BRUEGEL POLICY CONTRIBUTION

ISSUE 2012/15
AUGUST 2012

INTRA-EURO REBALANCING IS INEVITABLE, BUT INSUFFICIENT

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Highlights

- Greece, Portugal and Spain face a serious risk of external solvency due to their cl to minus 100 percent of GDP net negative international investment positions, whi are largely composed of debt. The perceived inability of these countries to rebalan their external positions is a major root of the euro crisis.
- Intra-euro rebalancing through declines in unit labour costs (ULC) in souther Europe, and ULC increases in northern Europe should continue, but has lim because: the share of intra-euro trade has declined; intra-euro trade balances ha already adjusted to a great extent; the intra-euro real exchange rates of Greece, tugal and Spain have also either already adjusted or do not indicate significant app ciations since 2000; there are only two main current account surplus countries Germany and the Netherlands; a purely intra-euro adjustment strategy would requ too-significant wage increases in northern countries and wage declines in southe countries, which do not seem to be feasible.
- Before the crisis, the euro was significantly overvalued despite the close-to balanced current account position.
- The euro has depreciated recently, but more is needed to support the extra-eu trade of southern euro-area members. A weaker euro would also boost expor growth, inflation and wage increases in Germany, thereby helping further intra-eu adjustment and the survival of the euro.

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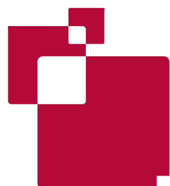


there are four euro-area countries, Greece, Ireland, Portugal and Spain, in which the net international investment position is much worse, close to minus 100 percent of GDP (Figure 2).

As also emphasised by European Commission (2012), the composition of foreign assets and liabilities and their maturities also matter. Foreign direct investment (FDI) is generally regarded as a less risky and more stable source of funding (Furceri et al, 2012), while debt, and in particular short term debt is riskier. In terms of the composition of net foreign liabilities, Ireland differs from Greece, Portugal and Spain: Ireland has very large net liabilities in equity portfolio investments and is a creditor of the rest of the world. The other three countries have large net debt liabilities (Table 1).

The reasons for the accumulation of net foreign liabilities are similarly important. Ireland again differs from the other three countries in this respect. While the Irish net IIP deteriorated by €173 billion from 1998 to 2011, the cumulative current account deficit during this period explains just a small part of the total, €37 billion. In 2007 Ireland's net IIP was minus €37 billion (19 percent of GDP) – a reasonable figure – which suddenly deteriorated to €153 billion (98 percent of GDP) by 2011 (Figure 2). This sudden deterioration was mostly the result of valuation changes and is captured in the last but one line of Table 2. In Greece, Portugal and Spain, by contrast, the cumulative current account deficit was of a similar magnitude to the deterioration of the net IIP. Among the components of the current account deficit, the balance of goods deficit was prominent in these three countries (Table 2 on the next page).

Therefore, while Ireland should also aim to improve her net IIP, the reasonable IIP position before the crisis suggests that the country will be better able to do this than Greece, Portugal and Spain, where external sustainability is a serious issue.

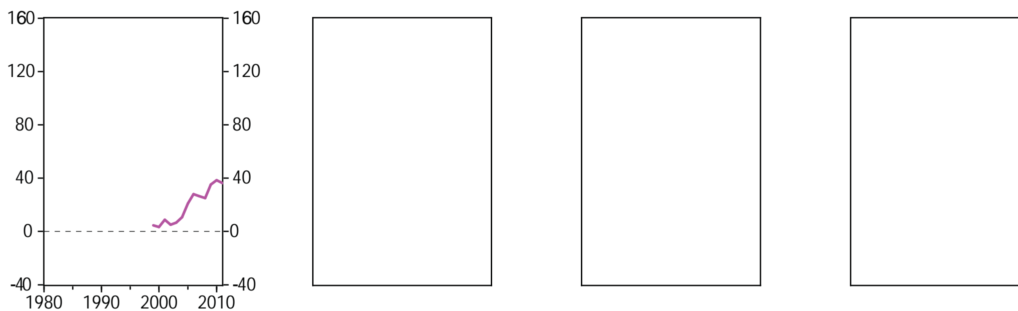


Table 1: Composition of net international investment position, 2011 (% GDP)

	(1)=(2)+(3)+(4)+(5)+(6)+(7) Net international investment position	(2) Net foreign direct investment	(3) Net portfolio investment in equity securities	(4) Net portfolio investment in debt securities	(5) Net other investment (mostly loans)	(6) Net financial derivatives	(7) Reserve assets
Greece	-79	5	6	-10	-84	1	2
Ireland	-98	31	-451	264	53	5	1
Portugal	-103	-18	-7	-10	-76	-1	10
Spain	-92	0	-8	-43	-45	1	3

Source: author's calculations using data from Eurostat.

