

Balance of payments adjustment mechanisms in the Euro area

Martina JIRÁNKOVÁ*, Pavel HNÁT**

Abstract

The article aims at analysing the current situation in the Euro area with respect to the balance of payments adjustment mechanism that should normally be at place. Internally, the Euro area membership represents a combination of the fixed exchange rate, capital mobility and no monetary policy autonomy; externally, the Euro area countries apply floating exchange rates with high capital mobility, and autonomous monetary policy. Member states thus cannot use the monetary instruments to prevent external influences; they can only use fiscal policies, which are limited by the Stability and Growth Pact and debt constraint. When external imbalance occurs (such as today), the economies of member states are exposed to the price and income adjustment processes as well as to their own fiscal and ECB policy impacts. This article shows that all these factors interfere and influence real effects of automatic adjustment mechanisms which in some cases cannot come forth at all. Factors within domestic economic policies that limit the restoration of external balance within the Euro area thus create an important outcome of this paper.

Keywords: Euro area, balance of payments, income and price adjustment mechanisms, external imbalance, global imbalances, Mundell-Flemming model

JEL classification: E31, E52, F32, F41

1. Introduction

Even though Global Imbalances, i.e. the increasingly significant differences between the surplus and deficit countries reflected by their current

* Martina Jiránková is Ph.D., Department of World Economy, University of Economics, Prague; e-mail: jirankov@vse.cz.

** Pavel Hnát is assistant lecturer Ph.D., Department of World Economy, University of Economics, Prague; e-mail: hnntp@vse.cz.

The article has been worked out within the Research Plan of the Faculty of International Relations, University of Economics in Prague Nr. MSM6138439909 „Governance in the Context of a Globalized Economy”.

account positions, are frequently analysed in contemporary international political economy, European Imbalances are often neglected. This can be caused by the fact that the Euro area's overall position in global imbalances is almost balanced and thus insignificant at a global scale. Internally, i.e. within the Euro area, the scope of current account imbalances is nevertheless as significant as it is globally. Among similarly developed Euro area countries, external imbalances moreover reflect imbedded differences in economic policies and competitiveness and thus offer an important chance to understand the Euro area's current problems. This is why this article aims at analysing European Imbalances and understanding why external balance is not restored by well stipulated adjustment mechanisms. Identifying economic policy factors that do not allow the adjustment mechanism to come forth should be the main outcome of this study.

Relevant literature has been studying recent imbalances in current account ever since they started to build-up in the late 1990's, both in Europe (e.g. Blanchard, Giavazzi, 2002, Giavazzi, Spaventa, 2010 or Lane, 2010) and the United States (e.g. Blanchard, 2007). Similarly, recent theoretical literature on Current Account Imbalances (e.g. Makin, 2010) has been developed in the early 2000's when IMF and other international organizations tried to draw more attention to globally imbalanced current accounts. There is however a very important aspect of those works, which only changes gradually after the current crisis: current account imbalances are generally seen as an outcome of effective savings-investment allocations enabled by a more effective economic integration and these arguments are widely supported by quantitative models outcomes. However, these models also have economic effectiveness, symmetric information, and effective allocation such as the straightforward arguments of "both financial and goods market integration are likely to lead, in the poorer countries, to both a decrease in saving and an increase in investment, and so to a deterioration of the current balance" (Blanchard, Giavazzi, 2002, p. 11) in their initial conditions. As a result, the main policy reaction to the build-up of external imbalances has been a "benign neglect" (Blanchard, Giavazzi, 2002, p. 48) and even today, global and European imbalances are often seen as no economic policy issue at all. It is thus not surprising that the IMF's effort to induce coordinated policy response by major global imbalances players mostly went in vain throughout the 2000's (Jiránková, Hnát, 2010, p. 13). Similarly, the European Union has largely attributed the growing imbalances to improved investment allocation enabled by the financial integration under euro: "the strong performers have been thriving on investment booms spurred by capital inflows attracted by comparatively high rates of return, with the single currency and the integration of financial markets acting as a catalyst" (Giavazzi, Spaventa, 2010, p. 2). And again, as a result, the current account has always been a neglected variable in the management of the Euro area and in the assessment of its members' performance.

In its first section, this article first defines Global Imbalances as a result of the growing ineffectiveness in global savings-investment allocation and explores the mainstream explanations of this ineffectiveness and applies them to the current situation in Europe. It thus rejects the belief in the economic and effective allocation of the current financial system, both in the world and in Europe. Methodologically, the article uses international political economy and international economics as a main approach in order to understand how political processes affect the balance between state and market within the current Euro area. These relations are crucial for understanding real and deeply build-in causes of its current crisis that must be seen in the states' influence on the economic system. Authors of this paper do not call for simple activist policy response to correct imperfections of global or European financial systems, just on the contrary, they call for a careful study of state intervention so that it does not contribute to already imperfect systems. It is for instance clear, that government can (or even should, if we accept that government intervention not only helps economies recover but also prevents overheating) limit current account deficit by increasing government savings, and indeed, governments across Europe went through a fiscal consolidation in the late 1990's to fulfil the Maastricht criteria; later, however, most of them started to spend again. By doing this, they however did not benignly neglect imbalances, they contributed to them.

