Imbalances in the Euro Area

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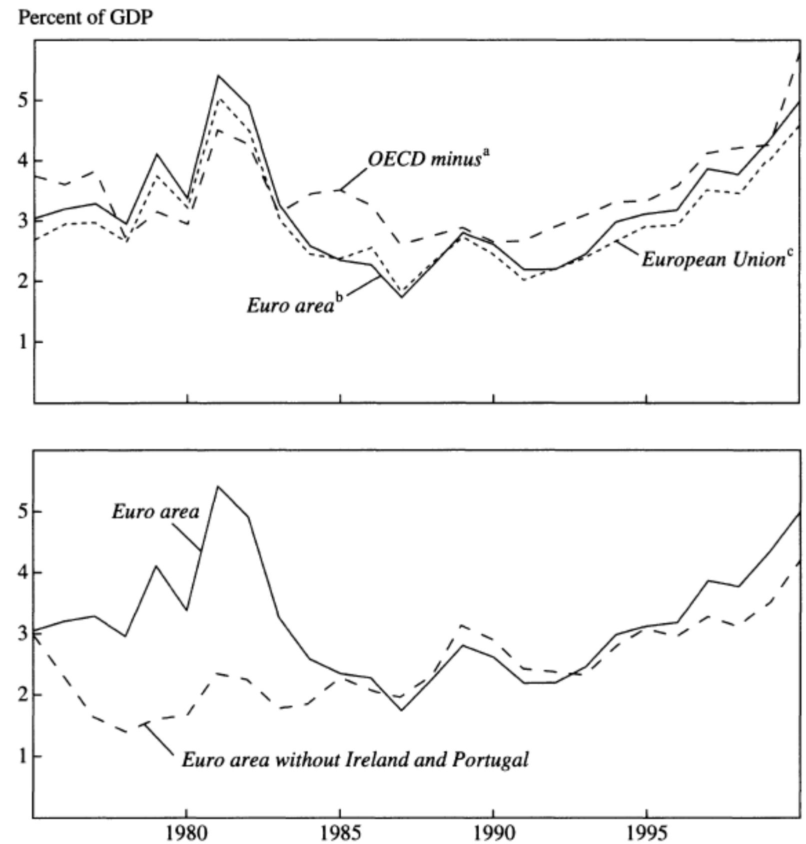
- In this presentation, and the associated paper, I attempt to provide a synthesis of the debate, evidence and prospects for imbalances within the euro area.
- By imbalances I mean current account imbalances and the associated capital flows.
- Our organizers, in asking us to talk about imbalances, were sufficiently astute not to specify whether they meant current account imbalances, fiscal imbalances, or competitive imbalances.
- Obviously, current accounts, budget balances and unit labor costs are "three sides of the same coin." One really can't talk about one without talking about the others.
- That said, I will focus here on current accounts – appropriately, I think, given recent events.

The starting point for any discussion of this is necessarily Blanchard-Giavazzi 2002

- They showed that savings-investment correlations fell significantly even before but especially with the advent of the euro.
- They interpreted this in terms of the increased financial integration that comes with the adoption of a single currency.
- This was even truer if one excluded Ireland and Portugal (“interesting…”).

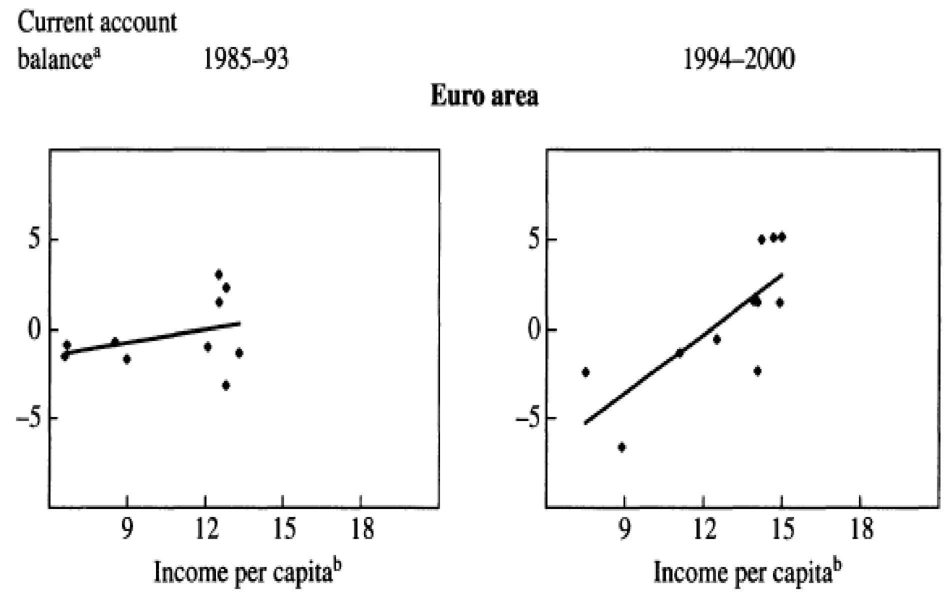
Figure 1. Cross-Country Standard Deviations of Current Account Balances for Selected Country Groups, 1975–2000



