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Grant Agreement nr 266800

EU policies addressing current account imbalances: an assessment

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18th FMM Conference
„Inequality and the Future of Capitalism“
Berlin, 30 Oct – 1 Nov 2014

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Outline

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1. Recent reforms in the EU governance: Macroeconomic Imbalance Procedure (MIP)
2. Short-term approach: Fiscal austerity
3. Medium- to long-term approach: Internal devaluation
4. Did internal devaluation work? A closer look at Greece, Spain, and Ireland
5. Conclusions

1. Recent reforms in the EU governance: MIP

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- Europe 2020 strategy → European Semester
- The new European economic governance to achieve a stronger and more binding coordination of economic policies among Member States

„Six-Pack“

5 regulations and 1 directive: 2 regulations deal directly with macroeconomic imbalances → Macroeconomic Imbalance Procedure (MIP) and Excessive Imbalance Procedure (EIP)

The remaining 3 regulations + 1 directive aimed at strengthening SGP and are oriented at fiscal / budget balancing policies → preventive arm + corrective arm (Excessive Deficit Procedure).

Recent reforms in the EU governance: MIP

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Dealing with imbalances – components of the Macroeconomic Imbalance Procedure (MIP):

1. Alert Mechanism Report (AMR)
2. The scoreboard
3. In-depth review
4. Excessive Imbalance Procedure (EIP)
5. Potential sanctions

Recent reforms in the EU governance: MIP

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Table 1: The MIP scoreboard indicators

Indicators	Threshold values
External imbalances and competitiveness	
Three year backward moving average of the current account balance as a percentage of GDP	**-4/+6%**
Net international investment position as a percentage of GDP	**-35%**
Three years percentage change of the real effective exchange rate based on HICP/CPI deflators	**± 11% (±5% euro area)**
Five years percentage change of export market share (share of world exports)	**-6%**
Three years percentage change in nominal unit labour cost	**+ 12% (+9% euro area)**
Internal imbalances	
Year-on-year change in house prices relative to the final consumption deflator	**+6%**
Private sector credit flow - consolidated - as a percentage of GDP	**14%**
Private sector debt - consolidated - as a percentage of GDP	**133%**
General government gross debt (EDP) as a percentage of GDP	**60%**
Three year backward moving average of unemployment rate	**10%**
Year-on-year change of total financial sector liabilities	**16.5%**

Source: Eurostat

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Dealing with imbalances

- Macroeconomic imbalances seen mainly as a result of "downward wage rigidities" (ECB 2012)
- The new European system of economic governance introduced mechanisms and tools for directly intervening into national wage policies and collective bargaining agreements

- Two approaches endorsed by the EU institutions in dealing with imbalances and crisis:

1. An immediate enforcement of austerity policies of deficit countries: budget consolidation, reduction of government demand → shrinking GDP, unemployment, a sharp drop in domestic demand and thereby imports;
2. A more long-term adjustment process consisting of an internal devaluation in current account deficit countries: improve competitiveness and thus exports.

→ An asymmetric adjustment process as a re-balancing strategy

2. Short-term approach: Fiscal austerity

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3 main channels of intervention:

I. Country-specific recommendations (CSR) in the framework of the European Semester

II. Conditionalities imposed upon receiving financial assistance (bail-out)

III. ECB's Outright Monetary Transactions (OMT) programme with conditionalities

- Six-Pack, Euro Plus Pact, Fiscal Compact, Two-Pack… common theme: overarching concern with public finances → tighter discipline, closer oversight, sanctions for non-compliance.
- Troika's economic adjustment programmes consist in fiscal, financial, labour market reforms in neoliberal tradition.
- ECB will engage in OMTs provided that the countries apply to the ESM which would imply further austerity measures.

→ Implementation of fiscal austerity measures should help deficit countries to rebalance, via a reduction in aggregate demand and thereby in imports.

Short-term approach: Fiscal austerity

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Figure 1a: Austerity and GDP growth, selected countries, 2011-2012

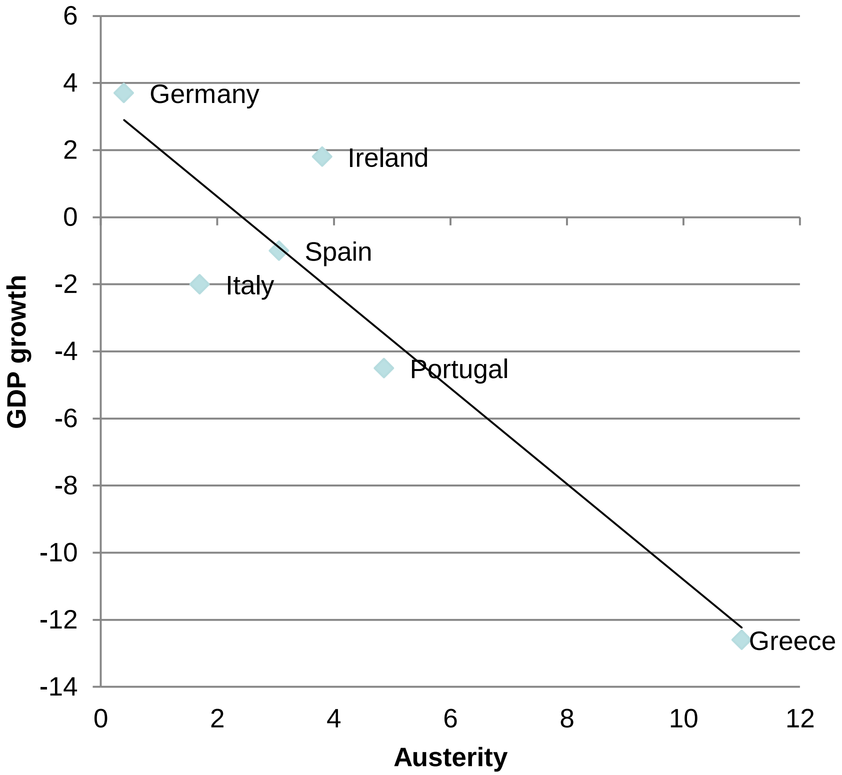
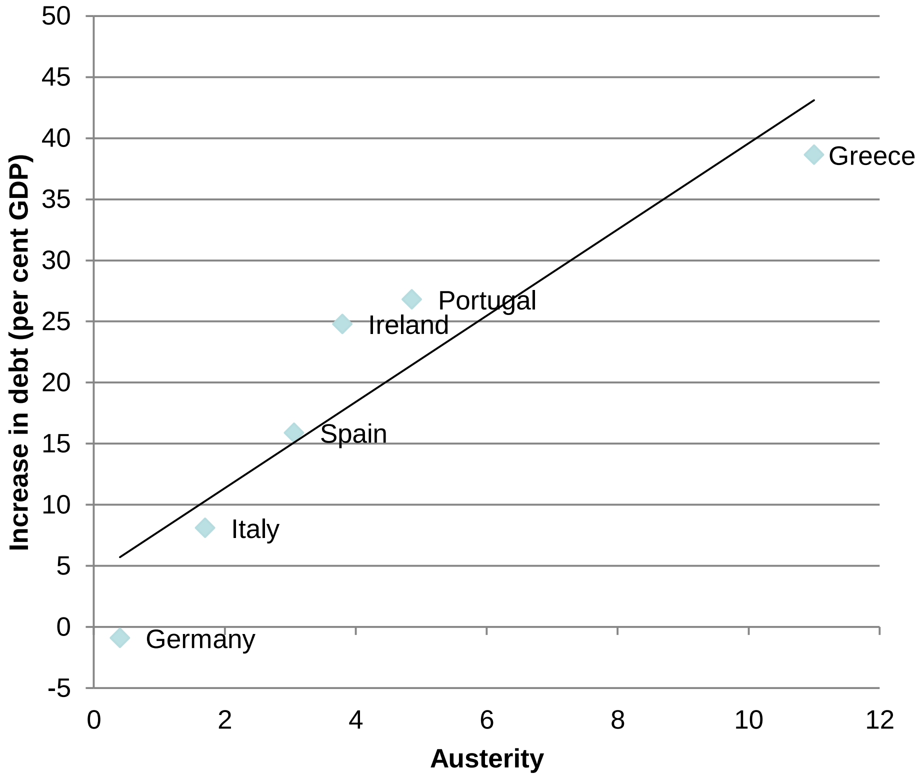