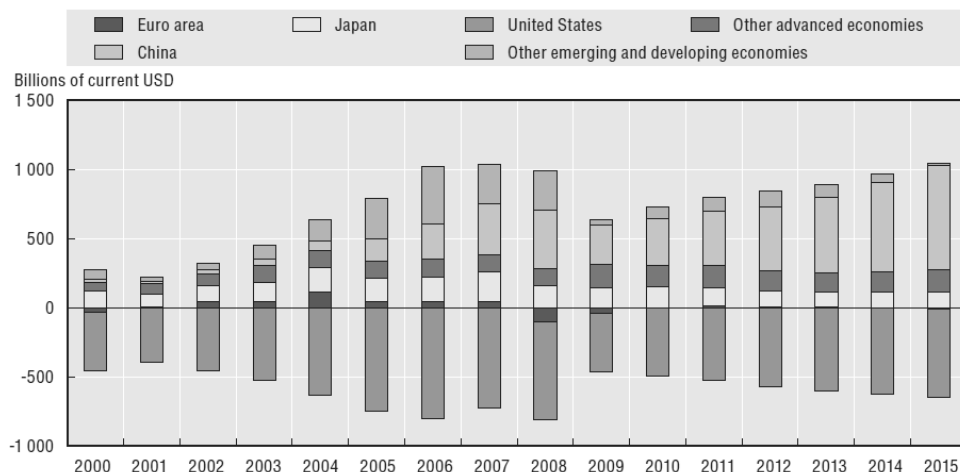
The second section uses the main macroeconomic indicators that should normally be affected by the balance of payments adjustment process, i.e. prices, wages, and output, to verify whether the adjustment mechanisms work or not in the recent Euro area. Additionally, it analyses policies constraints, such as debt, that limit economic policies reactions to external imbalances. State intervention and its effectiveness is cornerstone of this section again. Automatic adjustment mechanisms are a well stipulated and repeatedly verified process that today builds a basis of education in international economy. If it really is the case that none of them fully comes forth – that is for sure, that specific conditions under euro must be carefully taken into account – then authors of this article assume that it is the state and its current policies that must interfere here. It would be no surprise as the adjustment mechanisms usually anticipate race-to-the-bottom before the economy starts recovering thanks to improved external positions. This can hardly be accepted by today's interventionist states in Europe. Since the first two sections show that automatically stabilising mechanisms can hardly come forth in most countries of the Euro, the article continues by analysing those domestic policies and international influences that limit the auto-corrective processes of external imbalance. As such, it shows inappropriate policies and reactions that affect external balance within the Euro area, as well as distribution of its wealth and competitiveness. Cluster analysis of the data provided throughout the text was conducted to show different policy mixes applied in

Europe during the build-up phase of the current crisis. The analysis clusters the Euro Area countries according to cumulated current accounts, public deficits, unemployment, inflation, and GDP between 2002 and 2012 to show how different policy strategies contributed to different economy outcomes. Since the authors of this paper suppose that cumulated current account was also caused by significant policy failures motivated by stabilising the economic cycle, it will be interesting to see, whether the cycle was truly stabilised (lower unemployment or inflation, and higher GDP growth) or not – the crises periods are thus involved by purpose. The outcomes are summarized within the conclusion.

2. Global and European current account imbalances

Global imbalances are usually understood as large current account deficits and surpluses that reflect trade and financial flows in global scale, namely between the United States and East Asia, these being the largest trade deficit and surplus regions respectively. This definition however does not reflect an important feature of global imbalances and thus the systemic risk and deviation from equilibrium (i.e. namely the policy interventions including policy failures into global trade and financial mechanism) they include. More precise definition thus explains global imbalances as “external positions of systemically important economies that reflect distortions or entail risks for the global economy” (ECB, 2008, p. 12). At a global scale, the financial system imperfections firstly build upon real dissaving in the United States that can hardly be seen as optimal even though it is enabled by the current financial system. Secondly, they are enabled by precautionary saving in China, which is caused by an absence of pensions scheme. Thirdly, they build upon lower than optimal levels of saving in China, East Asia or in the Gulf that are caused by insufficient financial intermediation. Last but not least, rigid labour markets in Europe and Japan contribute to Global Imbalances as well.

Even though Graph 1 clearly suggests that the United States’ current account deficit is the most significant one during the build-up for the global financial crisis, there are other countries where the current account deficits are of major concern, e.g. Spain (145 billion USD and 10 % of GDP in 2007 according to UNCTAD, 2009), United Kingdom (79 billion and 3 % of GDP), Greece (45 billion USD and 14 % of GDP in 2007), Italy (2 %), France (1 %), Portugal (10 %), Poland (4 %), Bulgaria, Croatia, the Czech Republic, Baltic countries, Romania (14 %), Slovakia, or Turkey (8 %). Except for Croatia and Turkey, all the above mentioned countries are EU members; Estonia, Greece, Ireland Portugal, Slovakia and Slovenia belong to Euro area.

Graph 1. Global imbalances between 2000 and 2015, in billions of current USD

Source: OECD (2010, p. 55)

Table 1 shows the situation of the Euro area countries in the longer perspective. Obviously, Germany, Luxemburg, the Netherlands, and Finland have been marked as surplus countries throughout the period. Belgium has been more or less in balance or in slight surplus; France and Italy have seen current account deficit no higher than 5 per cent of their respective GDPs. Other countries have run significant current account deficits, sometimes more than ten per cent (Estonia, Cyprus and Greece). All in all, European Imbalances are clearly stipulated.

Table 1. Current account balances in Euro area as a percentage of GDP (in %)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Belgium	4.5	3.4	3.2	2.0	1.9	1.6	-1.8	0.0	1.0	0.6	0.9
Estonia	-10.6	-11.3	-11.3	-10.0	-15.3	-17.2	-9.7	4.5	3.6	2.4	2.3
Finland	8.5	4.9	6.2	3.4	4.2	4.3	2.8	2.3	3.1	2.5	2.5
France	1.2	0.7	0.5	-0.5	-0.6	-1.0	-1.7	-1.5	-1.7	-2.7	-2.5
Ireland	-1.0	0.0	-0.6	-3.5	-3.5	-5.3	-5.7	-2.9	0.5	1.8	1.9
Italy	-0.8	-1.3	-0.9	-1.7	-2.6	-2.4	-2.9	-2.1	-3.3	-3.5	-3.0
Cyprus	-3.8	-2.3	-5.0	-5.9	-7.0	-11.7	-17.2	-7.5	-7.7	-7.2	-7.6
Luxemburg	10.5	8.1	11.9	11.5	10.4	10.1	5.3	6.9	7.8	9.8	10.3
Malta	2.5	-3.1	-5.9	-8.7	-9.8	-8.1	-7.4	-7.5	-4.8	-3.8	-4.8
Germany	2.0	1.9	4.7	5.1	6.1	7.5	6.3	5.6	5.7	5.0	4.9
Netherlands	2.5	5.6	7.8	7.6	9.7	6.7	4.4	4.9	7.1	7.5	7.7
Portugal	-8.3	-6.5	-8.3	-10.4	-10.7	-10.1	-12.6	-10.9	-9.9	-8.6	-6.4
Austria	2.7	1.7	2.2	2.2	2.8	3.5	4.9	3.1	2.7	2.8	2.7