More Blanchard-Giavazzi 2002

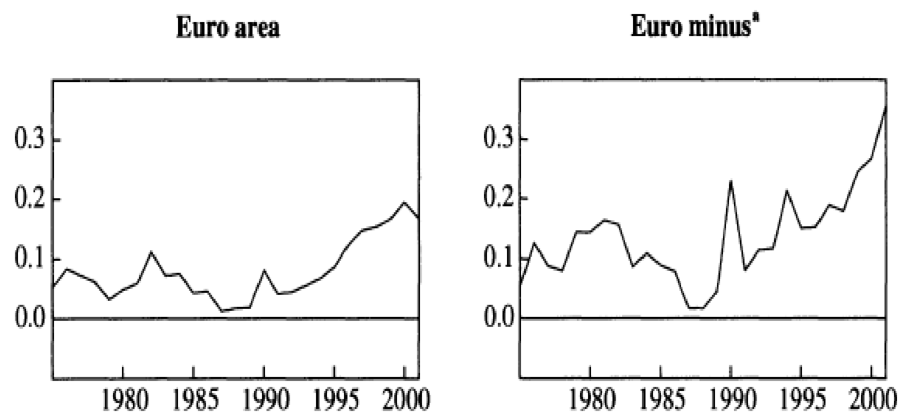
- They demonstrated that the current account balances (surpluses) of the member states increased with per capita income.
- In other words, they showed capital to be flowing "downhill" from more advanced, capital-abundant countries to their less advanced, capital-scarce euro-area partners.
- This reflected the scope for high productivity growth in the catch-up economies.
  - And the pattern was even more evident when one looked at the (then) more recent period.
- So these were "good imbalances," or so it appeared.

Figure 2. Average Current Account Balances and Income per Capita, Selected Country Groups, 1985–2000



- But the pattern was more evident (revealingly) if one excluded Greece and Portugal.
- So I take this as something of a mixed early assessment.
- The authors were optimistic about capital flowing in the "right" direction.
- But they were also somewhat cautious about Ireland, Greece and Portugal.

Figure 3. Yearly Coefficients of Current Account Balances on Output per Capita from Panel Regressions, 1975–2001



Source: Authors' regressions discussed in the text using data from AMECO and from Penn World Tables.
a. Euro area as previously defined except Greece and Portugal.

- And, similarly, Ahearne, Schmitz and von Hagen (2009) – in the ancestor to the other paper in this session – use data through 2006 and affirm this tendency for intra-euro-area capital to flow from high- to low-per-capita-income countries.

With benefit of hindsight (and more data), we know that things didn't turn out exactly this way

- Convergence is conditional not just on the gap in per capita incomes but also on the quality of policies and institutions. The "good imbalances" driven by productivity differentials turned out to be "bad imbalances" driven by domestic distortions: bubble-driven asset booms, excessive budget deficits, and unrealistic expectations of future growth.
- Two papers – Zmanek, Belke and Schabl (2009) and Berger and Nitsch (2010) – now document the tendency for intra-euro-area capital to flow toward the countries where domestic distortions are most severe and structural reforms are least.
- The supposedly efficient German and Dutch banks at the center of the financial intermediation process, which funded themselves globally in order to load up on Greek, Spanish and Portuguese bonds, turned out to be dangerously over-leveraged institutions stretching for yield and taking on excessive risk.

And, already a decade ago, there were some disturbing anomalies

- Much of the growth in deficits in catch-up economies reflected declining saving, not rising investment (as Blanchard and Giavazzi already showed).
- Much of that additional investment that occurred was in property and real estate.
- The contribution of productivity to overall growth in the periphery declined with time.
- Differential inflation rates exceeded what Balassa-Samuelson could explain.

