

# **FESSUD**

FINANCIALISATION, ECONOMY, SOCIETY AND SUSTAINABLE DEVELOPMENT

## **Briefing Note 3**

### **Current account imbalances and the Economic and Monetary Union**

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#### **Introduction**

The exchange rates between the countries involved are irrevocably fixed in nominal terms at the point of the formation of a currency union (between nations); and so it was with the formation of the Economic and Monetary Union (EMU) with rates locked amongst initial members during 1998 prior to the launch of the euro. It has long been recognized that this fixed exchange rate (between nations) aspect of a currency union remove the flexibility of exchange rate adjustments in the face of asymmetric shocks, and the optimal currency area literature is focused on whether alternative adjustment mechanisms such as labour mobility are available. During the formation of EMU, there was rather little attention paid to these optimal currency area considerations and how EMU would respond to asymmetric shocks. Perhaps more significantly, there was little (or no) attention paid to the appropriateness of the exchange rates at which the national currencies entered the euro, and whether the pattern of exchange rates were consistent with a sustainable balance of payments position. The Maastricht Treaty convergence criteria did involve a degree of stability of exchange rate, albeit within a range of upto 6 per cent, in the two years prior to membership, with the presumption that such stability indicated an appropriate exchange rate. But that element of stability of the nominal exchange rate does not ensure the sustainability of that exchange rate, and more significantly it does not ensure the sustainability of the balance of payments position and current account

and capital account imbalances. A stable exchange rate which involved, for example, a current account deficit and a capital account surplus is reliant on the sustainability of the capital account surplus and the willingness of other countries to continue to lend to the country in question.

It is quite remarkable that there was no attention given to the current account position of a country in the convergence criteria of the Treaty of Maastricht nor to the current account imbalances between the founding member countries of EMU. As Jeremy Smith 'When the Treaty of Rome was first signed in 1957, it included an article which required member states "to pursue the economic policy needed to ensure the equilibrium of its overall balance of payments and to maintain confidence in its currency, while taking care to ensure a high level of employment and a stable level of price" and to co-ordinate their policies. The Treaty of Maastricht ... repealed this article entirely. This was a mistake. Current account imbalances are today at the heart of the problem of policy-making and co-ordination for the Eurozone. It's time to bring back a similar provision.' (Jeremy Smith, [Controlling Eurozone current account surpluses - revisit the Treaty of Rome!](#))

A single currency clearly fixes the nominal exchange rates between the constituent countries. In forming the euroarea without reference to current account imbalances, it can only be presumed that the authors of the Maastricht Treaty either thought that the existing current account imbalances were as sustainable and/or that appropriate adjustments to the real exchange rate could come through changes in the domestic price levels and competitiveness. Current account imbalances mean capital account imbalances, and corresponding (directly or indirectly) capital flows between countries. The consequences of the capital flows within the context of single currency with build-up of debts in current account deficit countries were also neglected.

The next section illustrates how current account imbalances tended to grow in the first decade of the euro, followed by declines in current account deficits after the financial and euro crises. The declines in deficits were largely engendered by deflation, and the major question arises on the constraints placed on future