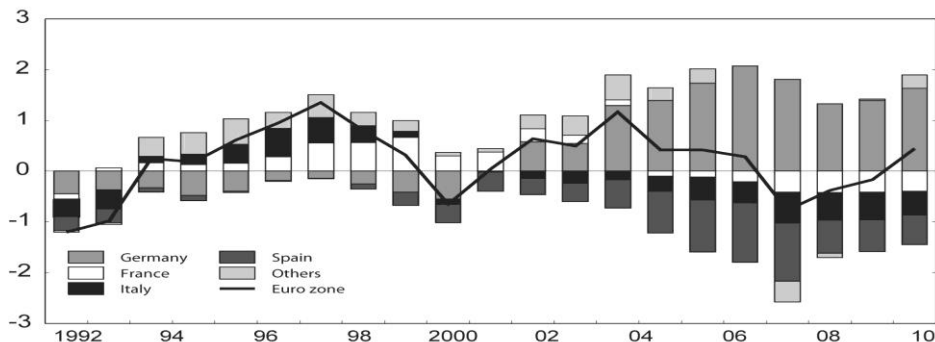
Greece	-6.5	-6.6	-5.9	-7.4	-11.2	-14.4	-14.7	-11.0	-10.5	-8.4	-6.7
Slovakia	-7.9	-5.9	-7.8	-8.5	-7.8	-5.3	-6.6	-3.2	-3.5	-1.3	-1.1
Slovenia	1.1	-0.8	-2.6	-1.7	-2.5	-4.8	-6.7	-1.3	-0.8	-1.7	-2.1
Spain	-3.3	-3.5	-5.3	-7.4	-9.0	-10.0	-9.6	-5.2	-4.6	-3.8	-3.1

Source: IMF (2011)

The question however remains, whether these imbalances reflect the desired outcome of broad financial and trade integration of Europe that distributes economic wealth across the continent or the inappropriate result of investment - savings misallocation driven by policy failures (see Global Imbalances definition with initial paragraphs of this section). Macroeconomic theory says that the current account imbalance shows several features:

- current account shows exports and imports in goods and services as well as income for domestic production factors operating abroad and foreign factors operating in domestic economy;
- it shows the ability of the economy to stand in the world competition. The size of the current account balance depends on the nominal exchange rate and the relation of the foreign and domestic price levels. The current account deficit thus indicates that the economy is not able to export competitive products and services. Eventually, it also indicates high income outflows paid for foreign factors used in the domestic economy. The surplus indicates the opposite.
- the Keynesian approach states that the current account shows the difference between the manufactured product and the total expenditures for consumption, investments and government purchases of a single country. The current account deficit signifies that the total expenditures were higher than the manufactured product, the surplus the contrary. The current account testifies savings and investments in a single country. The current account deficit states that investments were higher than savings, or that the country has state budget deficit, or even both possibilities together. The current account surplus – in the case of the balanced state budget – signs savings higher than investments in the country.

Taking all these aspects into account, a detailed analysis of surpluses and deficits within the Euro area can reveal numerous important features of its current macroeconomic and competitive position. Generally speaking, European imbalances – see Graph 2 – draw the difference between Europe's "hard core" and its periphery and amplify dissimilarities in their respective economic policies. Among the core countries, Germany's and Nordic countries' surpluses are seen as a very advisable policy outcome in view of the aging population and other costly reforms (e.g. product and labour market) needed in Europe.

Graph 2. European imbalances, current account deficit as % of the Euro area's GDP

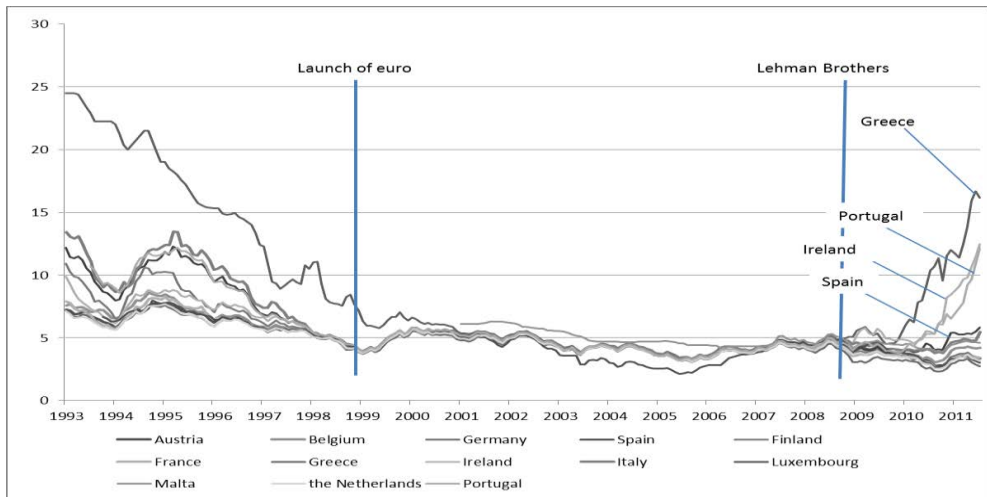
Source: OECD (2010, p. 47).

Moreover, it reflects higher competitiveness of these markets at least while measured by wages and other costs. “Since its creation, relative unit costs have diverged within the Euro area,” while “countries like Germany have gained competitiveness through wage moderation, productivity gains, or both” (Wyplosz, 2010). EU’s Southern members’ losing competitiveness was even escalated by the fact that the common currency has limited the option of currency devaluations in order to boost external competitiveness – even though only temporarily, as it was proved that “depreciations breed inflation and lessen incentives to seek competitiveness by tying wages and productivity”. Through higher wage demands, Southern Countries also let inflation grow, which reflects itself in different monetary policy outcomes, even though it is common for the whole Euro area. “The effects of monetary policy are more expansionary in countries with high inflation rates and more contractionary in countries with low ones. As a result, growing disequilibria may occur within the Euro area” (Mongelli, Wyplosz, 2008, p. 15). With different inflation rates across highly trade interconnected Euro areas – see Table 5 for inflation data, competitiveness changes must have been reflected in the real exchange rate changes. And as there is “a strong link between real exchange rate change and current account”, real exchange rate changes can at least partly explain current account divergences and connect them with the needed policy reforms, specifically at the supply-side (Wyplosz, 2010) and in the labour markets. As a result, the Euro area differences in current accounts are connected with the common currency project at least as an “unexpected challenge” as Mongelli and Wyplosz (2008, p. 16) put it in their paper.