Figure 1b: Austerity and increases in debt-to-GDP ratios, selected countries



Sources: Financial Times and Datastream

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Short-term approach: Fiscal austerity

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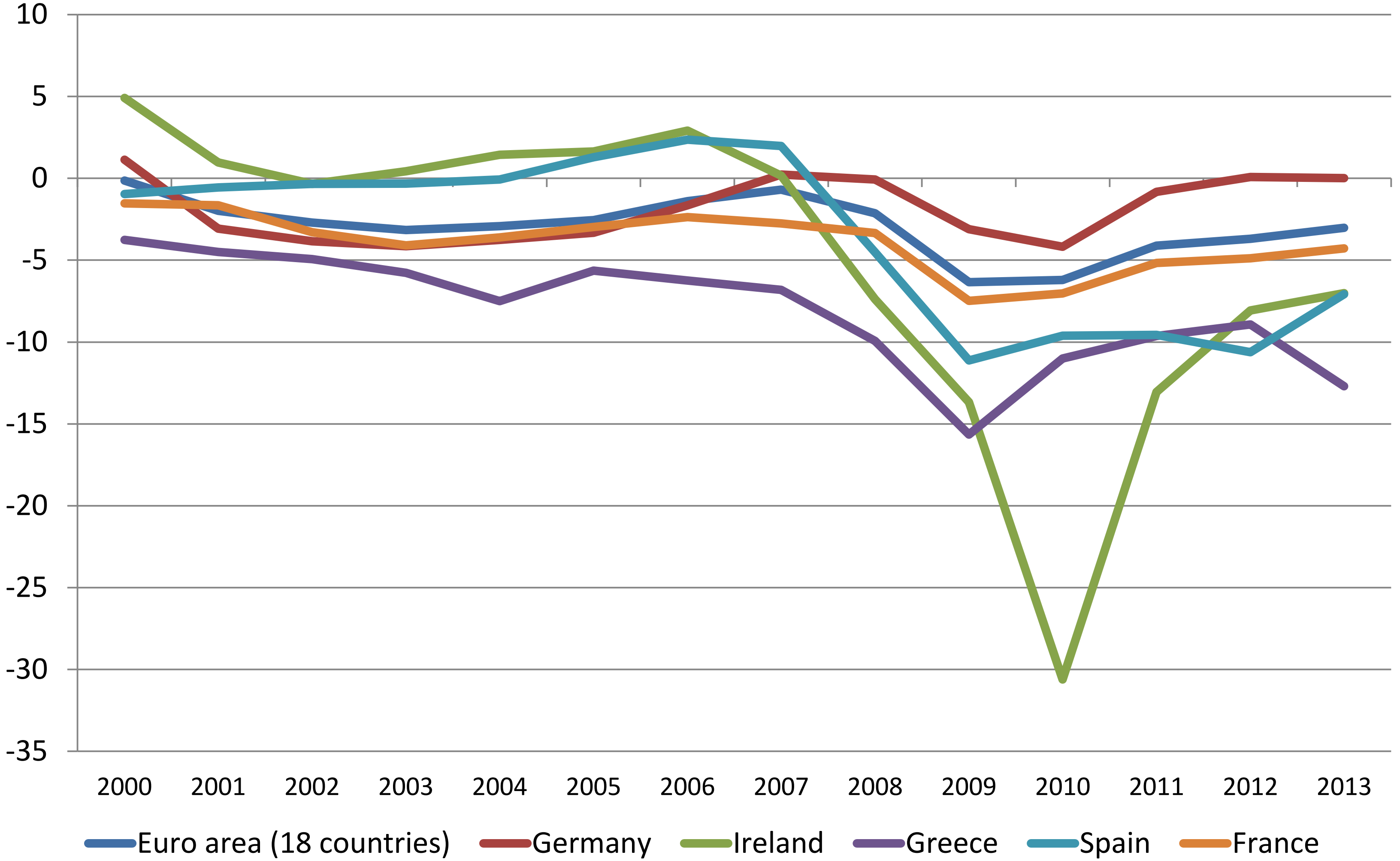
Figure 2: Budget balances in per cent of GDP, selected EU countries incl. euro area avergae, 2000-2013