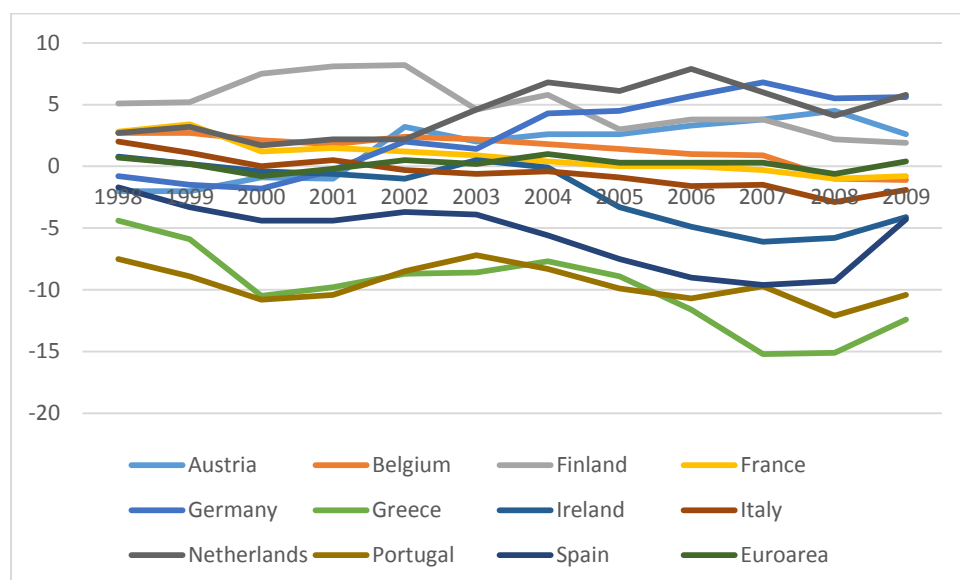
economic prosperity by the current account prospects. In the following sections the ways in which balance of payments considerations limit growth and employment are examined. This leads into thoughts on policy responses to the current account imbalances to enable future growth and prosperity for euroarea countries.

### **Current account record**

The current account record of the original member countries of the euroarea can be readily summarised. Figure 1 portrays the current account position (as a percent of GDP) over the period 1999 to 2008 during which there is a general widening of the current account imbalances in that those countries with a deficit in 1999 experienced a growing deficit, though Germany was an exception in that it had a small deficit in 1999 but large surplus in 2008. Countries starting with surplus tended to see their surplus growing. The standard deviation of the current account positions (as per cent of GDP) rises from 3.7 in 1998 to 4.4 in 2001, and after falling 2001 to 2003, gradually rose to peak at 7.3 in 2007. Since the financial crisis the standard deviation has continuously fallen, down to 3.4 in 2015. Prior to the financial crises of 2007/09, the euroarea as an entity averaged close to current account balance, which meant that broadly speaking the deficits of deficit countries are matched by the surpluses of the surplus countries, and that in effect surplus countries are lending to deficit countries (though that may not be a direct relationship).

The introduction of a single currency, the removal of exchange rate risk and the lifting of all capital controls could be anticipated to facilitate increased capital flows between EMU member countries. This in turn permitted rising current account imbalances. The significant aspects of these deficits and capital flows were whether the deficits and the capital flows were sustainable: in effect the answer brought by the financial crisis is that they were not. Further, and particularly given the scale of the deficits with three countries having deficits above 10 per cent of GDP, it has to be doubted whether, even in the absence of financial crisis and recession, the deficits would have been sustainable.

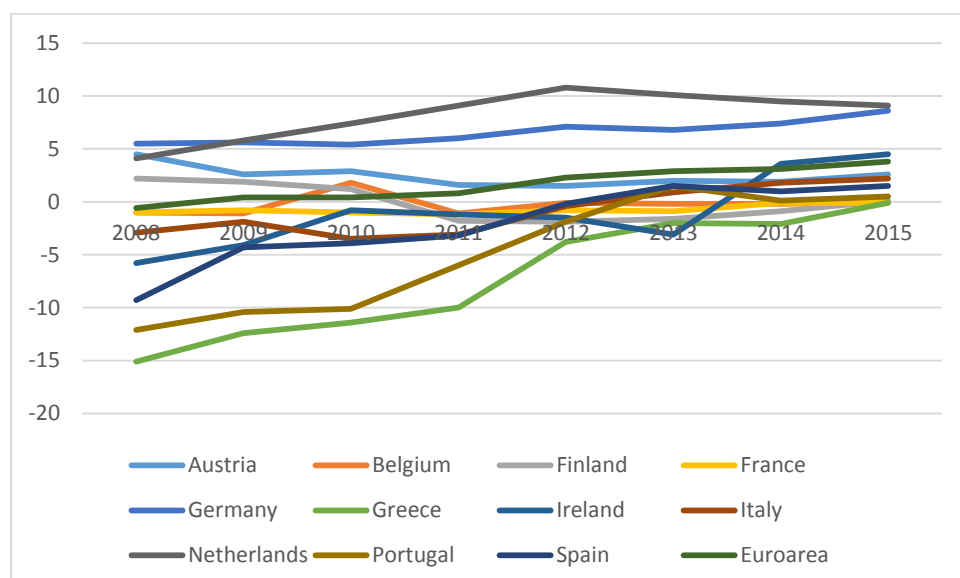
Figure 1: Current account positions (as percent of GDP): 1999-2009