“Another important source of divergence in the Euro area can be seen in excessive domestic spending”, private, public or both (Mongelli, Wyplosz, 2008, p. 23). That is again supported both by financial globalisation and by the existence of the euro, i.e. underestimating the default as well as the exchange

rate risk after the launch of euro – see Graph 3. “Easy external financing, allowed by monetary integration and absence of the exchange rate risk, could make it possible for a country to sustain large current account deficits for a significant amount of time, making the eventual correction more painful (significant fall in demand)”. Euro allowed for lower than optimal – see Graph 3 – real interest rates, which contributed to excessive demand, investment, and spending.

Graph 3. Long-term interest rates in Eurozone, 1993 – 2011, in %



Source: ECB (2011)

Combining all these factors globally, the United States was lately joined by countries such as Ireland, Spain, the United Kingdom, and CEE countries (peripheral Europe) in its continued low saving, with asset price booms and high investment” (IMF, 2009, p. 10). Within the asset boom, constructions played the main role in European countries; countries also encountered real exchange rate appreciation. Moreover, private saving was often offset by higher public saving (easy external financing allowed public spending even in countries with very high deficit (IMF, 2009, p. 20). The result of such a misallocation of resources can apparently be seen during the current situation of the Euro area.

2. Balance of payments adjustment processes

When the significant current account imbalance occurs, such as during the late 2000’s, the automatic adjustment processes should start (e.g. Neumann, Žamborský, Jiráňková, 2010) and restore the balance after some time. In theory, there are several channels, through which the rebalancing can take place:

- Exchange Rate Adjustment Process;
- Price Adjustment Mechanism;
- Income Adjustment Mechanism;
- Monetary Adjustment Mechanism.¹

The Exchange Rate Process works in countries using floating as their exchange rate regime. The current account deficit leads to currency depreciation, which restores external competitiveness of the country's exports and its increase decreases the current account deficit. From the above mentioned countries, namely the United States, and the United Kingdom (from surplus countries, it is notably Japan) use free floating as exchange rate regime.

On the contrary, China's (currently running the most significant current account surplus) currency is pegged to the American dollar (IMF, 2010a). The euro is floating against other currencies, but the Euro area member states are in a specific position: they cannot use exchange rate adjustment as a way of external balance restoration (i.e. deficit countries' currencies cannot depreciate anymore and support domestic exports while reducing imports) since they are on euro. Adjustment processes in individual Euro area countries (similarly as under pegged exchange rate regime) are thus similar to the Price Adjustment (or Hume's) Mechanism.² If compared to initial Hume's conditions, there is just one difference: gold is substituted by euro (Baldwin, Wyplosz, 2008, p. 320): when the current account deficit occurs, there are the euro (not gold) outflows from the country today; during current account surplus, euros flow into the country. Outflow of money from deficit countries decreases money supply and causes the Interest Rate increase in a short run. The interest rate increase causes capital inflow, which finances the current account deficit³, and also cuts economic growth and employment. Moreover, prices and wages should fall as a result of the adjustment process. As a result, exports grow, imports fall, and balance is restored.

The Income Adjustment Mechanism can simultaneously work here, too: Income Adjustment Mechanism, used e.g. by the Keynesian approach, suggests that a decrease in exports causes income decrease within domestic economy, which leads to decrease in imports – as a result, the current account balance is partially restored from deficit. However, it depends on the economic cycle which

¹ Monetary Adjustment Mechanism explains current account imbalance as a result of inappropriate monetary market conditions and cannot work at all within the Euro zone. Its partial impact will only be studied in Section 3.

² David Hume stipulated Price Adjustment Mechanism during the Classical Gold Standard era.

³ In developed economies (without significant exchange rate reserves), financial account surplus mirrors current account deficit showing that inflow of external financing is used to keep savings and investments in balance.

of the two processes prevails. Kliková, Kotlán (2003, p. 176) suggest that the Price Mechanism will restore the current account balance by relative changes in prices especially in economies operating close to the potential product; the income adjustment process rather works in economies far below potential or in recession. Moreover, while financial flows adjust immediately in today's globalised world, trade flows need a relatively longer time to take effect.

All in all, prices and wages must increase slower or even decrease in the current account deficit countries, should individual Euro area countries reach external balance restoration. "It is clear that the exchange rate process allows for domestic relative costs and prices flexible adjustment in comparison with foreign countries, but the Euro area membership only allows such adjustment process that is driven by real economy". The Euro area's deficit countries could re-balance their current accounts quite easily if they acquired higher labour productivity than the rest of Euro area (Baldwin, Wyplosz, 2008, pp. 319 - 320); this would allow them to keep wages on the socially acceptable level even during the times of adjustment. In an opposite case, decreases in production and employment must occur as a result of automatic economic processes since it is only the general price decrease that enables competitiveness to grow, which later leads to the current account balance.

If the automatic adjustment processes in the Euro area countries occur, one could expect that the deficit countries will (even though with some time lag of about one year) see a decrease in their economic growth or even a drop in their production, decrease in employment as well as in price level. Tables 2, 3 and 5 show the GDP growth rates, unemployment rate and inflation rate of individual Euro area countries: Greece, a country with the double-digit current account deficits between 2002 and 2008, saw positive GDP growth rates of around 4 or 6 per cent in 2003 and 2004 before slipping into recession in 2009. Additionally, it operated with relatively higher level of unemployment (from 7,5 to 10 %) and with the inflation rate of 3 or 4 %. Similarly, Portugal, which saw the current account deficits oscillating round 10 %, operated with non-decelerating, even though weak, or no GDP growth rates; the unemployment rate was from 7 to 10 % and inflation about 2 and 3 % in the pre-crisis period. Also Spain went through a similar development in the late 2000's: current account deficits of 5 to 10 %, quite stable GDP growth of 2 or 3 %, 9 % unemployment and inflation rate of 3 or 4 %.⁴

⁴ Since Cyprus, Malta and Estonia only joined the Euro zone lately, the authors do not analyse their long-term trends here.

