2014) forecast for updated numbers); ‘Legacies, Clouds and Uncertainties’, *IMF World Economic Outlook*, 2014.

⁽⁶²⁾ The reliability of cyclically adjusted current account estimates depends on the accuracy of output gap estimates. However, output gaps would have to be unrealistically large to overturn the conclusion that most of the adjustment is non-cyclical.

increase in exports. Naturally, given the collapse in demand, the resulting reduction in imports has been an important driver. However, expanding exports have also played an important role in some of the countries’ efforts to correct current account imbalances, in particular Ireland, Slovenia, Portugal and more recently Spain and Greece (Graph II.2.1).

An important consequence of countries’ having achieved positive current account balances is that the euro area as a whole has an increasingly positive current account. In this respect, debtor countries have been mostly responsible for rebalancing at euro area level, with creditor countries not adjusting their surplus positions. In fact, the current accounts in Germany and the Netherlands, the two main creditors with a surplus, have continued to grow since the crisis and now exceed 7% of GDP.

As for the other very large euro area economies, Italy posted a slight surplus in 2013 (with a cyclically corrected current account close to zero), while France’s current account has deteriorated in actual terms (-1.9% of GDP in 2013) and even more so in cyclically-adjusted terms (-2.2%) (Graph II.2.3). While France’s current account deficit is still relatively contained as a proportion of GDP, it is now the euro area’s largest in euro terms.

Graph II.2.3: **Contributions to euro-area current account balance**
(2002-2013, % of euro area GDP)

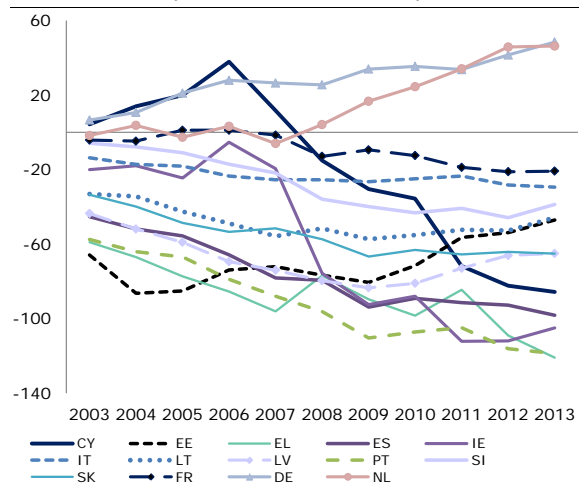


Source: Eurostat

Overall, the euro area’s current account balance increased from 2.0 % of GDP in 2012 to 3.0 % in 2013 and is expected to rise further, to 3.2 % in 2014.

However, in evaluating the extent of the adjustment made and how much remains to be done, one needs to assess progress in both flows and stocks. Despite the observed adjustment in flows, there has not been much adjustment in external liability stocks, which remain very high, particularly in vulnerable countries (Graph II.2.4).

Graph II.2.4: Net international investment positions
(2003-2013, % of GDP)



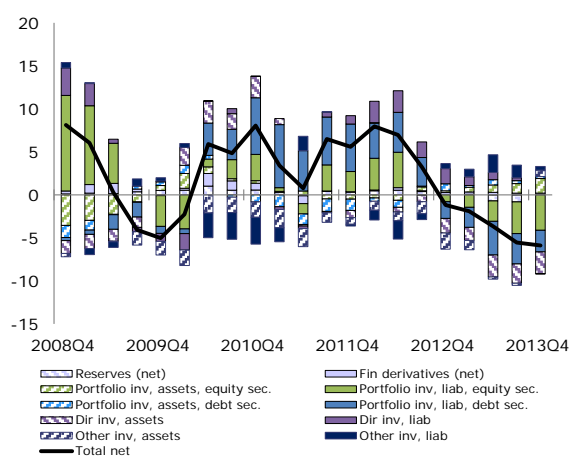
Source: Eurostat

For a number of countries (Greece, Portugal, Ireland and Spain), net foreign liabilities were close to, or above, annual output in 2013. In Italy and Slovenia, the Net International Investment Position (NIIP) is relatively contained (-29% and -37% of GDP respectively).

Even more importantly, of the euro area Member States with negative NIIPs, only Ireland and Slovenia have recorded some recent improvement in their NIIP levels. In the other countries, NIIPs either stagnated (Portugal) or continued to worsen. In this respect, the adjustment process is incomplete.

An additional dimension in assessing flow developments is given by valuation effects, which have been an important factor in recent changes in NIIPs (Graph II.2.5). On average in 2009-12, valuation gains on outstanding stocks of foreign assets and liabilities have tended to reduce external indebtedness in the vulnerable countries. After 2012, however, many of these countries recorded valuation losses, mostly accrued on their portfolio debt and equity liabilities.