Source: Calculated from OECD *Economic Outlook* June 2016

Figure 2 portrays the current account positions from 2008. The overall surplus of the euroarea has tended to grow (from 0.4 per cent of GDP in 2009 to 3.8 per cent in 2015). There have been sharp falls in the current account deficit of some countries, along with the maintenance of large current account surpluses in others, combining to enable the overall surplus of the euroarea to grow.

Figure 2: Current account positions (as percent of GDP): 2008-2015



Source: Calculated from OECD *Economic Outlook* June 2016

The decreases in the current account deficits owe much to deflation—reducing the demand for imports rather than boosting exports.

### **Balance of payments constrained growth**

The limitations on a country (or indeed any economic region) on having a current account deficit comes in the first instance for the observation that the residents of the country concerned have to borrow an equivalent amount from overseas through the capital account. Indeed, such borrowing from overseas may be viewed as a strength in that there is sufficient confidence shown by foreigners to lend to the country concerned. In such a case, the causal relationship may run from the capital account inflow to the current account deficit: a strong capital account inflow raising the exchange rate, leading to diminished exports and higher imports, widening the current account deficit. Within a currency union, the exchange rate mechanism would not be in operation. The removal of exchange rate risk with the formation of a currency union may though facilitate cross-border lending, as appear to have happened in the first decade of the euroarea as current account imbalances grew. Indeed, current account deficits can continue and indeed grow (as illustrated by the euroarea experience in its first decade) provided that the current account surplus countries are willing and able to lend to the deficit countries.

A trade deficit (as a proportion of GDP) may not be sustainable in the sense that it involves borrowing from overseas, and that borrowing in turn adds to future interest, royalty and dividend payments. A country's net debt position goes (relative to GDP), and its current account deficit (including the net interest payments) rise.

A current account deficit is potentially sustainable in the sense that a continuing deficit (relative to GDP) of  $d$  would lead to the foreign debt converging on  $d/g$  where  $g$  is the nominal growth rate. However, a trade deficit (net imports) of  $td$  (relative to GDP) is only sustainable (in terms of debt ratio) if  $g > r$  – that is the growth rate of a country is greater than the rate of interest etc. on foreign borrowing, which is possible but unlikely (though depends on remitted profits).

One influential expression of the emphasis on the scale of a country's current account deficit is the idea of balance of payments constrained growth. This approach focuses on the idea that the trade deficit would grow over time if the growth of imports exceeds the growth of exports, and that a trade deficit could not continue to grow indefinitely as other countries would not be willing to finance an ever growing deficit (to which would be added interest payments on previous borrowing). From that simple observation, the notion of what has become termed the balance of payments constrained growth rate (BPCGR) has been derived (following particularly the work of Thirlwall, e.g. Thirlwall, 1979); and see Hein and Detzer (2015) for development in context of single currency). The sustainability of the size of trade deficit generates an upper limit on the growth of the domestic economy. This is a long term constraint and it can be readily observed (as in Figure 1) that the trade deficit and the current account deficit can be relatively large and grow for significant number of years.

When the domestic demand for imports and the foreign demand for a country's exports are viewed as based on domestic income, foreign income and relative prices, the balance of payments constrained growth rate for a particular country depends on positively on foreign income growth, the income elasticity of demand for its exports, negatively on income elasticity of demand for imports. It also depends on the relative price elasticities of demand for exports and imports insofar as the relative prices of imports and exports vary.

The income elasticities of demand for imports and exports reflect the nature of the products produced within a country. An income elasticity of demand larger (smaller) than unity means that demand grows faster (slower) than income. The significance in general, and specifically for the euroarea, comes from the clear implications for the growth rate. A country producing high tech goods, for example, likely to find high income elasticity and perhaps low price elasticity whereas a country producing low tech goods likely to face low income elasticity.