Table 2. GDP growth rate of the Euro area members in constant prices (in %)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Belgium	1.4	0.8	3.1	2.0	2.7	2.8	0.8	-2.7	2.1	2.4	1.5
Estonia	7.9	7.6	7.2	9.4	10.6	6.9	-5.1	-13.9	3.1	6.5	4.0
Finland	1.8	2.0	4.1	2.9	4.4	5.3	1.0	-8.2	3.6	3.5	2.2
France	0.9	0.9	2.3	1.9	2.7	2.2	-0.2	-2.6	1.4	1.7	1.4
Ireland	5.9	4.2	4.5	5.3	5.3	5.2	-3.0	-7.0	-0.4	0.4	1.5
Italy	0.5	0.0	1.5	0.7	2.0	1.5	-1.3	-5.2	1.3	0.6	0.3
Cyprus	2.1	1.9	4.2	3.9	4.1	5.1	3.6	-1.7	1.0	0.0	1.0
Luxemburg	4.1	1.5	4.4	5.4	5.0	6.6	1.4	-3.6	3.5	3.6	2.7
Malta	2.6	-0.3	1.8	4.2	1.9	4.6	5.4	-3.3	3.1	2.5	2.2
Germany	0.0	-0.4	0.7	0.8	3.9	3.4	0.8	-5.1	3.6	2.7	1.3
Netherlands	0.1	0.3	2.0	2.2	3.5	3.9	1.8	-3.5	1.6	1.6	1.3
Portugal	0.7	-0.9	1.6	0.8	1.4	2.4	0.0	-2.5	1.3	-2.2	-1.8
Austria	1.6	0.8	2.5	2.5	3.6	3.7	2.2	-3.9	2.1	3.3	1.6
Greece	3.4	5.9	4.4	2.3	5.2	4.3	1.0	-2.3	-4.4	-5.0	-2.0
Slovakia	4.6	4.8	5.1	6.7	8.5	10.5	5.8	-4.8	4.0	3.3	3.3
Slovenia	3.8	2.9	4.4	4.0	5.9	6.8	3.7	-8.1	1.2	1.9	1.2
Spain	2.7	3.1	3.3	3.6	4.0	3.6	0.9	-3.7	-0.1	0.8	1.1
Euro area	0.9	0.7	2.2	1.7	3.2	3.0	0.4	-4.3	1.8	1.6	1.1

Source: IMF (2011)

On the other hand, Germany, which is a representative of high current account surplus countries of the Euro area, has not shown an exceptionally high GDP growth rates except in 2006 and 2007. German unemployment rate has reached some 10 % and the inflation rate was very low. The Netherlands combined high current account surpluses of 5 to 9 % with the GDP growth rate of less than 4 %, mild unemployment, and low inflation rates. Finland, having stable current account surpluses, has seen a relatively high GDP growth (in 2009 it nonetheless dropped by more than 8 %) but unemployment rate has been about 8 to 9 % and the inflation rate was only mild. High surplus Luxemburg showed economic growth around 4 to 6 % and insignificant unemployment and inflation rates.

These data do not confirm any performance of the price adjustment mechanism processes that should have been expected within the increasingly imbalanced Euro area. It is the truth even if we take the expected time lag of about one year for the adjustment process to take real effects into account, e.g. in case of Greece and Spain, giant current account deficits were accompanied by economic growth for a long time.⁵ It is probably only Portugal, where current

⁵ Even though we know today that growth was supported by excessive credit and debt, the absence of automatically stabilising effects is striking.

account deficits were followed by the real economy response. On the surplus side, Germany and Finland have faced relatively higher unemployment during the whole period. And only Luxemburg has combined current account surplus with expected economic growth and higher employment.

Table 3. Unemployment rate in Euro area countries (in %)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Belgium	7.5	8.2	8.4	8.5	8.3	7.5	7.0	8.0	8.4	7.9	8.1
Estonia	10.3	10.0	9.7	7.9	5.9	4.7	5.5	13.8	16.9	13.5	11.5
Finland	9.1	9.0	8.8	8.4	7.7	6.9	6.4	8.2	8.4	7.8	7.6
France	8.9	9.0	9.2	9.3	9.2	8.4	7.8	9.5	9.8	9.5	9.2
Ireland	4.4	4.7	4.5	4.4	4.4	4.6	6.3	11.8	13.6	14.3	13.9
Italy	8.6	8.5	8.0	7.7	6.8	6.1	6.8	7.8	8.4	8.2	8.5
Cyprus	3.6	4.1	4.7	5.3	4.6	4.0	3.6	5.4	6.4	7.4	7.2
Luxemburg	2.6	3.5	3.9	4.3	4.5	4.4	4.4	5.8	6.2	5.8	6.0
Malta	7.5	7.6	7.4	7.2	7.1	6.4	5.9	7.0	6.9	6.3	6.2
Germany	8.7	9.8	10.5	11.2	10.2	8.8	7.6	7.7	7.1	6.0	6.2
Netherlands	3.1	4.2	5.1	5.3	4.4	3.6	3.1	3.7	4.5	4.2	4.2
Portugal	5.7	7.1	7.5	8.6	8.6	8.9	8.5	10.7	12.0	12.2	13.4
Austria	4.2	4.3	4.9	5.2	4.8	4.4	3.8	4.8	4.4	4.1	4.1
Greece	10.3	9.7	10.5	9.9	8.9	8.3	7.7	9.4	12.5	16.5	18.5
Slovakia	18.5	17.4	18.1	16.2	13.3	11.0	9.6	12.1	14.4	13.4	12.3
Slovenia	6.3	6.7	6.3	6.5	6.0	4.9	4.4	5.9	7.3	8.2	8.0
Spain	1.5	1.5	11.0	9.2	8.5	8.3	11.3	18.0	20.1	20.7	19.7
Euro area	8.6	9.0	9.2	9.2	8.4	7.6	7.7	9.6	10.1	9.9	9.9

Source: IMF (2011)

While the unemployment data are certainly influenced by long-term structural conditions of all the above economies, the development of nominal wages can offer a more reliable picture. Based upon the stabilising processes, wages should either have grown less or have fallen in deficit countries. Even though ECB (2008a, p. 18-19) analytically proves that dispersion in nominal wage demands across Euro area has decreased, there have been countries whose wage acceleration significantly exceeded the general rate in the Euro zone. And surprisingly, these were namely the current account deficit countries with higher unemployment, where wage acceleration is the least desirable outcome of economic policies. Greece has seen the highest wage acceleration after the launch of euro (about 4 % during 1999 and 2006), followed by Ireland and Portugal. Greece and Portugal moreover saw the highest wage acceleration between 1993 and 1998, too. On the contrary, Spain and Italy tamed nominal wage demands and only saw tiny wage increases during the period. Wages in Germany were however nominally decreasing throughout the period, which certainly contributed to increasing external competitiveness and current account surpluses of Germany.

