II. Underlying domestic macroeconomic imbalances fuelled current account deficits

Macroeconomic imbalances, including housing and credit bubbles, contributed to significant current account deficits in the years preceding the crisis. The crisis has corrected a number of these imbalances, including a progressive cooling-off of housing markets. At the same time, significant imbalances remain and there is a need for further adjustment involving a rebalancing of relative prices and demand across Member States. However, the crisis might render the adjustment more challenging because the combination of low inflation and nominal rigidities as well as lower growth potential can make necessary wage adjustments more difficult. Balance sheet adjustment and impaired financial intermediation may further hamper the necessary adjustment processes. At the same time, recent developments have sharpened awareness of the underlying problems as well as of the necessary steps to address them.

Current accounts and competitiveness diverged significantly in the decade preceding the financial crisis with, in particular, some Member States accumulating large current account deficits. This section briefly recaps the domestic macroeconomic imbalances that have been the counterpart to these deficits and discusses the impact of the crisis on the imbalances in detail. It then studies how the crisis has affected the adjustment capacity of deficit countries. The next section will turn to the issue of persistent current account surpluses in some Member States.

The divergence in current accounts can be related to a range of domestic imbalances

Divergence in competitiveness and current account positions is not necessarily bad in a monetary union. Distinguishing between 'harmful' competitiveness developments – which require some form of policy intervention – and 'benign' ones – where adjustment can be left to market forces – is key for economic policy.

As discussed more extensively in last year's special issue of the Quarterly Report on the Euro Area on competitiveness divergences, economic theory suggests that the distinction largely depends on the extent to which changes in external performance are driven by market dysfunction or policy mistakes. ([8]) Last year's analysis showed that the divergence trend in competitiveness and current accounts within the euro area up to the beginning of the crisis can only partly be attributed to benign factors such as Balassa-Samuelson effects, price convergence or deeper financial integration. Divergence was also associated with a range of domestic macroeconomic imbalances in some Member States. Labour markets did not always respond appropriately to country-specific shocks. In those catching-up Member States which accumulated large current account deficits and external debt, capital inflows were not channelled to the most productive uses and were associated with disappointingly weak productivity performance. In some Member States running current account deficits, the inflow of foreign capital facilitated the rise in household and/or corporate debt, fuelling excessive credit dynamics and contributing to the emergence of housing bubbles. Furthermore, these capital inflows were not associated with sufficient fiscal restraint. Finally, weak domestic demand in some surplus countries contributed to the divergence in current accounts (this is analyzed in depth in section III).

Progressive cooling-off of housing markets is helping to reduce current account imbalances

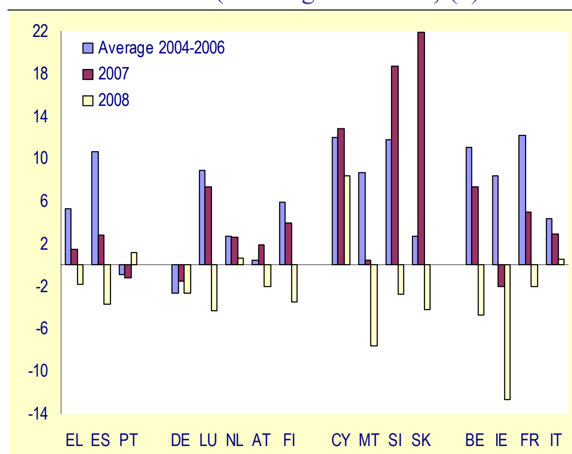
Housing markets have played a pivotal role in the divergence of external positions across euro-area Member States over the past decade. They have amplified the effects on domestic demand of Member State differences in real interest rates and in the speed of financial deepening. In some Member States, the rapid expansion of the construction sector has also contributed to diverting resources away from the export sector. These trends were all the more worrying since house price developments were in some cases clearly unsustainable.

The ongoing cooling-off of housing markets is affecting all euro-area Member States except Germany and Portugal, where house prices remained fairly flat or negative in the years preceding the crisis (Graph II.1). It tends, however, to be more marked in countries with

([8]) Earlier discussions of the topic include European Commission (2006), 'The EU Economy 2006 Review' and European Commission (2008), 'EMU@10: successes and challenges after 10 years of Economic and Monetary Union'

competitiveness problems and where house price booms had been greatest before the onset of the crisis (BE, EL, ES, IE, FR, MT, SI).

Graph II.1: **Real house prices, euro-area countries** (annual growth in %) (1)



(1) House prices deflated by the HICP.
Source: ECB, Commission services.