The interpretation of these results in the context of the euro can be a little complicated. For trade between the member countries, the (nominal) exchange rate

between the countries is, of course, fixed through membership of the single currency. A member country could potentially improve its competitive position through a form of internal devaluation with its prices rising less quickly than prices in the rest of the currency union. In other words, domestic inflation (particularly in tradeable goods and services) below the average rate of inflation elsewhere in the currency union.

The balance of payments constrained growth rate emphasizes that the growth of exports and the growth of imports have eventually to be broadly in line. A country whose products (and potential exports) have a low income elasticity of demand face particular constraints on their ability to grow. In the context of a single currency, there is limited opportunity for internal devaluation through domestic prices rising less quickly than foreign prices, and there may be doubts on the effectiveness of internal devaluation particularly on a continuing long-term basis.

### **Unemployment and output**

A country's ability to run a current account deficit depends on its ability to borrow from external sources, that is to run a capital account surplus. A country in a fixed exchange rate regime can run an overall balance of payments deficit provided that it possesses sufficient foreign exchange reserves to meet that deficit – but of course the foreign exchange reserves could soon be exhausted with a persistent balance of payments deficit. In the context of the euro currency union, a country can run a balance of payments deficit for some while. A balance of payments deficit by one country implies that the reserves of that country's central bank held at the ECB are falling, and correspondingly the reserves of other countries' central banks are rising. Again there are limits on how long that would be able to continue.

The focus is then on the scale of current account deficit which can be funded through overseas borrowing. The key question which faces a number of euro area countries (Greece, Portugal for example) is: if the economy were to operate at high levels of output and employment what would the resulting current account position be, and would the people of that country be able to collectively borrow from external sources. In other words is there a balance of payments constraint which effectively

precludes anything resembling full employment, even if there were sufficient demand and sufficient productive capacity to support full employment. As is evident from Figure 2 above current account deficits have fallen sharply in most countries which had large deficits in 2008. But those countries have suffered high levels of unemployment and recession, and most, perhaps all, of the reduction in current account deficits is attributable to low levels of domestic output and demand for imports. There has also been some degree of 'internal devaluation' as prices and wages have been pushed down. The

### **The policy bind**

The current account positions of the euroarea member countries continue to be problematic and serve to place major constraints on many of them returning to prosperity. The notion of balance of payments constrained growth indicates that those with low income elasticity for their exports and/or high income elasticity for imports are likely to be constrained to relative low growth. For many countries, moves towards full employment and higher incomes would involve substantial current account deficits which would have to be financed through capital inflows.

The devaluation option is limited in the context of a single currency as it would require lower domestic prices, though it could be aided by inflation in the surplus countries. The effectiveness of any 'internal devaluation' is limited in so far as price elasticities are relatively low (and the Marshall-Lerner conditions barely hold) and/or there is limited productive capacity to meet any increase in export demand.

Within a national currency union, there are fiscal transfers between regions of the currency union. Tax revenues are relatively high in the more prosperous regions and public expenditure relatively high in the less prosperous regions. The fiscal transfers may come about as an effect of a proportional or progressive tax regime whereby tax revenues relative to income remain constant or rise as income rises. The fiscal transfers may come through deliberate policies designed to support expenditure in the less prosperous regions. The fiscal transfers can offset a region's trade deficit, and allow that deficit to continue.

In the context of the euroarea though a member country's ability to devalue in real terms is limited and fiscal transfers are virtually non-existent. The balance of payments position in a number of countries threatens to consign some countries to prolonged periods of unemployment and slow growth. Those countries can only escape those constraints with large scale investment and industrial development. Investment undertaken wisely can provide the capacity to produce exports and thereby ease the balance of payments issues. In a similar vein, industrial policies are required to mould the industrial structure in ways which are conducive to growth and enable the balance of payments constrained growth rate to be raised. The problems of formulating and implementing such policies are substantial and always require funding. Yet if such policies are not implemented the prospects for many euro area countries is indeed bleak.

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