Table 4. Nominal compensation per employee growth relative to the euro area (in %)

	1993-1998	1999-2006	1999	2000	2001	2002	2003	2004	2005	2006
Belgium	0.8	0.4	0.9	-0.4	1.0	1.2	-0.6	-0.1	0.8	0.6
Germany	0.2	-1.2	-1.4	-0.6	-1.0	-1.3	-0.7	-1.7	-1.8	-1.5
Ireland	2.1	3.6	2.0	5.1	4.1	2.1	2.8	4.5	3.3	2.8
Greece	8.3	4.1	4.0	3.5	3.1	7.4	2.4	3.7	4.9	3.8
Spain	1.8	0.5	-0.4	0.3	1.1	0.8	0.6	0.7	0.3	1.1
France	-0.1	0.5	-0.3	-0.1	-0.2	0.8	0.5	1.3	1.1	1.1
Italy	1.4	0.2	-0.5	-0.2	0.3	-0.4	0.2	1.1	1.1	0.3
Luxembourg	0.7	1.3	1.4	2.9	0.9	1.0	-0.4	2.1	2.0	0.2
Netherlands	0.3	0.9	0.8	2.1	2.3	1.7	1.1	1.1	-0.6	1.3
Austria	0.5	-0.6	-1	-0.4	-1.6	-0.5	-0.1	-1.1	-0.1	0.3
Portugal	4.0	1.7	2.4	4.2	2.8	1.4	0.5	0.5	1.2	0.3
Finland	0.8	1.0	-0.4	1.3	2.1	-0.8	0.6	1.5	2.1	1.3

Source: ECB (2008a, p. 19)

Wage acceleration can also be connected with the overall inflation and thus further contributes to the riddle of the malfunctioning adjustment processes within the Euro area – see table 5 for further details.

Table 5. Inflation rate in Euro area countries (change in %)

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Belgium	1.6	1.5	1.9	2.5	2.3	1.8	4.5	0.0	2.3	3.2	2.0
Estonia	3.6	1.3	3.0	4.1	4.4	6.6	10.4	-0.1	2.9	5.1	3.5
Finland	2.0	1.3	0.1	0.8	1.3	1.6	3.9	1.6	1.7	3.1	2.0
France	1.9	2.2	2.3	1.9	1.9	1.6	3.2	0.1	1.7	2.1	1.4
Ireland	4.7	4.0	2.3	2.2	2.7	2.9	3.1	-1.7	-1.6	1.1	0.6
Italy	2.6	2.8	2.3	2.2	2.2	2.0	3.5	0.8	1.6	2.6	1.6
Cyprus	2.8	4.0	1.9	2.0	2.2	2.2	4.4	0.2	2.6	4.0	2.4
Luxemburg	2.1	2.0	2.2	2.5	2.7	2.3	3.4	0.4	2.3	3.6	1.4
Malta	2.6	1.9	2.7	2.5	2.6	0.7	4.7	1.8	2.0	2.6	2.3
Germany	1.4	1.0	1.8	1.9	1.8	2.3	2.8	0.2	1.2	2.2	1.3
Netherlands	3.8	2.2	1.4	1.5	1.7	1.6	2.2	1.0	0.9	2.5	2.0
Portugal	3.7	3.3	2.5	2.1	3.0	2.4	2.7	-0.9	1.4	3.4	2.1
Austria	1.7	1.3	2.0	2.1	1.7	2.2	3.2	0.4	1.7	3.2	2.2
Greece	3.9	3.4	3.0	3.5	3.3	3.0	4.2	1.4	4.7	2.9	1.0
Slovakia	3.5	8.4	7.5	2.8	4.3	1.9	3.9	0.9	0.7	3.6	1.8
Slovenia	7.5	5.6	3.6	2.5	2.5	3.6	5.7	0.9	1.8	1.8	2.1
Spain	3.6	3.1	3.1	3.4	3.6	2.8	4.1	-0.2	2.0	2.9	1.5
Euro area	2.3	2.1	2.2	2.2	2.2	2.1	3.3	0.3	1.6	2.5	1.5

Source: IMF (2011)

All in all, indicators of real, as well as nominal development within the Euro area show a completely different picture in the late 2000's from that suggested by the current account adjustment mechanism theory. The price adjustment mechanism that should have come forth during the period of marked imbalance does not seem to be working at all. However striking this conclusion is, it is hardly surprising. The underlying causes are however of great importance, because the above analysed data clearly show that, in reality, the automatic adjustment processes are evidently modified by other factors, including by economic policy instruments used by governments. They are not a result of international re-allocation of savings and investment based upon allocation effectiveness, and thus can create a suboptimal build-up for a more abrupt adjustment in nominal as well as real indicators.

3. Domestic economic policy influence

The economic role of State, the basic object of international political economy, has been markedly changing throughout recent history. Under Classical Gold Standard the price adjustment process worked fully with all impacts into the social sphere since the State only started to form its welfare policies. After the Great Depression and even more rapidly after the Second World War, the roles of the State significantly turned to social and welfare oriented policies and governments decided to influence markets for the sake of production and employment stimulation as well as business cycle stabilization. Production and employment decreases, which should have equalled external imbalance, started to be limited while governments stimulated production and employment by means of economic instruments in order to maintain social stability and consensus. Additionally, these measures could have been quite successful, since economies were relatively closed. Still, there was an outspoken principle that State and its economic policies should not try to prioritize domestic welfare in favour of external balance. On the contrary, (1) balanced Balance of Payments, (2) high level of total employment, (3) price stability, and (4) trusted domestic currency were seen as similarly important motives as government intervention.⁶ Moreover, the Gold Standard and its post WWI reconstruction clearly revealed systemic importance of international coordination of (not only) external economic policies; the overall conditions for domestic policies have however rapidly changed.

⁶ These four principles also govern the Treaty of Rome founding the EEC. Stable economic cycle is even stated as a common interest of the Community in its Art. 103. It should however be reached by individual members states. Similarly, the exchange rate policy (still under the Bretton-Woods Monetary System) has belonged to common interest of the EEC.