In most euro area countries that underwent or still undergo a catching-up process, as well as France although to a lesser degree, the crisis has entailed a dramatic downshift in construction activity relative to pre-crisis trends. In contrast, the downshift has been more muted in current account surplus countries, with the exception of Finland.

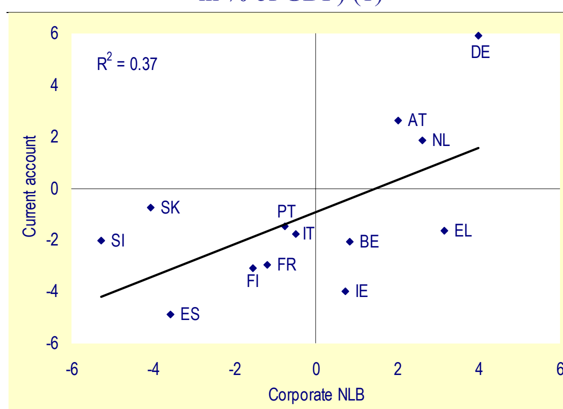
Overall, the reduction of housing imbalances is helping to reduce external imbalances within the euro area. At this juncture, it remains difficult to say, however, to what extent the reduction is durable or will be reversed with the recovery.

Households and corporations have embarked on a balance sheet adjustment process

Following the shock of the financial crisis, households have embarked on significant balance sheet adjustment in current account deficit countries (ES and IE and to a lesser degree PT and SK). It is translating into a large increase in households' net lending/borrowing (NLB), ([9]) reducing current account deficits. ([10]) The extent to which the ongoing adjustment is durable or just a temporary by-product of the crisis is difficult to assess. The crisis has probably led to a lasting change in risk attitudes, particularly in the banking sector, suggesting that at least part of the adjustment will persist. In contrast, the increase in NLB has generally remained limited in Member States that do not feature high current account deficits or other competitiveness problems (with the exception of FI).

Corporate NLB has been a central determinant of changes in current accounts in euro-area Member States since the launch of the euro. ([11]) Excluding new euro-area Member States, about two thirds of the changes in current account levels between the early phase of EMU and the more recent period can be ascribed to corporate NLB (Graph II.2).

Graph II.2: **Changes in corporate NLB and in the current account, euro-area countries** (average 2004-08 vs average 1999-03, in % of GDP) (1)



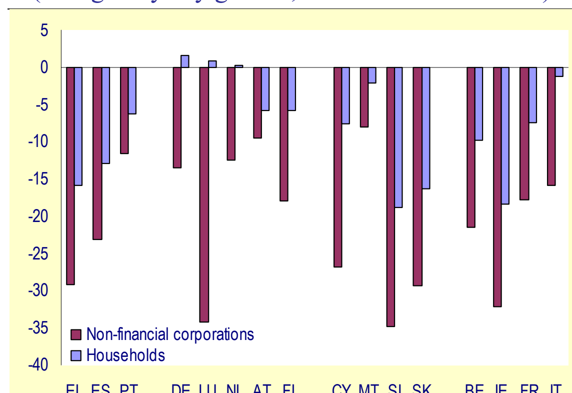
(1) Corporate NLB data are not available for CY, MT, and LU. Data for IE cover 2004-08 relative to 2002-03.
Source: Commission services.

To a lesser degree than in the household sector, the crisis has been associated with some early signs of balance sheet adjustment in the corporate sector. While in a world of perfect capital markets, adjustment to debt overshooting and excessive leverage can be obtained by the issuance of new equity, in reality the issuance of new equity is often constrained by many factors such as fixed costs of equity issuance, temporarily high risk aversion, the cost of external funding, or issues related to corporate control. These capital market imperfections force corporations to rely, at least partly, on internal funding to adjust their balance sheet structure. To achieve this, corporations simultaneously cut investment and raise corporate savings. Since the onset of the crisis, such concurrent movements in investment and savings have been registered essentially in

([9]) NLB is the difference between saving and investment of the institutional sector considered. NLB is positive (resp. negative) when the sector lends to (resp. borrows from) the rest of the economy.
([10]) No data available for CY, LU and MT.
([11]) For a further discussion see section III, 'Anatomy of current account surpluses in the euro area' in this issue.

Spain and Greece and, to a lesser degree, in France. In other Member States, investment has generally dropped due to various cyclical factors but savings have also decreased due to deteriorating profitability.