Source: AMECO

Short-term approach: Fiscal austerity

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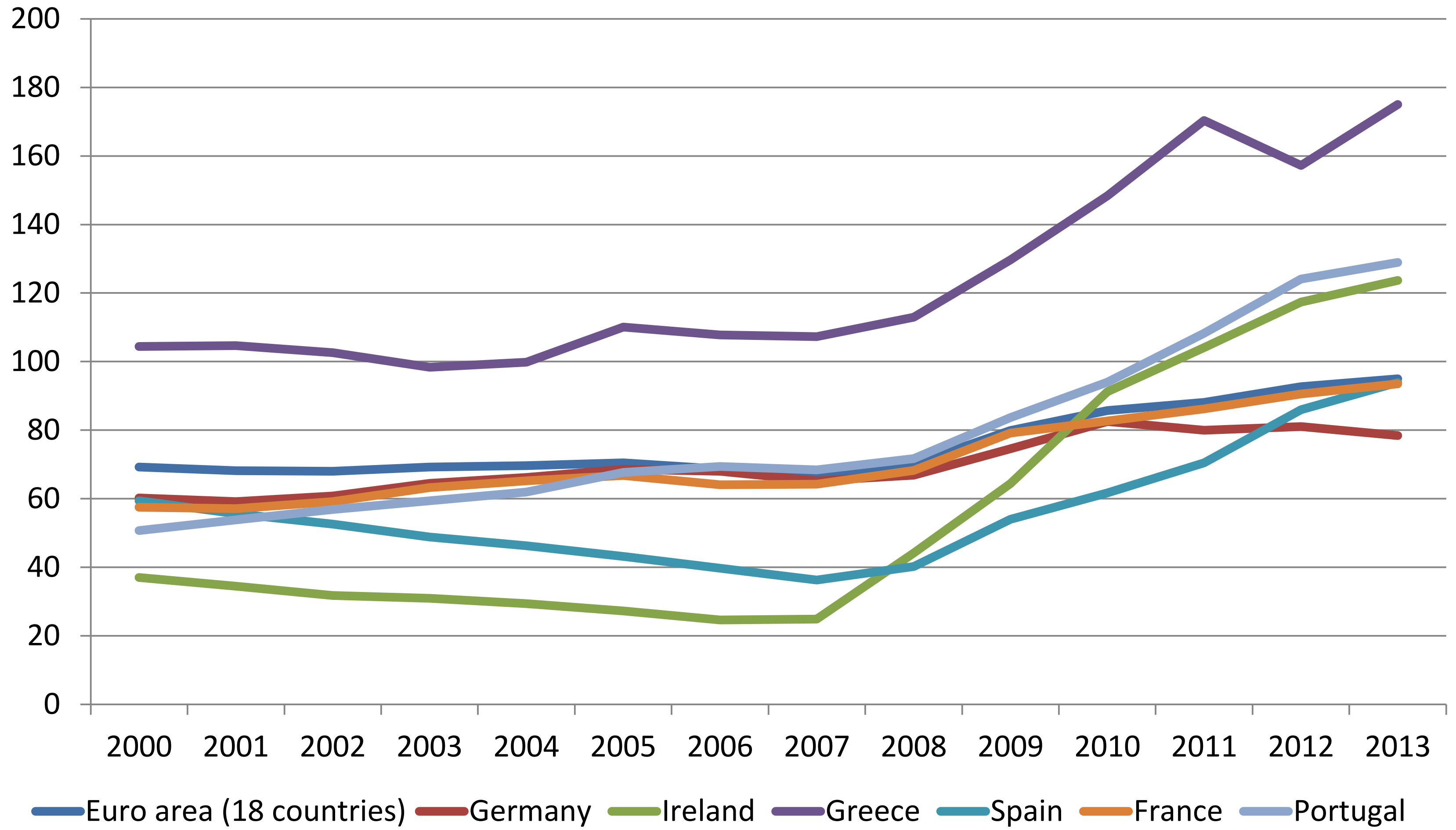
Figure 3: Public debt to GDP, selected EU countries and euro area average, 2000-2013



Source: AMECO

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Short-term approach: Fiscal austerity

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Failure of the austerity strategy:

- Negative multiplier
- Recession deepens
- Aggregate demand collapses
- Increasing unemployment
- Tax revenues collapse
- Debt-to-GDP ratios increase

→ Why then austerity?

Possible explanations can be found in the dominance of neoclassical theory, pressures from financial markets, surplus countries seizing the chance to enforce neoliberal reforms across Europe…

3. Long-term approach: Internal devaluation

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→ Increasing competitiveness via a reduction of labour costs as a functional substitute to currency devaluation

- Falling nominal wages and falling goods prices and thus deflationary development

→ Productivity increases are as well a long-term goal, including technology improvements, education and intensification of work

- Labour market deregulation

Long-term approach: Internal devaluation

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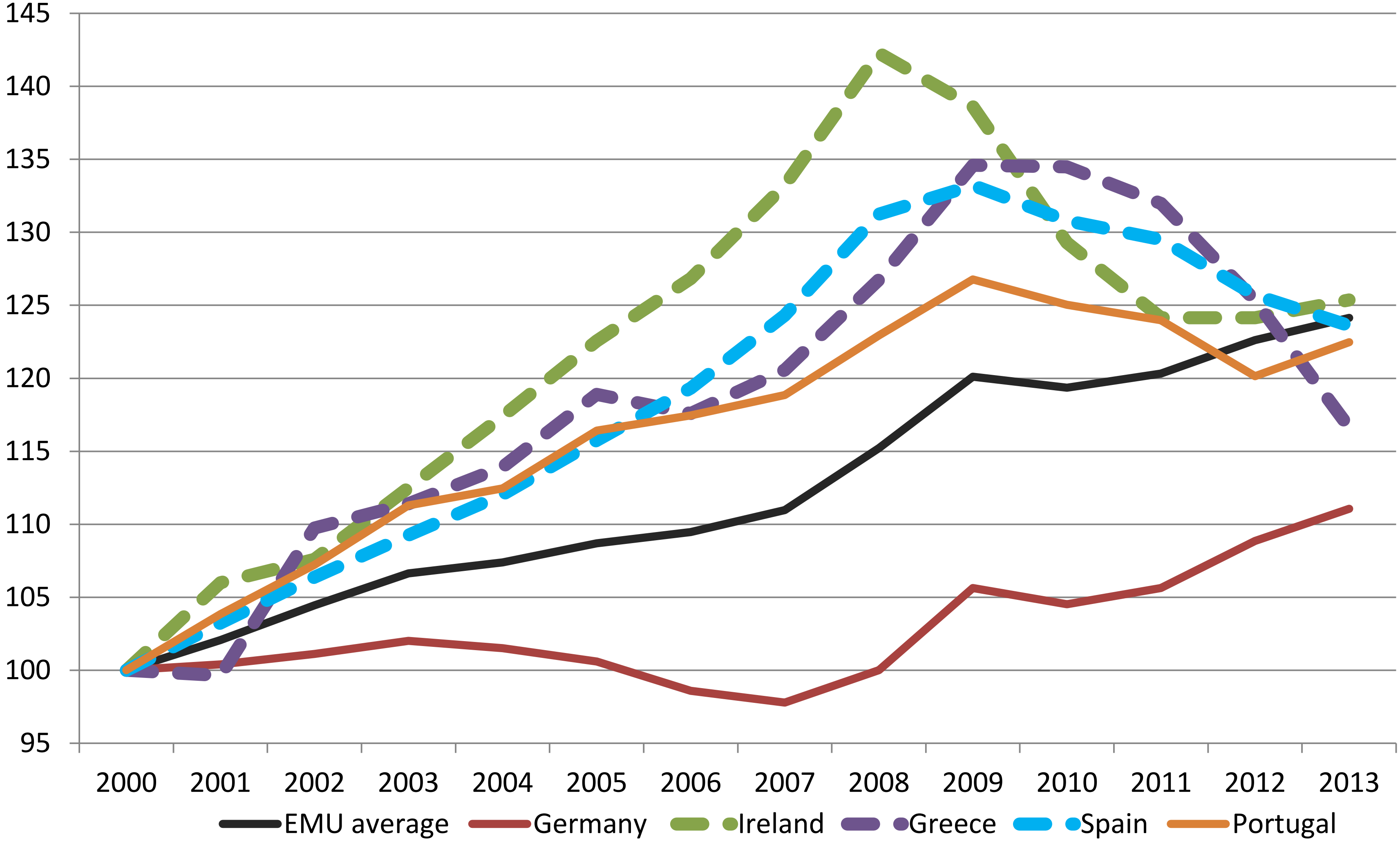
Figure 4: Developments in unit labour costs, 2005-2013, 2005=100, selected countries