Graph II.2.5: Breakdown of valuation effects
(2008Q4-2013Q4, % of GDP)

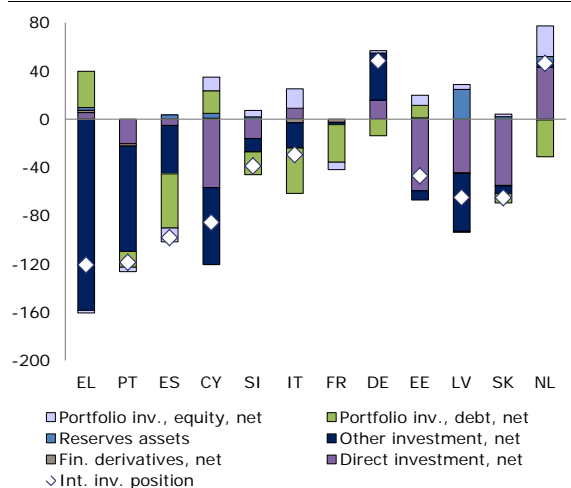


(1) Chart includes aggregated data for EL, ES, PT, CY and SI. IE excluded due to data issues.

Source: Eurostat.

A dominant share of the vulnerable countries' NIIPs is composed of debt, which further adds to sustainability risks. Graph II.2.6 shows that these countries' net foreign liabilities consist in large part of 'other liabilities', i.e. cross-border loans (Greece and Portugal) and portfolio debt (Spain and Cyprus).

Graph II.2.6: Breakdown of net international investment positions
(2013, % of GDP)



Source: Eurostat

Financial instruments that allow for better financial risk-sharing, i.e. FDI or portfolio equity, account for a fairly negligible proportion.⁽⁶³⁾ By contrast,

⁽⁶³⁾ In the case of Greece, sustainability concerns are different, because for the most part the NIIP level reflects financial

Estonia, Latvia and Slovakia have very substantial FDI components in their NIIPs, which allows for a better distribution of risk and the burden it imposes.

How much adjustment is still needed?

Determining how much more adjustment is needed depends on what level of external indebtedness countries should aim to achieve. Since there is no consensus as to the ideal level of external indebtedness or how quickly it should be achieved, below we postulate alternative NIIP target levels for countries to reach by different dates⁽⁶⁴⁾ and show what efforts this would involve. The scenarios vary both in terms of the stringency of requirements and the pace at which they should be met. The resulting current account position is then compared with the cyclically-adjusted current account forecast for 2014.

Table II.2.1: Average level of current account (% of GDP) needed to reach various benchmarks (1)

Benchmarks	ES	PT	IE	SI	CY	EL
NIIP in 2014 (expected)	-95.4	-115.0	-95.0	-31.3	-86.0	-121.0
Stabilise at 2014 NIIP level in 10y	-3.3	-3.4	-4.1	-1.1	-2.2	-2.4
Bring NIIP to -35% of GDP by 2024 (in 10 y)	3.6	5.7	3.3	-1.4	3.3	6.7
Bring NIIP to -35% of GDP by 2030 (in 16 y)	1.2	2.5	0.9	-1.3	1.2	3.3
Bring NIIP to -50% of GDP in 10y	1.8	4.0	1.5	-3.1	1.6	5.1
Reduce 2013 NIIP by half in 10y	2.2	3.2	1.8	0.9	2.2	4.0
Reduce 2013 NIIP by half by 2030 (in 16y)	0.2	0.8	-0.1	0.2	0.4	1.4
CA in 2014 (expected)	1.4	1.0	7.4	6.0	0.0	-2.3
Cyc.-adjust. CA in 2014 (expected)	-0.9	0.3	8.3	5.6	-2.2	-5.7

(1) The shaded cells show benchmarks that are more demanding than the cyclically adjusted current account balance estimated for 2014.

Source: DG ECFIN

We start by computing NIIP-stabilising current accounts, i.e. the average current account levels that countries would have to sustain (for a conventional period of 10 years) to keep their NIIP-to-GDP ratio unchanged from the latest value. We complement this basic benchmark with

assistance received under the programme (and central bank liabilities). For Cyprus, financial programme assistance represents about 30% of GDP. In the case of Ireland (not shown in the graph), the composition of the NIIP is more favourable, thanks to FDI and the fact that multinationals' debts are not intermediated by the domestic banking system.

