Summary for non-specialists
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External Imbalances and Public Finances in the EU

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The global financial crisis has revealed in particular that the increase in EU trade and financial integration might lead to the building up of large external imbalances heightening the costs associated with the risk of sudden increase in debt-financing cost. Dynamic internal demand favoured by the credit expansion and property prices appreciation has led some euro area countries (such as Ireland or Spain) to experience growing current account deficits, appreciating real exchange rates and significant increase in net foreign liabilities prior the outbreak of the current financial crisis. Other countries (such as Germany or the Netherlands) have, on the contrary, benefited from dynamic export-led growth but appeared also exposed to the sudden halt in world trade with disruptive consequence for public finances and economic growth. Outside the euro area many recently acceded Member States experienced significant real exchange rate appreciation and fast deteriorating current account balances increasing their exposure to the financial crisis and the sharp cyclical downturn that followed. Existing evidence shows that, in the past, countries facing such sudden increases in debt-servicing costs often relied on exchange rate adjustment to restore competitiveness and promote export-led recoveries following the advent of major economic downturns. Such mechanisms, however, no longer exist for euro area countries, providing further prominence to fiscal policy as macroeconomic adjustment device for preventing the building up of external imbalances and smoothing the adverse effects of post-crisis adjustment process on prices and economic growth.

As illustrated by the Public Finances in EMU – 2010 report, over the last ten years, significant divergences in the external economic performance of the EU Member States have set in and this has carried contingent economic and budgetary costs. This has brought into focus the consequences of external imbalances and the interrelation between the two key challenges of winding them down and reversing the increases in government debt ratios. The coming years will thus see EU governments undertake consolidations at a time when external imbalances will have to be corrected. The effects of such fiscal contractions on output - through large multipliers affecting domestic demand and revenues - may be sizeable, however, owing to credit and liquidity constraints. At the same time, competitiveness adjustment starting from overvalued real exchange rates and highly leveraged economies, will likely lead to low real growth and high real interest rates as relative prices adjust thus making the need to achieve successful fiscal consolidations through lower debt level even more pressing.

The existing literature on the link between external imbalances and public finances remains inconclusive however and provide too little guidance about the best strategies to be adopted in the EU and euro context regarding the prevention of macroeconomic imbalances and their incidence on the success of fiscal consolidations. Most studies consider the effects of budget deficits and government debt on aggregate demand. According to the Keynesian approach, where fiscal deficits are assumed to result in higher domestic, the accompanying increase in imports leads to the so-called twin deficits. The literature finds some, albeit limited, support for this effect. In contrast according to the Ricardian approach, as the private sector adjusts its future expectations of income in the light of rising public debt and the related debt burden and increases its savings accordingly, both output and the current account balance are unaffected by fiscal policy. There is some evidence in favour of the Ricardian approach too, in the literature, qualified by the prevalence of liquidity constraints faced by private agents. However, alongside the overall inconclusive evidence of these macro studies, the run-up to the current crisis has evidenced the possible effect of macro and micro transmissions channels whereby fiscal policy can affect investment and savings decisions despite the fiscal stance being neutral. A thorough analysis of non-conventional macro and microeconomic transmission channels is thus badly needed to expose the full effect of the public finances on external imbalances.

The questions faced by European policy makers are therefore difficult and to a large extent still unresolved. The Directorate General for Economic and Financial Affairs (DG Ecfin) has set out to investigate these questions by organising a workshop in November 2009 which is summarised below. This workshop encouraged further discussions and work in DG Ecfin on the implication of external imbalances for the conduct and surveillance of economic and fiscal policies in Europe. These analyses contributed to recent policy initiatives as illustrated by the Commission's Communication on enhancing economic policy coordination for growth and jobs published on the 30 June 2010 in which questions regarding the need to advert the build up of imbalances in future fiscal surveillance were directly taken on board. External imbalances are likely to weigh on Europe economic recovery in the coming years as well. Countries with competitiveness problem will need to address external imbalances decisively in order to achieve successful fiscal consolidations and invigorate growth recovery. The best strategies to adopt in such context are still open to discussion, however. For this very reason, this report also includes an additional chapter based on recent work by DG Ecfin on the link between external imbalances and fiscal consolidation strategies.

The workshop was organised in three sessions, focusing on respectively "global imbalances and fiscal policy", "Country experience" and "The Ricardian hypothesis and the role of tax policy". The papers presented mirrored the existing literature in that they covered a wide spectrum of approaches without providing conclusive evidence on the relationship between internal and external imbalances. In particular there was no consensus on either the short or long-run relationship between fiscal policy and current account imbalances, although a wide range of models and possible effects were presented leading a rich debate. The panel discussion that followed the presentations focussed on the role that fiscal policy can play in addressing and correcting existing and emerging external imbalances in the light of the research presented within the context that the European economies currently find themselves in.

The role of fiscal frameworks was considered and the possibility of including the avoidance of imbalances within the remit of fiscal policy was discussed. In particular, the possibility of looking at how microeconomic policy leads to the build-up of both internal and external imbalances was highlighted, with a case being made for using micro-policy to bring balance where divergences were noted. A serious consideration in this issue, however, is that it can be difficult to judge when an imbalance exists, or at least when it is sufficiently large to merit a fiscal intervention. Overall, a comprehensive approach to economic policy was seen as important to ensuring macroeconomic stability. The interdependence of the fiscal and structural policies together with macrofinancial surveillance was flagged as key to both the significant questions that remain about the relationship between fiscal and external imbalances as well as to the need to address emerging issues together. In the European context the possibility of incorporating external imbalances in the preventive and, where appropriate, the corrective arms of the Stability and Growth Pact would provide a means for increasing the importance given to such imbalances and helping to avoid the problems that they can cause. However, making the avoidance of such imbalances a requirement on a par with the avoidance of deficits and debt was seen as a task difficult to achieve and possibly requiring further analysis integrating microeconomic channels of fiscal policy related to, for instance, taxation, public wages and employment. In terms of internal imbalances, the need to improve the measurement of liabilities – whether explicit or implicit – was stressed as was a better understanding of the implications of micro policies on the wider economy.

Of course, in doing so it would be necessary to make a judgement about how significant the risk posed by emerging imbalances is. In the current crisis, it appears that countries with the largest external imbalances seem to be the hardest hit – focussing on the worst case scenario implied by the macroeconomic fundamentals at any point in time would be one way of addressing difficulties before they materialise but this should be weighed against a concern that credibility should not be compromised. A delicate balance needs to be struck. The discussion of the role of the internal budget imbalances in the current crisis considered the possibility of using rainy day funds to mitigate against pro-cyclical fiscal policy and avoid the damaging deficits that have emerged in a large number of countries in the current juncture. While these have potential benefits they also present difficulties. While they may be desirable on an individual country level, they can lead to global (or regional – if implemented regionally) imbalances and also pose the question of whether using fiscal means to address problems that in the current instance are financial would be a wise approach.