Source: EUROSTAT

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4. Did internal devaluation work?

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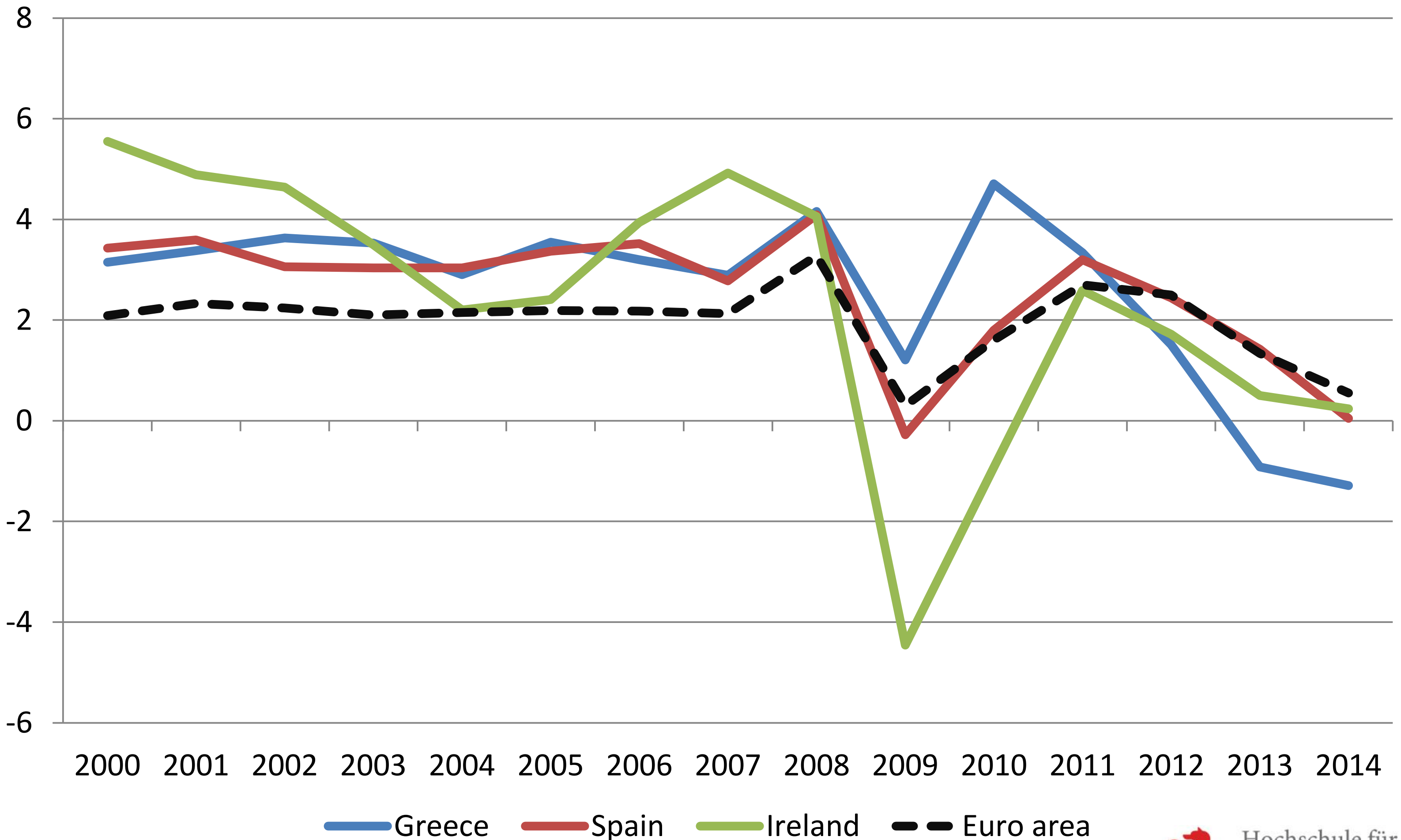
Figure 5: Average inflation (CPI), by year, Greece, Spain, Ireland, EMU average, January 2000-May 2014



Source: Inflation.eu and EUROSTAT

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Long-term approach: Internal devaluation