The situation has markedly changed namely with the trade liberalization, Bretton-Woods collapse, and most recently with the financial globalization. In spite of marked changes, governments only slowly retreat from traditional state interventions and only slowly modernise the set of their economic instruments. Automatic market adjustment processes are thus modified and limited even though their role is increasingly important due to marked international interconnections.⁷

One of the important changes for domestic policies is the choice between fiscal (especially in deficit Europe more traditional) and monetary intervention. We can assume that the monetary policy is relatively highly effective in the Euro area as a whole and it is traditionally connected with the high emphasis that Germany puts on it. Using monetary stimuli, is however rather complicated for individual Euro area countries. The Mundell-Flemming trilemma stipulates that the country can only reach two of three desired aspects of economic policies: 1. capital mobility, 2. fixed exchange rate, or 3. autonomous monetary policy. As explained above, the Euro area can be seen as one economy which combines floating exchange rate, high capital mobility, and autonomous monetary policy. On the other hand, the Euro area members gave up autonomous monetary policy by accepting highly autonomous European Central Bank.

Its uniform monetary policy naturally has different impact on different states (Baldwin, Wyplosz, 2008, p. 412) as shown in Section 1. In the case of the current account deficit country with low real interest rate, the current account deficit will tend to decrease income and to increase interest rates, both nominal and real. On the other hand, initially low real interest rate rather tends to stimulate income, and the overall result thus depends on which of the two processes prevail. When the current account deficit is connected with the high real interest rates, the price adjustment process is even stronger and also the income adjustment process tends to decrease imports by decreasing income. The combination of the current account surplus and the high real interest rate causes in the first case the income increase (import increase) and the interest rate decrease, while in the second case it causes economic stagnation (import decrease). The influence is again unambiguous. The current account surplus and the low real interest rate affect in the same direction, including the income adjustment mechanism.

Based upon the Mundell-Flemming Model (IS-LM Model for opened economy), fiscal policies should on the other hand be fairly effective: under fixed exchange rate, fiscal expansion in individual Euro area member states

⁷ Expansive monetary or fiscal policy can for example leave no effect on domestic employment while it strongly supports employment in other states by transferring demand stimulus via exports and through transnational corporations operating in domestic markets.

increases income and transaction demand for money and thus increases the interest rate in the short run. The interest rate increase attracts capital inflows which induces pressure on the currency appreciation (central banks would normally intervene and restore monetary stability at higher income) – in the Euro area, the appreciation however cannot follow since the country is on euro. This is why the mechanism will affect the real economy. Additionally, part of the increased income will find its outlet in exports (this is the Monetarist approach; Keynesians will rather see an increase in imports at fixed prices). If the country exports mainly to the Euro area, higher exports will decrease the export prices and price competitiveness will probably also drive imports down. All in all, the domestic effect of fiscal expansion will probably prevail. The Euro area countries are however limited by the Stability and Growth Pact as well as by the debt constraint. With this taken into account, it is rather surprising, that especially already more indebted Euro area countries have used the fiscal expansion the most, benefiting from loose monetary conditions in global and Euro area markets – see Graph 3 and Table 6 for comparison.

When current account deficit countries apply fiscal expansion (Greece combined current account deficit, high public debt, and more than 7 % general government deficit in some years, Italy exceeded 4 % deficit, Portugal's deficit peaked at almost 6 % of GDP), the price adjustment mechanism (money supply decrease, income decrease, interest rate increase) directly clashes with the intended impacts of the fiscal stimulus (income increase, money demand increase, interest rate increase).⁸ Similarly, automatic adjustment mechanism should decrease domestic income to restore external balance, while fiscal expansion stimulates the income to rise. Moreover, change in income will probably lead to the income adjustment process described above.

Table 6. General government net lending in Euro area (% of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Austria	-1.9	-0.2	-0.9	-1.7	-4.6	-1.8	-1.7	-1.0	-1.0	-4.2	-4.6
Belgium	-0.1	0.4	-0.2	-0.2	-0.4	-2.8	0.1	-0.4	-1.3	-6.0	-4.2
Denmark	2.2	1.2	0.3	-0.1	1.9	5.0	5.0	4.8	3.3	-2.8	-2.9
Estonia	-0.2	-0.1	0.3	1.7	1.6	1.6	2.4	2.5	-2.9	-1.8	0.1
Finland	6.8	5.0	4.0	2.3	2.1	2.5	3.9	5.2	4.2	-2.9	-2.8
France	-1.5	-1.6	-3.2	-4.1	-3.6	-3.0	-2.3	-2.7	-3.3	-7.5	-7.0
Germany	1.3	-2.8	-3.6	-4.0	-3.8	-3.3	-1.6	0.3	0.1	-3.0	-3.3
Greece	-3.7	-4.4	-4.8	-5.7	-7.4	-5.3	-6.0	-6.7	-9.8	-15.6	-10.4
Ireland	4.8	1.0	-0.3	0.4	1.4	1.6	2.9	0.1	-7.3	-14.3	-32.4
Italy	-0.9	-3.1	-3.0	-3.5	-3.6	-4.4	-3.3	-1.5	-2.7	-5.3	-4.5
Luxembourg	6.0	6.1	2.1	0.5	-1.1	0.0	1.4	3.7	3.0	-0.9	-1.7

⁸ Let us assume synchronised timing of the mentioned effects.

Netherlands	2.0	-0.3	-2.1	-3.2	-1.8	-0.3	0.5	0.2	0.5	-5.5	-5.3
Portugal	-2.9	-4.3	-2.9	-3.1	-3.4	-5.9	-4.1	-3.2	-3.6	-10.1	-9.2
Slovakia	-12.3	-6.5	-8.2	-2.8	-2.4	-2.8	-3.2	-1.8	-2.1	-8.0	-7.9
Slovenia	-3.7	-4.0	-2.5	-2.7	-2.3	-1.5	-1.4	-0.1	-1.8	-6.0	-5.6
Spain	-1.0	-0.7	-0.5	-0.2	-0.4	1.0	2.0	1.9	-4.2	-11.1	-9.2

Source: OECD (2011)

Only for the surplus Euro area countries, there is a certain synergy between the automatic adjustment process and the fiscal expansion. The price adjustment process tends to increase money supply and decrease interest rates, while fiscal expansion (apart from income and money demand increase) should not cause major interest rate increases provided that the money supply is fully satisfied by financial inflows based upon the positive current account. As a result, the interest rate would probably not change, capital would not flow out, and increased income would increase prices, wages, and imports – thus decreasing the current account surplus.