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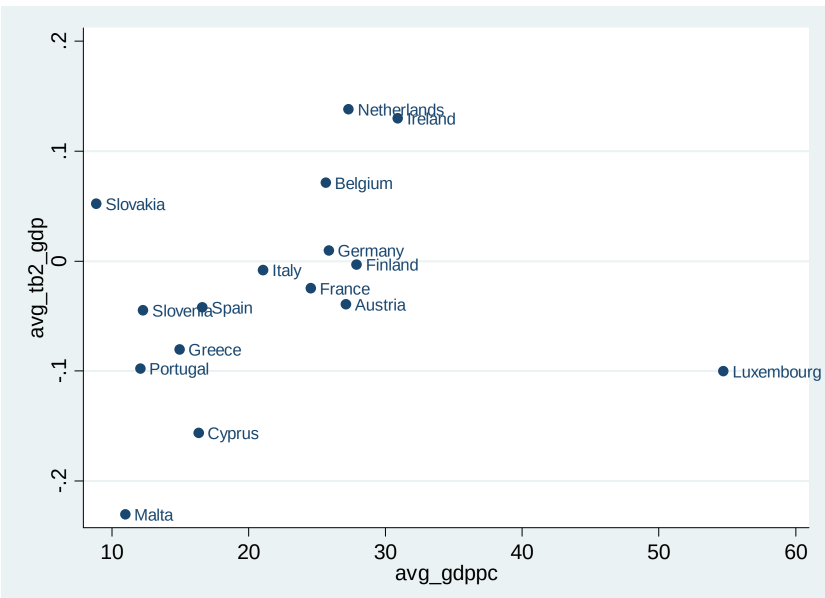
- I would submit that part of the answer is the intrinsic difficulty of distinguishing “good” and “bad” imbalances.
  - The same debate prevailed in the United States about whether the current account deficit in the decade through, say, 2004 was a good imbalance driven by attractive investment opportunities associated with information and the productivity miracle or a bad imbalance reflecting chronic budget deficits and asset-market distortions.
    - But even now, long after the fact, there is disagreement about how to apportion those deficits into their “good” and “bad” components.
  - Again more recently, there was extensive debate about whether the capital flows into the “sand states” of Arizona, California, Florida and New Mexico in the years leading up to 2007 reflected their rosy economic prospects or an unsustainable housing boom.
- A similar problem prevailed in Europe.

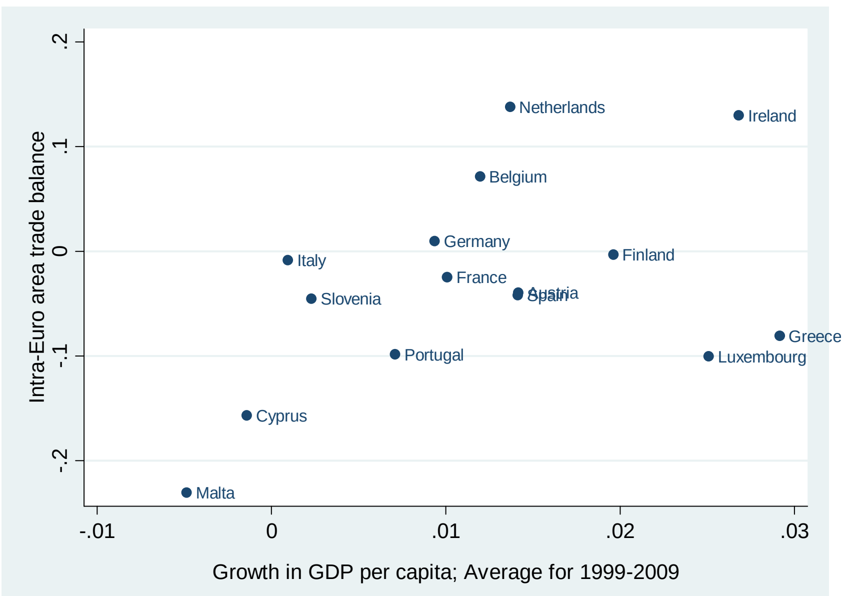
- Attempts to answer the question empirically turn out to be problematic.
  - As I now show…

Here we have the intra-euro-area imbalance against per capita income, 1999-2009



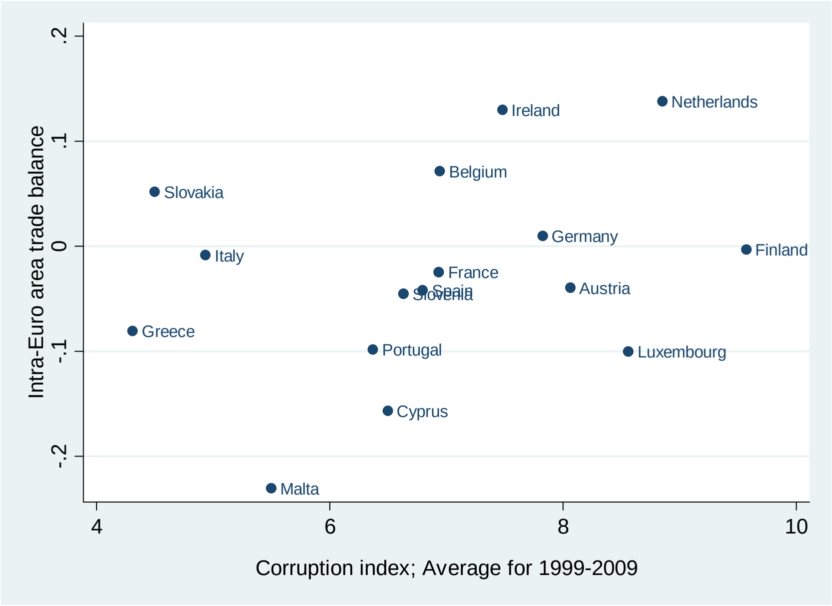
- This relationship is positive.
- Statistically significant.
  - Ignoring Luxembourg.
- Looks like good imbalances, with capital flowing from high- to low-income euro-area countries.