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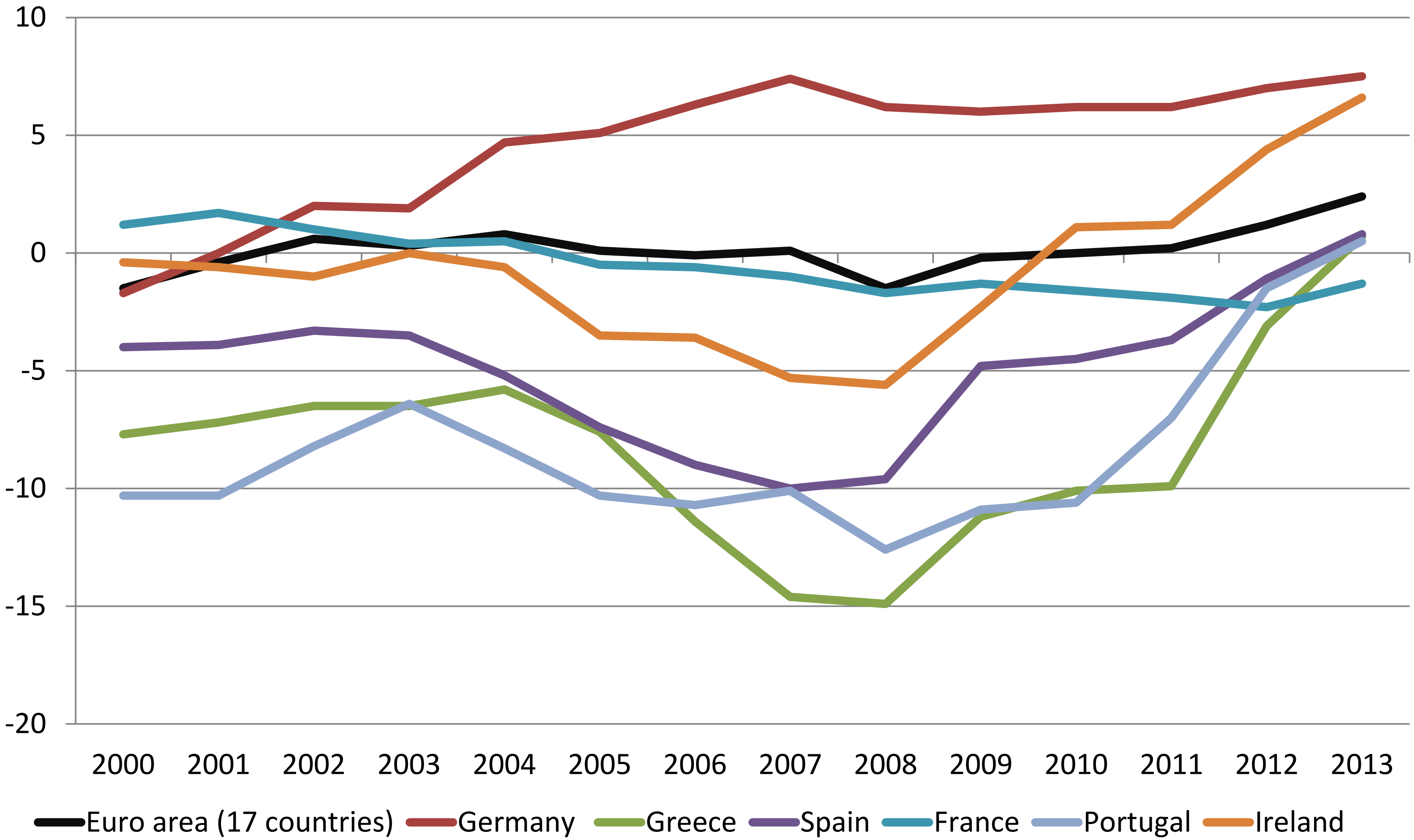
Figure 6: Current account balance in per cent of GDP, selected countries, 1999-2012



Source: Eurostat

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Did internal devaluation work?

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- Asymmetric adjustments of unit labour costs accross EMU
- Euro area as a whole realised current account surpluses which also depend on international capital flows and exchange rate movements. There is the danger that low cost increases in the EMU are compensated by an appreciation of the euro.
- One-sided adjustment comes at great economic and social costs to deficit countries.
- Re-balancing (to be) achieved at much lower levels of output and employment as it could have been with a more symmetric adjustment process.
- Increase in precarious jobs
- Negative changes in personal income distribution via increasing wage dispersion, tax and expenditure policy of the government, etc.
- Dampening effects on demand
- Real danger of **deflation**, in particular in Greece and Spain, if the fall in wages and prices gets out of hand → no bottom limit in the absence of minimum wages or other mechanism which could prevent the downward spiral

Did internal devaluation work? Greece

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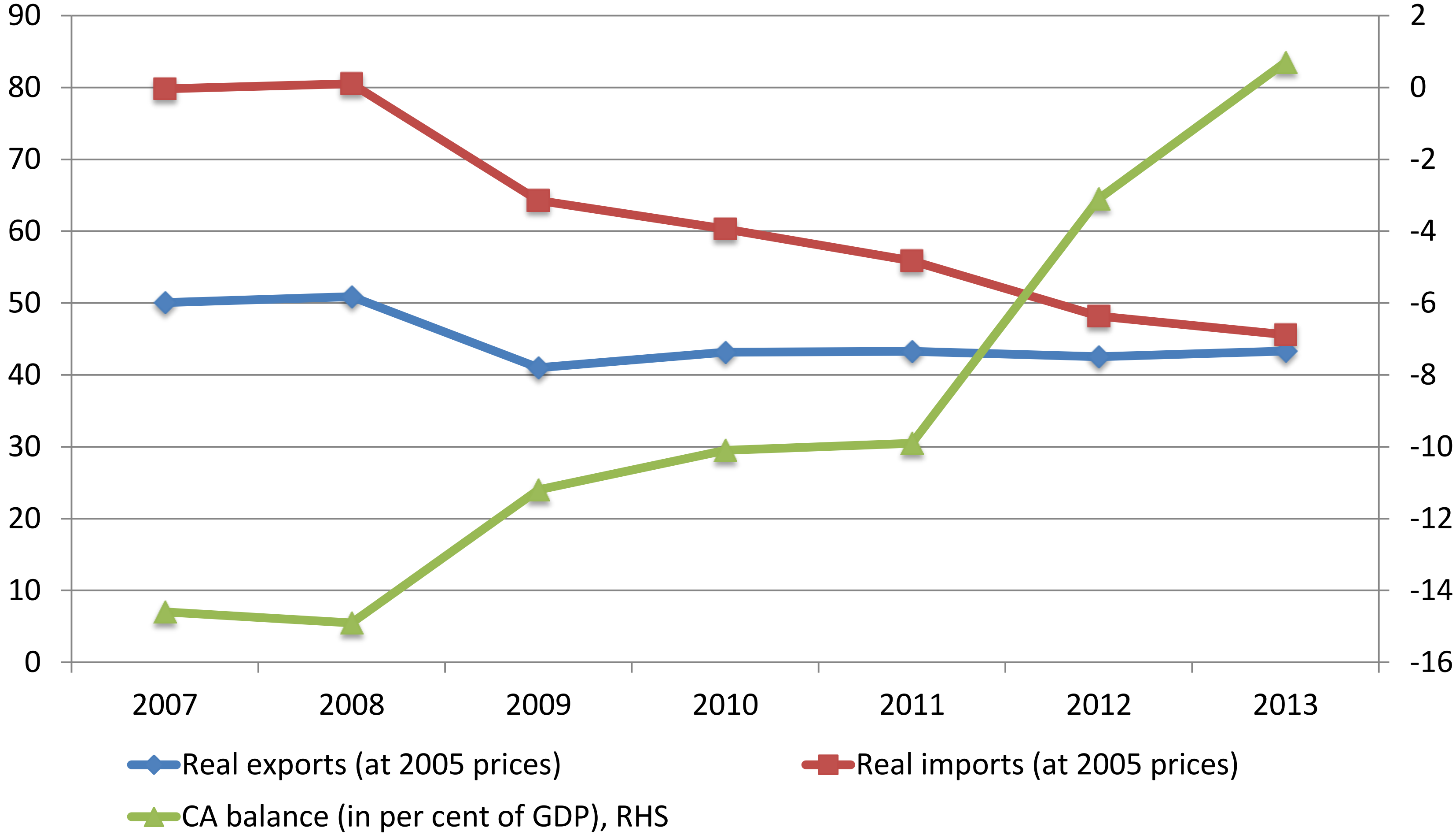
Figure 7: Greece, real exports and real imports (in billions of euros) – LHS, and current account balance (in per cent of GDP) – RHS, 2007-2013