4. Conclusions

European imbalances mirror a global investment-savings misallocation in the late 2000's and represent a significant challenge for European social-economic models. As proved by analysing nominal as well as real economy data, these imbalances flourish because automatic adjustment mechanisms are not let to work. As a result of the European monetary integration, price mechanism should be the main way of restoring external balance within the Euro area. Its effects are however distorted by contradictory measures taken by governments that tend to prioritize domestic welfare and long-lived fiscal stimuli. Cluster analysis of the data provided throughout the paper suggests that countries with the largest cumulated current account deficit i.e. Spain, Portugal, and Greece also saw the highest cumulated deficit between 2002 and 2012, with a more rapid GDP growth than the surplus countries (Belgium, the Netherlands, Germany, Austria, and Finland) but also with the highest cumulated inflation. Additionally, the highest cumulated unemployment after 2008 suggests that the cost induced by the current crisis can after all be too high. Another cluster of slightly deficit countries, i.e. France, Italy, and Ireland, saw similarly high public deficits throughout the period, but a slightly lower growth, and inflation and unemployment slightly higher than surplus countries. As a result, current account surplus countries grew more slowly than those with the biggest current account deficits, but more rapidly than the other cluster of deficit countries. They only saw a slight deficit in public finances and the lowest inflation as well as unemployment. What can be seen as relatively sound economic policy did not bring any worse economic outcome than significant spending and capital inflow when the current crisis is taken into account.

Stipulating this, the authors of this article conclude that the economic policies of States do not sufficiently reflect the markedly internationalised and globalised economic environment they operate in. Driven mainly by traditional aims to stabilise economic cycle, States often contradict automatic adjustment processes. Since they tend to prioritize domestic welfare (employment, wages, GDP growth), external imbalances are not adjusted or are even increased by government intervention. Even though many governments do not see them as an important risk to their domestic and often strictly political goals, embedded investment misallocation together with inappropriate capital flows affect the governments' ability to act as a stabiliser of economic cycles. Firstly, because global financial flows increasingly direct themselves to areas with easy profit, which usually correspond to those with misallocated investment and financial bubbles. Business cycles thus become more and more dependent on globalised economic flows, far beyond individual government intervention means. Secondly, capital and debtors can retreat quickly, whenever they see signs of economic weakness – a high level of indebtedness, combined with current account deficit seems to be a deadly combination. Previously easy monetary conditions (increasing government deficit and offsetting private investment) can thus turn to liquidity and solvency crises. Initial intentions to use fiscal policies to protect economy are then changed into an abrupt need of budget cuts and long postponed policy reforms; years of artificial prosperity changed into hard times both in the economic and the political sense.

In order to prevent abrupt changes in economic well-being, this article suggests that governments should let the economic mechanism come forth more easily than before. Especially in Europe, postponing the needed reforms of labour and product markets is no longer an option since Global and European Imbalances tend to punish peripheral countries with weaker economic systems the hardest. However, fostering labour productivity, investing into innovations and other pro-competitiveness reforms need time to bring effects; this time must be followed by stabilising efforts of the whole European Union. Without real changes within the economic structures of affected countries, these efforts will however have no use. All in all, it must be stressed that sound economic policies, which do not bring miraculous increases in the countries' wealth (that can soon be proved to be merely bubbles of misallocated investment and credit) must be seen as the best option even though they may potentially slow the business cycle down from time to time.

References:

- Baldwin, R., Wyplosz, Ch. (2008), *Ekonomie evropské integrace*, Grada Publishing, Praha.
- Blanchard, O. (2007), Current Account Deficits in Rich Countries, *IMF Staff Papers*, Vol. 54, No 2.
- Blanchard, O., Giavazzi, F. (2002), *Current Account Deficits in the Euro Area: The End of the Feldstein-Horioka Puzzle?* Brookings Papers on Economic Activity, No. 2.
- ECB (2008), A Framework for Assessing Global Imbalances, *Occasional Paper*, No. 78.
- ECB (2008a), Wage Growth Dispersion across the Euro area countries, *Occasional Paper*, No. 90.
- ECB (2010), Reverse Causality in Global Current Accounts, *Working Paper*, No. 1208.
- ECB (2011), *ECB Statistics*, available at: www.ecb.int/stats/html/index.en.html.
- Giavazzi, F., Spaventa, L. (2010), Why the Current Account Matters in a Monetary Union. *CEPR Discussion Paper*, No. 8008.
- IMF (2009), Global Imbalances: In Midstream?, *IMF Staff Position Note*.
- IMF (2010), World Economic Outlook 2010, cited 2011-11-17, available at: <http://www.imf.org/external/pubs/ft/weo/2010/01/pdf/c1.pdf>.
- IMF (2010a), IMF Annual Report 2010, cited 2012-02-24, available at: <http://www.imf.org/external/pubs/ft/ar/2010/eng/pdf/a2.pdf>.
- IMF (2011), World Economic Outlook, cited 2012-02-26, available at: <http://www.imf.org/external/pubs/ft/weo/2011/02/weodata/index.aspx>.
- IMF Annual Report (2010) [Online], [cit. 2012-02-24], available at: <http://www.imf.org/external/pubs/ft/ar/2010/eng/pdf/a2.pdf>.
- Jiráňková, M., Hnát, P. (2010), Vliv současné ekonomické krize na institucionální uspořádání světové ekonomiky, *Acta Oeconomica Pragensia*, Oeconomica, Vol. 18, No 5, Prague.
- Klíková, Ch., Kotlán, I. (2003), *Hospodářská politika*, Sokrates, Ostrava.
- Lane, R. (2010), *A European Perspective on External Imbalances*, SIEPS Report, No. 5.
- Makin, A. (2010), *Global Imbalances, Exchange Rates and Stabilization Policy*, Palgrave Macmillan, Houndmills.
- Mongelli, F., Wyplosz, Ch. (2008), *The euro at ten - lessons and challenges*, ECB.
- Neumann, P., Žamborský, P., Jiráňková, M. (2010), *Mezinárodní ekonomie*, Grada Publishing, Praha.
- OECD (2010), *Economic Survey: Euro Area*, Paris.
- OECD (2011), *OECD Factbook*, Paris.

UNCTAD (2011), UNCTAD Handbook of Statistics, <http://stats.unctad.org/handbook/>.

Wyplosz, Ch. (2010), *Germany, current accounts and competitiveness*, <http://www.voxeu.org/>.