⁽⁶⁴⁾ We examine here only the countries with high levels of indebtedness (very negative NIIP). We include SI for completeness, even though its NIIP is not very negative (by comparison).

alternative scenarios in which NIIPs must reach various levels within a given period. All simulations assume average growth, inflation and trade balance based on Commission staff projections.⁽⁶⁵⁾ The simulations also assume that there are no valuation effects, i.e. prices of foreign assets and liabilities remain unchanged. Given the difficulty of predicting valuation effects, this is a standard way of dealing with them in the literature (Gourinchas, 2008).⁽⁶⁶⁾

Table II.2.1 sets out the scenarios and results and Table II.2.2 shows the main assumptions.

Table II.2.2: Main assumptions in the baseline scenario

Benchmarks (2015-2024)	ES	PT	IE	SI	CY	EL
Average real GDP growth rate	2.2	1.5	2.6	1.3	1.6	0.9
Average inflation rate (GDP deflator)	1.6	1.6	1.7	1.8	1.8	1.5

Source: DG ECFIN

The figures show that further, sometimes quite sizeable, improvements are still needed in a number of countries if they are to meet these benchmarks. Efforts to contain the level of indebtedness vary significantly according to country and target level:⁽⁶⁷⁾

- All countries except France and Greece are estimated to achieve current account positions in 2014 that stabilise their NIIP position at their current level. However, for a number of them (Ireland, Spain, Portugal and Greece), the current level of external indebtedness is a potential risk. Running current accounts that simply stabilise the level of indebtedness may therefore not be sufficient.
- As estimated for 2014, Greece's cyclically-adjusted current account position is not compatible with any of the benchmarks. It will have to increase by more than 3 pps. to reach

⁽⁶⁵⁾ Short-term projections (AMECO) and Medium-term projections from medium term forecasting framework (AMECO) and long-term projections are published in the Fiscal Sustainability Report (2012), European Commission.

⁽⁶⁶⁾ Gourinchas, P.O. (2008), 'Valuation Effects and External Adjustment: a Review', *Central Banking, Analysis, and Economic Policies Book Series*, Central Bank of Chile.

⁽⁶⁷⁾ These simulations do not take account of second-round effects, i.e. further increases in current account surpluses in these countries dampening growth and inflation, in turn increasing the surplus required to reach a given benchmark.

the least demanding benchmark (stabilising the NIIP at the 2014 level). However, a mitigating factor is the fact that programme assistance constitutes a substantial component of external liabilities (see footnote 8).

- Cyprus' cyclically-adjusted current account position in 2014 stabilises the NIIP at the 2014 level, but falls short of other benchmarks.
- Spain and Portugal both require greater improvement in their current account balances to achieve any benchmark.
- The high surpluses in Ireland and Slovenia are currently compatible with fast NIIP reductions that achieve all the benchmarks. Irrespective of countries' efforts to reduce their indebtedness, NIIP developments depend crucially on growth and inflation assumptions.
- All our simulations assume a constant path for growth and inflation. The risks surrounding the baseline scenario stem from persistently low inflation coupled with weaker-than-expected growth. Such adverse shocks could be generated by developments, e.g. deleveraging pressures, but could also be related to the asymmetric nature of adjustment in the euro area. As domestic demand in creditor countries has not increased (reflected in higher current account balances), demand at the euro area level remains depressed. This puts downward pressure on prices and growth, which could negate some of the vulnerable countries' efforts to become more competitive.

Conclusions

In conclusion, current account positions in most countries meet the NIIP sustainability conditions, but the attendant risks are high. In Greece, where the adjustment observed so far appears mostly cyclical and the cyclically-adjusted current account position does not ensure that external debt will not increase, greater efforts will be needed to reduce external indebtedness. Also, the position of Cyprus appears rather vulnerable, partly because its external position has fluctuated widely of late due to a mix of other (real, financial and accounting) factors. Spain and Portugal have stabilised their external positions and their current account surpluses are helping to reduce net external indebtedness at a moderate pace. More ambitious targets do not seem feasible within the ten-year timeframe. There are also significant risks involved: any adverse shocks to inflation and/or growth would cause their external positions to deteriorate significantly. For Ireland and Slovenia, this problem is less acute. Italy and France, the two large countries with negative NIIPs, have relatively low external debts, although in the case of France these are growing gradually as a result of current account deficits.

Lastly, the creditor countries also have an important role to play as contributors to the macroeconomic environment in which vulnerable countries are asked to adjust. Low domestic demand suppresses inflation and relative prices do not necessarily adjust as required if vulnerable countries are to regain competitiveness. In this respect, greater symmetry in adjustment, creating the conditions for growth to pick up, would relieve some of the risks contributing to the current unfavourable macroeconomic climate.