Graph II.3: **Credit growth, euro-area countries** (change in y-o-y growth, Jan. 2008 to Jan. 2010)



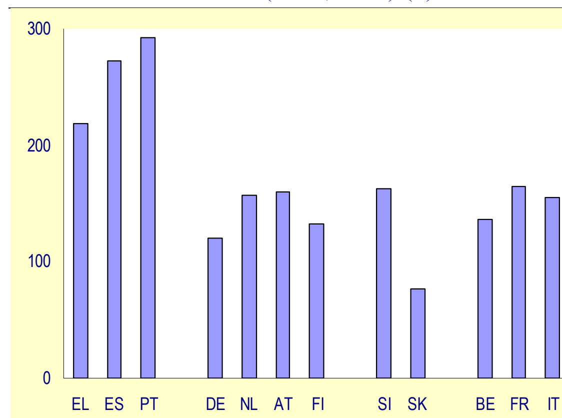
Source: ECB, Commission services.

In line with balance sheet data, growth in credit to households and corporations has fallen dramatically in recent months in most Member States with large current account deficits (Graph II.3). In some of the countries where deficits are not large but export performance was weak prior to the crisis (mostly BE and IE) as well as some of the new euro-area Member States (CY, SI and SK), credit growth also fell dramatically. In contrast, the deceleration in credit growth has been less strong in Member States with current account surpluses (except LU).

Further balance sheet adjustment might be necessary in a range of Member States

Further balance sheet adjustment appears likely in some Member States, particularly in the corporate sector. Adjustments to asset price falls, high leverage and lower growth prospects can trigger protracted phases of balance sheet adjustment characterised by substantial reductions in the net borrowing of the corporate sector. The crisis has triggered sharp falls in asset prices which have led to a strong increase in leverage ratios across euro-area Member States. In addition, the crisis is also projected to impact euro-area potential growth negatively. ([12]) This would raise the debt burden relative to expected earnings and would force companies to reduce debt further. Due to these factors combined with more cautious risk attitudes by lenders and borrowers, the financial turmoil is likely to be followed by a drawn-out period of corporate balance sheet repair in the euro area.

Graph II.4: **Corporate leverage, euro-area countries** (2008, in %) (1)



(1) Ratio of debt to value added in the non-financial corporate sector. Debt is the sum of securities other than shares and loans. Data for IT are for 2007.

Source: Commission services.

Balance sheet correction needs appear particularly large in Member States with large external deficits. Leverage is indeed high in their corporate sector (Graph II.4). Potential growth is likely to decelerate more strongly than in the rest of the euro area as balance sheet adjustment depresses investment. Moreover, pressures on profitability in the years preceding the crisis were already higher, as national accounts data suggest. Some of these factors are also at play in other countries and could entail some balance sheet adjustments to respond to past pressures on profits (CY, IT) or a sharp slowdown in growth prospects (IE and most new Member States).

Some imbalances have improved but others remain and new ones have emerged

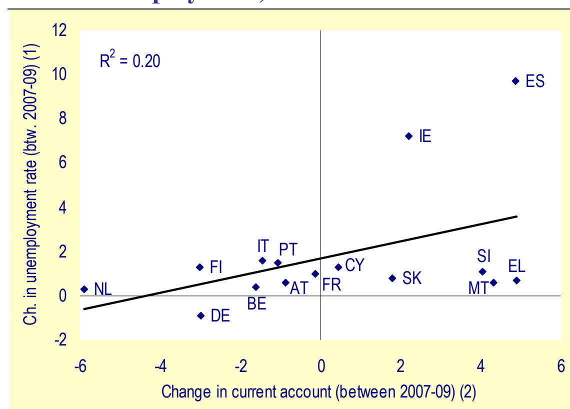
Some of the countries with external imbalances or competitiveness problems have registered a cooling-off of the housing market and early signs of improvements in private-sector balance sheets. These improvements in underlying domestic imbalances have, however, been associated with large rises in unemployment. This is particularly the case in Spain and Ireland (Graph II.5).

Part of the rise in slack in labour markets is cyclical and will be absorbed when the economy picks up. However, part of it risks becoming of a more structural nature. The crisis has triggered a process of structural downsizing in some sectors,

([12]) European Commission (2009), Impact of the current economic and financial crisis on potential output, Occasional Paper 49.

notably construction (EL, ES and IE). The required reallocation of the labour force from the non-tradable sector to expanding sectors (mostly the export sector) will take time – involving workers' retraining but also new capital investment – and therefore risks being associated with a lasting rise in unemployment. This adjustment process will also have to go hand-in-hand with substantial changes in relative prices, including the internal exchange rate. So far, however, the data show little evidence of substantial price adjustments, highlighting the need for more consistent wage policies in order to avert further increases in unemployment.

Graph II.5: **Changes in current account and unemployment, euro-area countries**



(1) In percentage points of labour force. (2) Change in net lending (+) or net borrowing (-), total economy (in percentage points of GDP); balance of current transactions for LU.
Source: Commission services.