Source: AMECO

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Did internal devaluation work? Spain

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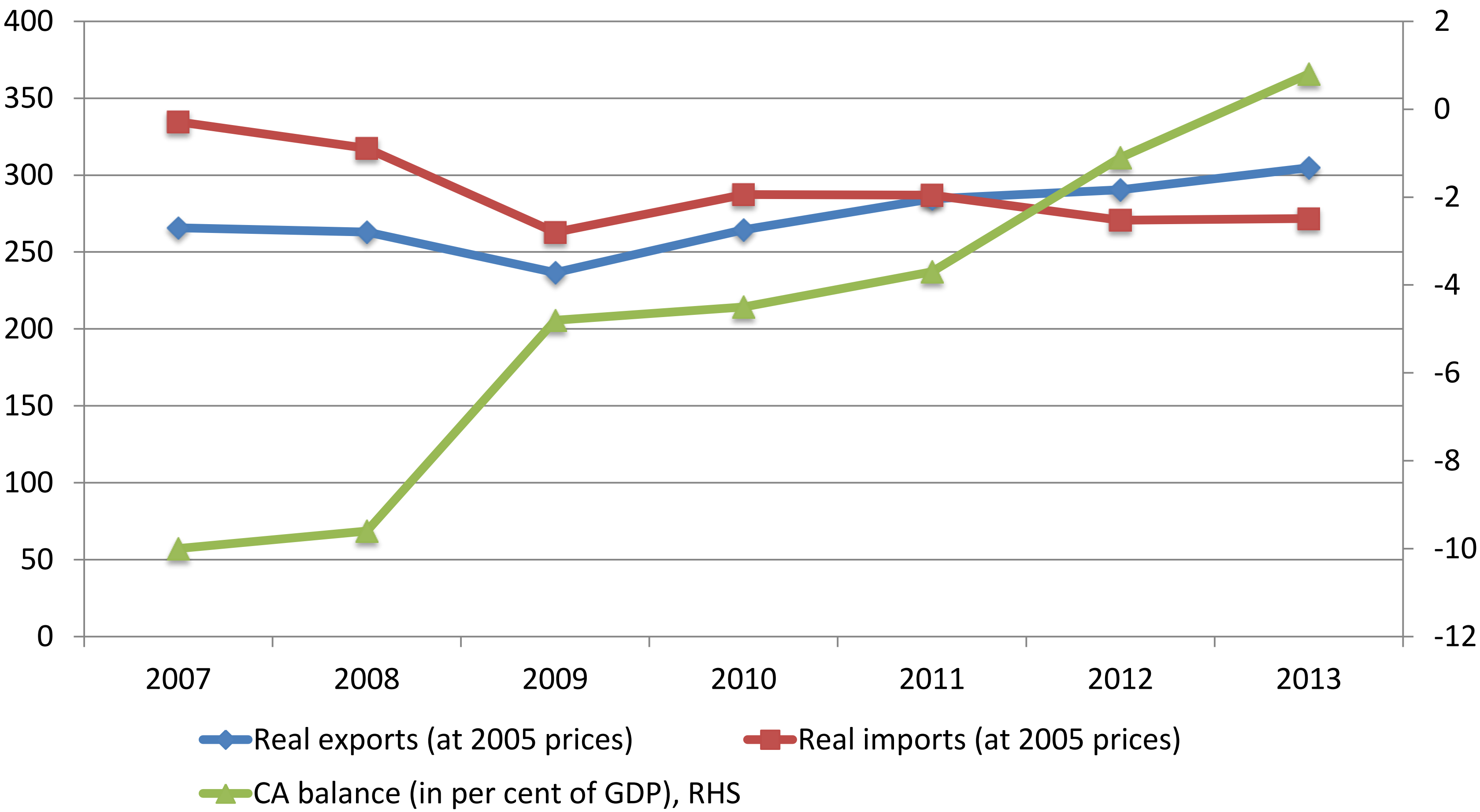
Figure 8: Spain, real exports and real imports (in billions of euros) – LHS, and current account balance (in per cent of GDP) – RHS, 2007-2013



Source: AMECO

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Did internal devaluation work?
Ireland