But here we have it with the growth of per capita income rather than its level



- Again the relationship is positive.
- Again it is significant.
- This one looks like bad imbalances, with capital flowing *from* fast- *to* slow-growing economies.

And here we have the correlation with the inverse of corruption



- Here it looks like capital is flowing toward less transparent ("more corrupt") countries.
- More evidence of bad imbalances?

These variables are of course highly correlated

- Rendering regression results extremely sensitive.
- I have looked at an unbalanced panel of euro-area countries only, 1999-2009.
- Dependent variable is intra-euro-area-imbalances.
- GLS regressions with heteroscedastic errors and autocorrelation (AR1) correction, with and without Luxembourg, and with and without additional controls.
- When one includes level of per capita GDP, looks like good imbalances: pc GDP matters, corruption does not.
- But when one includes growth rate of per capita GDP, looks like bad imbalances, growth of pc GDP does not matter, corruption does.
- This makes my point about the difficulty of distinguishing good from bad.

- But simply because a task is analytically difficult, policy makers do not have dispensation to ignore it.
- Officials have reluctantly come around to this view when it comes to asset market bubbles: while bubbles may be hard to identify, that doesn’t mean that they can be treated with benign neglect.
- The same logic, I would submit, applies to imbalances, whether we mean global imbalances or intra-European imbalances.

The other thing that the debate over good and bad imbalances reminds us is that mechanical rules for intra-EU imbalances would be wrong-headed

- Calls for a "Stability Pact" for intra-EU current account imbalances, under which countries running current account deficits in excess of 3 per cent of GDP would be subject to automatic sanctions and fines, are misplaced.
- Good thing you resisted Secretary Geithner…
- There is such a thing as a good imbalance, and one would not wish to penalize a country for running one.
- Unavoidably, policy makers will have to make a judgment. They will have to trace intra-euro-area imbalances to their source, whether that source is differential productivity growth leading to differential investment opportunities or domestic distortions.
- And where domestic distortions are their root, this warrants intervention by regulators (if the distortions in question originate in the financial sector and manifest themselves as asset and property bubbles) or by the fiscal authorities (if the distortion is political and manifests itself in the form of budgetary excesses).

- Here the European Commission, the ECB and the von Rompuy taskforce have taken the right approach by seeking to extend the Stability Pact to determinants of the external position and international competitiveness above and beyond budget deficits.
- They have done the right thing by agreeing that sensitive matters such as the national political arrangements and procedures through which budgets are decided, the structure of regulation, and wage-bargaining systems are fair game for surveillance.
- But now the Commission, with its expanded jurisdiction and strengthened mandate, needs to put in place procedures that work.

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- Why don't we have problems with current accounts within the USA?
- One explanation is that we don't gather data on them.
- But there is more to it than that. For many years California, Arizona, New Mexico and Florida ran substantial current account deficits vis-à-vis the rest of the United States. This reflected job and economic growth that consistently exceeded the national average and more-than-typically attractive investment opportunities.
  - These were "good" imbalances of the sort described above.
- More recently, however, these same states saw some of the most extreme housing-market bubbles and building booms.
  - We can say, with benefit of hindsight, that miles of McMansions were financed by bad imbalances.

- But in the absence of statistics on capital flows and trade balances, the focus of the resulting policy discussion is on the domestic distortions that resulted in “bad” imbalances:
  - Inadequate regulation of the mortgage-broking industry and banking sector
  - The incentive to take on excessive leverage created by no-recourse mortgages
- Not on the current account deficits per se.
- The focus is thus on the source of the problem and not the symptoms.
- And it is on the source rather than the symptom that the focus belongs in a well-functioning monetary union.

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- The answer, in my view, is nothing.
- “Bad imbalances” are not obviously more prevalent inside the euro area than elsewhere.
- In the last ten years, we have had a mammoth flow of capital uphill from emerging markets to the United States that dwarfs anything witnessed in Europe.
- Maybe this is telling us that the current international monetary non-system is even less sustainable than the euro.

- Thank you very much.