More generally, it is of crucial importance to take the appropriate policy choices. Policies that boost productivity and skills reduce the need for nominal wage adjustment. Similarly, enhanced workers' retraining would facilitate the necessary labour reallocation.

The crisis has not reduced the need for adjustment

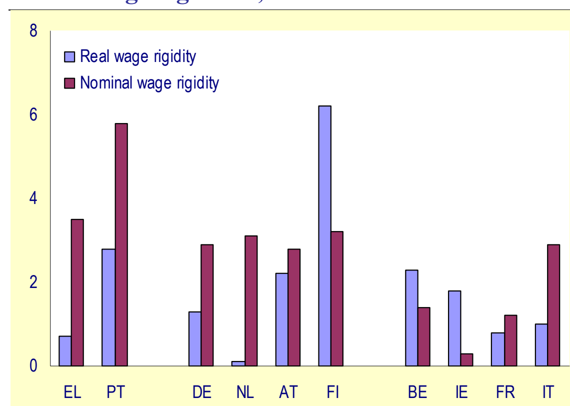
The global economic crisis has triggered a convergence in current accounts which has both temporary and structural features. The convergence is in part due to a sharp drop in private sector demand in some large current account deficit countries which is driven by a balance sheet adjustment process. Part of this effect is likely to persist over the coming years. However, the convergence is also explained by the differentiated impact of the crisis on Member States' exports and imports (see previous section). This effect is likely to be essentially temporary and reversed with the recovery.

Except for Ireland, convergence in current accounts has so far been associated with only modest changes in relative prices. This means that the need for substantial competitiveness improvements in countries with high external deficits highlighted in last year's issue of the Quarterly Report on the Euro Area largely remains.

Most euro-area Member States have low competitiveness adjustment capacity …

The correction of competitiveness and external imbalances requires significant changes in relative prices and a reallocation of demand and supply between the non-tradable sector and the export sector. The euro-area economy is characterised by a significant labour and product market rigidity which, in the absence of additional reform effort, would lengthen the period of adjustment and make them more costly in terms of unemployment.

Graph II.6: **Micro evidence on nominal and real wage rigidities, euro-area countries**



Source: Dickens et al. (2007), 'How wages change: micro evidence from the International Wage Flexibility Project', Journal of Economic Perspectives, No 21(2), pp. 195-214.

This is particularly true for most Member States, which need to recoup the large losses in price competitiveness incurred during much of the decade. Product and labour market rigidities tend to be high as micro-evidence from firm-level data shows (see Graph II.6). Other evidence presented by the ECB also points to significant real rigidities in concerned Member States. ([13])

([13]) See for instance ECB (2009), 'New survey evidence on wage setting in Europe', ECB Monthly Bulletin, February 2009.

… and the crisis will render the necessary competitiveness rebalancing more challenging

Unless structural reform policies are stepped up, in most countries with large price competitiveness problems, the global economic and financial crisis risks hampering the adjustment capacity further.

First, in the period of very low inflation brought by the crisis, nominal rigidities are more likely to hamper downward adjustments in relative wages and prices. But the recent experience in Ireland and Greece shows that determined policy action in terms of public wages facilitates overall competitiveness adjustment.

Second, unless appropriate policies are put in place, the crisis risks weighing significantly on medium-term prospects for potential output growth. Possible losses in growth potential are generally projected to be stronger in Member States with large competitiveness problems. In these countries, wage bargaining systems face the double challenge of having to adjust to past losses in competitiveness as well as to weaker productivity growth. Clearly, policies to boost potential growth would be highly beneficial.

Third, pre-crisis balance-sheet stress has been severely compounded by the crisis-induced drop in asset prices and changes to risk attitudes. The ongoing phase of balance sheet correction is likely to persist for some time. Member States which face considerable adjustment needs in terms of both price competitiveness and corporate balance sheets will have to strike a delicate balance between raising corporate cash flow to fix balance sheets and lowering prices to restore competitiveness. In other words, corporate balance sheet correction may slow the speed of the adjustment process by reducing firms' capacity to pass through lower wage costs into output prices.

Finally, the crisis has negatively affected financial intermediation, thereby hampering the necessary reallocation of capital and, consequently, labour across sectors. Financial sector repair therefore remains a key policy priority.

While the adjustment has been made more difficult by the crisis, determined, comprehensive and effective policy action can still facilitate the necessary rebalancing. As the case of Ireland demonstrates, fast and effective policy intervention is possible and can lead to substantial gains in competitiveness. Moreover, large adjustment needs in some Member States could act as a catalyst for structural reforms which would both facilitate adjustment and enhance long-run growth prospects.