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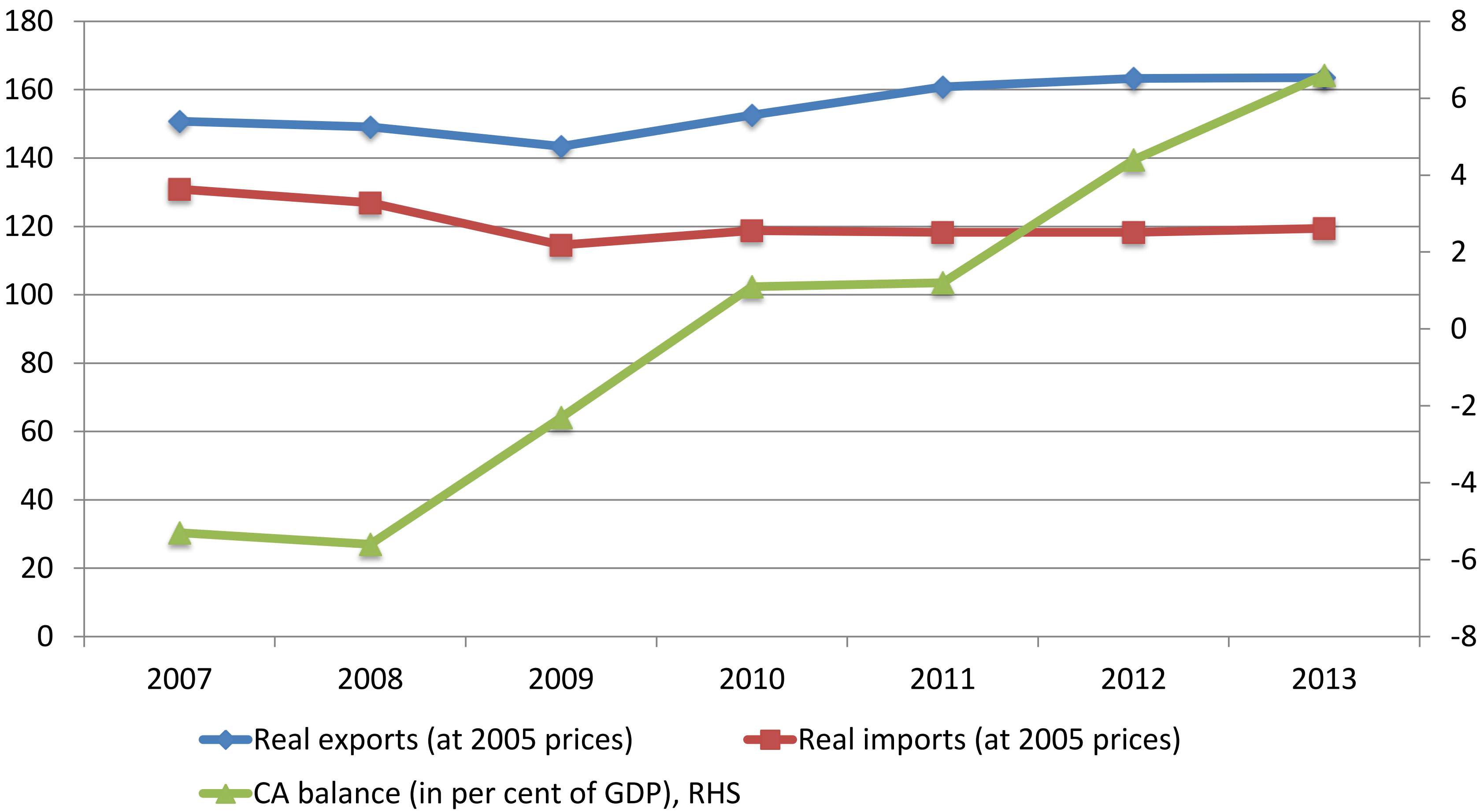
Figure 9: Ireland, real exports and real imports (in billions of euros) – LHS, and current account balance (in per cent of GDP) – RHS, 2007-2013



Source: AMECO

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Did internal devaluation work?
Greece, Spain, Ireland

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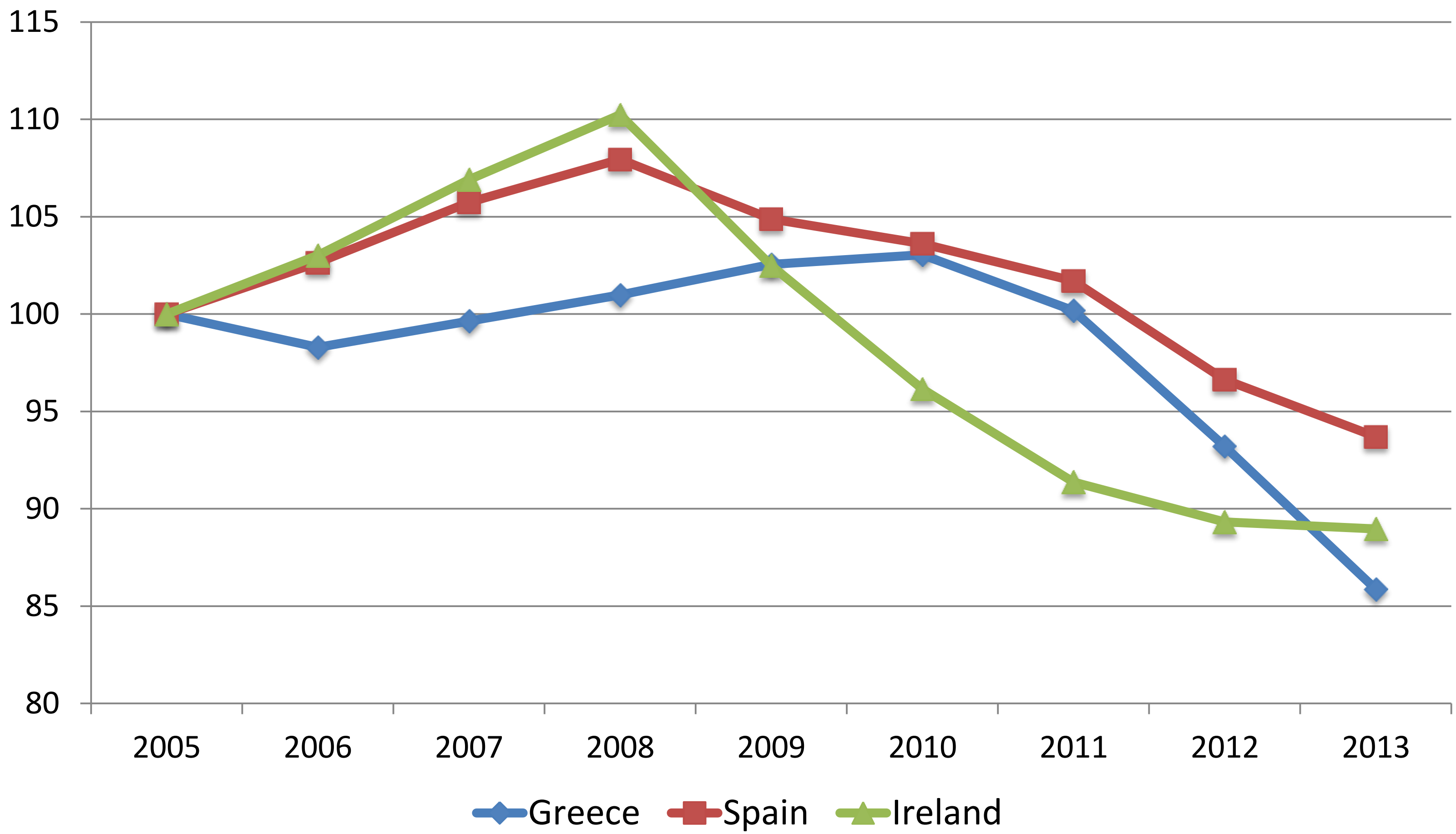
Figure 10: Real effective exchange rate (deflator: unit labour cost in the total economy), Greece, Spain and Ireland, 2005-2013 (2005=100)