3 EXPORTS AND REAL EXCHANGE RATES

Exports should play a major role in the adjustment process, which can be facilitated by improvements in the price and non-price dimensions of competitiveness. The main tools to improve non-price competitiveness are structural reforms, education, innovation and improvements in corporate governance. Such improvements are indispensable in most countries, but they require a long time before they take effect. Price (or cost) competitiveness can be improved via a depreciation of the real effective exchange rate (REER), which is usually measured by the unit labour cost (ULC) based REER[4]. Figure 3 shows that there was a rather strong association between

Time period	Indicator	Greece	Ireland	Portuga	Spain
1998-2011	(1) Change in net IIP	-141	-173	-151	-812
Cumulative sum 1999-2011	(2) Current account = (2.1)+(2.2)+(2.3)+(2.4)	-234	-38	-189	-665
	(2.1) Goods				

4. We found that the ULC-based REER (as calculated in Darvas 2012a and 2012b with fixed sectoral weights for the business sector excluding agriculture, construction and real estate) better correlates with export performance than the consumer price index-based REER.

countries and non-EU countries. Italy’s significant real appreciation also highlights that ULC-REER is not the only driver of trade balances: while Italy had the worst export performance out of the euro-area countries before the crisis (ie the overall ULC-REER is well correlated with export performance, as shown by Figure 3), Italy did not have such huge trade and current account deficits as eg Greece, Ireland, Portugal and Spain (Figure 1). Domestic demand developments also played a strong role in driving current accounts. In this regard European Commission (2009) presented a very telling chart showing a close relationship between the change in current account balance (as a percent of GDP) and the percent change in housing prices. The latter was influenced by domestic demand developments.

Since 2008, real exchange rates have adjusted to

REER (the cumulative increase from 2000 to 2011Q4 is 10 percent);

- The Irish intra-euro REER has depreciated sharply during the past few years, even if it has started to appreciate recently[5].

But the middle and right hand panels of Figure 4 show that the non-euro EU and the extra-EU REERs are still much higher than in 2000, even though some depreciation, fuelled by the depreciation of the euro, can be observed in all countries.