Source: EUROSTAT

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Did internal devaluation work? Greece, Spain, Ireland

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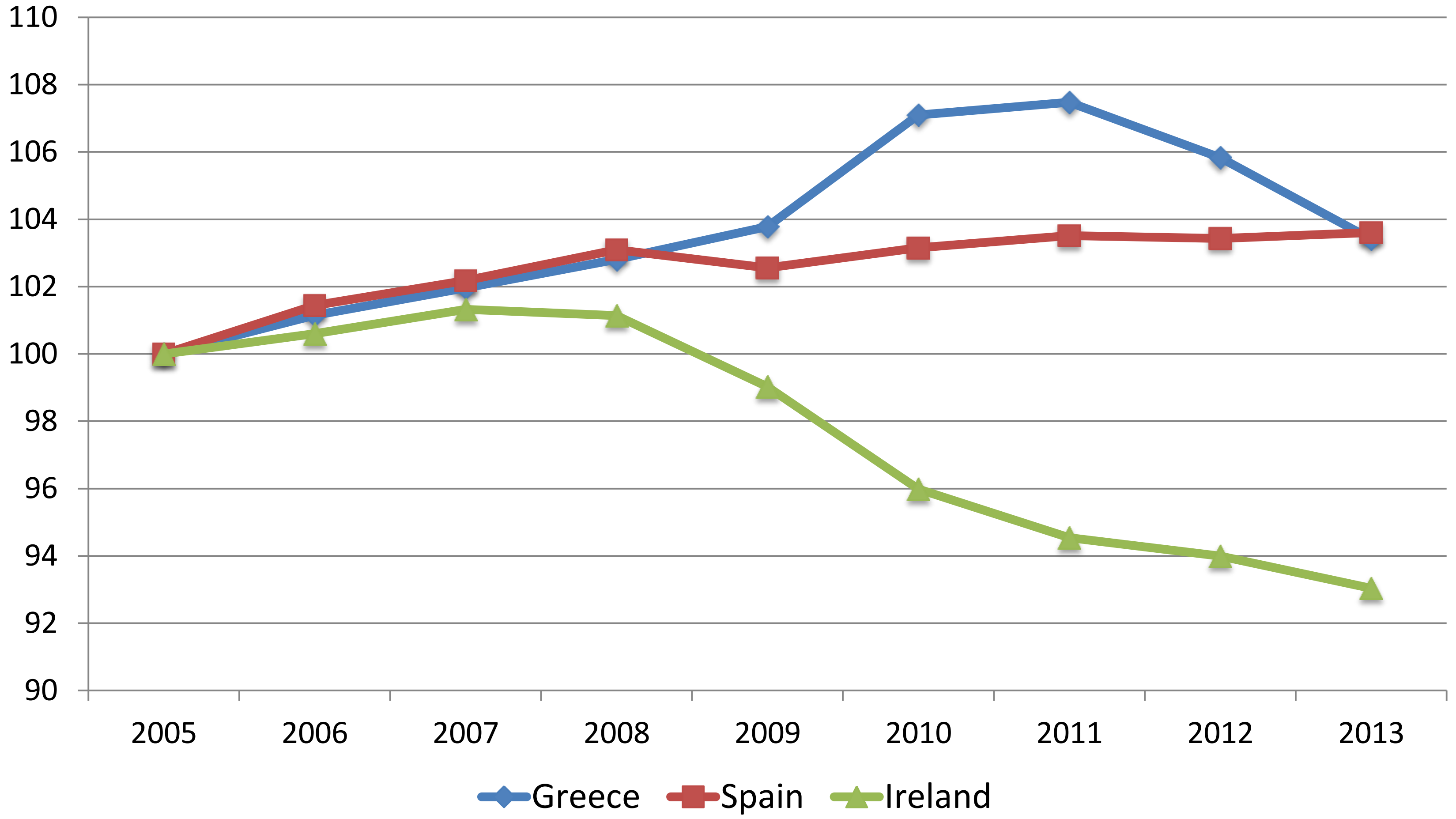
Figure 11: Real effective exchange rate (deflator: consumer price index), Greece, Spain and Ireland, 2005-2013 (2005=100)



Source: EUROSTAT

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Did internal devaluation work? Greece, Spain, Ireland

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- **Greece**: fiscal austerity and a related dramatic drop in domestic demand were major contributors in bringing its current account slightly over zero. Despite the fall in ULC, prices of export goods actually increased in Greece (likely due to incresing profit margins). Greek example also highlights the difficulties of internal devaluation – an increase in competitiveness is much more difficult to achieve than a reduction in imports.

- **Spain**: rebalancing came both from a reduction in imports and an increase in exports, still the former channel dominates.

~ Cases of Greece and Spain show that, despite wage cuts, it might still be very difficult to achieve international price competitiveness.

- **Ireland**: a success story? Both channels worked and Ireland saw CA surplus of 6.6 % of GDP in 2013. However Ireland – unlike Greece and Spain – managed to achieve a significant increase in price competitiveness.

8. Conclusions

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i. Short-term strategy did not work → crisis countries pushed into a deeper recession;

ii. Long-term strategy does not work → deflation; also a question whether real exchange rate channel works;

iii. Overall an extremely asymmetric adjustment imposed on the current account deficit countries → rebalancing comes at a higher cost for all;

iv. Mistaken belief that structural reforms will unfold market forces and lead to recovery and full employment → total absence of demand creation policies;

v. Without changes in economic governance → prolonged stagnation, but also possibility of Japan-like deflationary scenario;

vi. Breakdown scenario of the euro → political destabilisation in some countries - escalating conficts in the EU, withdrawal of support for the EU project, etc.

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Thank you for your attention.