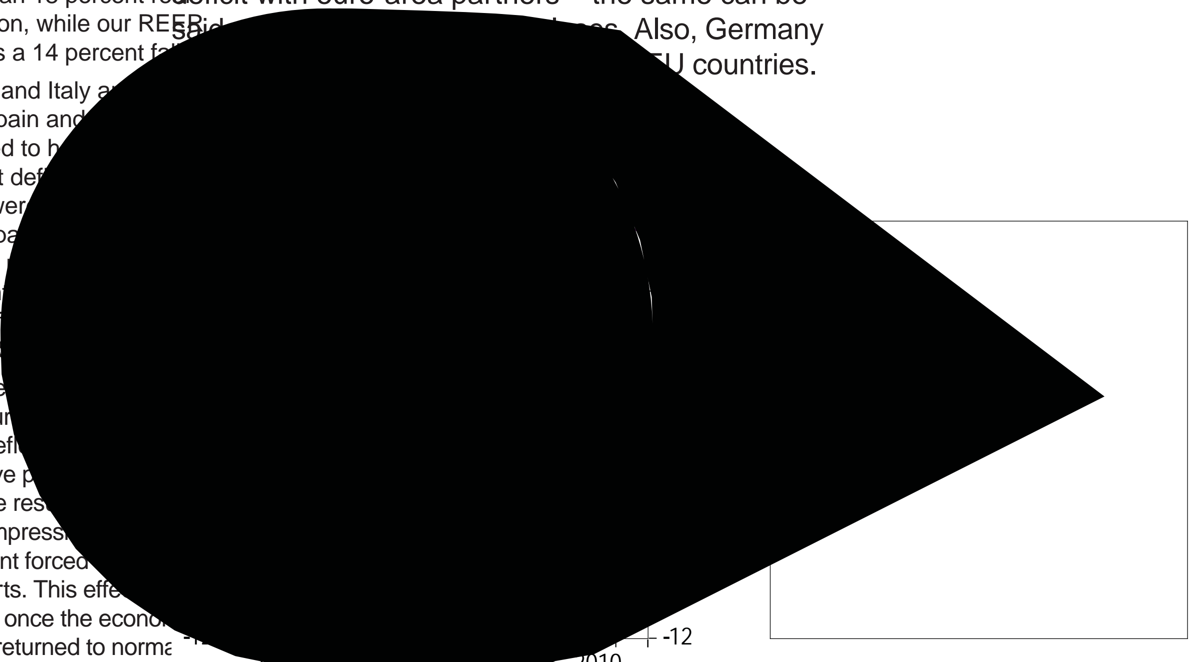
4 THE ROLE OF EXTRA-EURO TRADE

Figure 5 shows the balances of trade in goods and current accounts of Spain and Germany, the euro area's largest main deficit and surplus countries[6]. Bilateral current accounts are generally not available, but bilateral trade balances are. In a number of countries, including Spain and Germany, bilateral trade balances account for a significant portion of the current account balance.

In 2006 and 2007, the last good years before the crisis, Spain's trade deficit with partners outside the EU was even slightly higher than the trade deficit with euro-area partners – the same can be said ... Also, Germany ... EU countries.

After 2007, intra-euro trade balances adjusted significantly: Spain's deficit and Germany's surplus with the rest of the euro-area have declined substantially toward zero. Yet Spain's overall trade deficit remained sizeable, about 5 percent of GDP[7]. It is also interesting to observe that Germany was able to increase her surplus with non-EU countries, partly compensating for the reduction of the surplus with EU countries. As a consequence, in 2011, 70 percent of the German trade surplus came from extra-EU trade, 23 percent from non-euro EU members, and less than 7 percent from euro-area members.

The shift from intra-euro area to extra-euro area trade can also be detected in gross trade numbers (Table 3). In 2011, euro-area partners accounted for 53 percent of Spanish exports and 38 percent of German exports. As we show in Table 4, the proportion of Greek exports going to euro-area partners is even lower at 29 percent.



5. Note that in the case of Ireland, there is a significant difference between Eurostat's intra-euro REER, which shows a 28 percent real appreciation from 2000 to 2008Q2, and our REER, which indicates an appreciation of 9 percent only. The major reason for this discrepancy is that Eurostat considers the total economy, while we consider only business sectors excluding agriculture, construction and real estate, and we also exclude the impacts of compositional changes. As shown by Darvas (2012b), ULC rose massively in the public sector and significantly in the construction industry and real estate, yet neither the public sector, nor construction nor real estate matter directly for export performance and hence our indicator is preferable. From 2008Q2 to 2011Q4 the difference is smaller: Eurostat's intra-euro REER indicates an 18 percent real depreciation, while our REER indicates a 14 percent fall.

6. France and Italy a... than Spain and ... used to h... account def... deficits wer... than in Spa... their ... investmen... more f...

7. The ... deficits du... not refl... competitive p... be the res... compress... consequent forced ... in imports. This effe... disappear once the econo... has returned to norma... (whic... ately seem... ay ir...

differs somewhat
considering intra-euro and
extra-euro imports, the
different pattern of the
Spanish trade deficit across

of the US from the early 1970s, the price level should had been lower, ie the actual exchange rate should have been below the PPP exchange rate. However, Figure 6 shows that there were a number of periods, including 2003-2011, when the actual exchange rate was even above the PPP rate. This

difficulties and pain in domestic ULC reductions.

- There is a strong case for calling for ULC increases in the 'northern' euro-area trading partners, see for example De Grauwe (2012), Wolff (2012), and Merler and Pisani-Ferry (2012)[11]. To some extent wage increases have started in Germany, but in any case this process will take a long time. ULC increases of non-euro area trading partners would help as well, but this is clearly beyond the scope of international policy coordination.
- In their elegant analytical paper, Merler and Pisani-Ferry (2012) also demonstrate that reducing the pace of fiscal adjustment in the northern members of the euro area would facilitate the REER adjustment of the southern members[12]. They also show that structural reforms which make wages more responsive to unemployment in southern Europe would facilitate intra-euro REER adjustment. Unfortunately, the relaxation of fiscal targets in northern Europe does not seem to be on the agenda, and it will take a long time before structural reforms in southern Europe take effect.
- Members of the euro area do not have individual exchange rates, and the exchange rate of the euro is not under the control of national policymakers. But the European Central Bank could implement measures which affect the exchange rate of the euro.

The key issue is if further adjustments in real exchange rates and trade balances should be treated as a purely intra-euro story, or if