

ECONOMIC GROWTH AND SYMMETRICAL ADJUSTMENT IN EUROPE

A positive sum game rebalancing is vital for the future of the euro area



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INTRODUCTION AND SUMMARY

Only finding a new and stable growth path, Eurozone and Europe will once again be seen as a source of benefits and opportunities, and not just constraints and sacrifices. **Adjustment of huge current imbalances is vital for the relaunching of economic growth in Europe.** Over the first 10 years of the euro Southern Europe has massively lost competitiveness and built up large current account deficits vis-à-vis the North. Current account imbalances derived both from structural microeconomic factors and from the macroeconomic effects of the EMU on creditor and debtor countries. It follows that the adjustment process in the South is affected by economic conditions in the North.

Euro-area rebalancing of current account positions is on-going. But in quantitative and qualitative terms the external adjustment in current account deficits is not yet sufficient to ensure sustainable and sound external debt positions.

The official policy, however, is that this adjustment should be entirely one-sided. Spending must fall in the debtor countries, with no offsetting expansionary policy in the creditors. The present zero-sum-game approaches will be very risky for the stability of the euro area. **The right approach must combine more symmetrical macroeconomic**



fiscal adjustment with microeconomic policy measures aimed at encouraging productivity increases (to narrow price and non-price competitive gaps across member states). In other words, convergence and adjustment will not happen automatically in EMU, but need to be policy driven. Cooperation and policy coordination of some kind are needed to avoid the present 'beggar thy neighbor' situation. New policy priorities are thus required in the Eurozone that put more emphasis on cooperative games in convergence and competitiveness. In the background, however, must remain aware that economic integration as necessary is not sufficient. It takes in parallel political integration, by strengthening the democratic mechanisms.

THE OMT GIVES MORE TIME TO ADJUST

The new monetary measures (Outright Monetary Transactions) announced between July and September last year by the European central bank to buy sovereign bonds on secondary markets for Spain and Italy, have contributed decisively to the recent sharp drop in the spreads of all peripheral countries, notably Spanish and Italian bonds. The Eurozone is thus enjoying a relative period of tranquility. But such intervention measures (so far only announced) should not be considered, of course, as the solution to the European debt crisis. They serve to provide liquidity to the system and thus give more time to the European policy makers in order to launch a credible policy plan, somehow innovative, to solve the crisis. Such a plan should include three fundamental ingredients: a European Banking Union based on a unified banking supervisory system led by the European Central Bank, a deposit guarantee scheme and a banking crisis resolution mechanism. Second a medium long-term strategy is needed to guarantee the sustainability of sovereign debts, in terms of sharing the risks of these debts within the euro countries group, to lower funding costs significantly. Finally, as already pointed out, you have to get to a much more effective coordination of macroeconomic policies based on much more symmetric adjustment mechanisms at the European level, which makes it conducive to sustained growth of the entire Euro area. Without a quick return to growth, the main problems of the Eurozone – sovereign debts - will likely become even more unsustainable.

A CRISIS OF IMBALANCES AND PRIVATE DEBT ACCUMULATION

More than just a fiscal crisis, the situation in Europe is more a crisis of unsustainable private debt accumulation linked to large and persistent imbalances in the euro area.

Removing exchange rate risk with the introduction of the euro encouraged massive capital flows to and as a consequence large current account deficits in the

Southern European nations— Greece, Italy, Portugal and Spain. Nordic countries run spectacular current account surpluses, notably Germany (6 percent of GDP in 2011). External divergence also took the form of steadily widening and different competitive positions of the two groups of countries.

For many years, however, very little attention was paid to these imbalances by national authorities and European institutions, even more so because the banks of the core countries (Germany and France) heavily financed the excess demand in the peripheral countries, thus promoting the accumulation of large macroeconomic imbalances within the Eurozone. The global financial crisis in 2008-2009, however, has put an end to this easy financing and has revealed many weaknesses in the Euro architecture. Private funding of imbalances dried up and the system of euro area central banks has had to replace the banking sector as a key source of funding of current account imbalances and private capital movements. This massive intervention was to a certain extent successful, but the cost was the dramatic increase of budget deficits and sovereign debts in deficit countries. In the years after the crisis highly indebted European countries with large external deficits experienced the highest sovereign bond yield spreads. Current imbalances were placed at the heart of eurozone crisis. As a result, the euro system has become exposed to the risk of sovereign and bank defaults. In this perspective high public deficits and debts are much more an effect than a cause of the eurozone crisis.

The present zero-sum-game approach

The huge challenge now is to make managing the crisis compatible with the adjustment of these external imbalances. Current account imbalances derived both from structural microeconomic factors (the Germany's successful production restructuring) and from the macroeconomic effects of the EMU on creditor and debtor countries. It follows that the adjustment process in the South is affected by economic conditions in the North. And this adjustment is vital for the future of the euro.

Euro-area rebalancing of current account positions is on-going. But firstly in quantitative terms the external adjustment in current account deficits is not yet sufficient to ensure sustainable and sound external debt positions. A majority of Member States have (negative) net international investment positions beyond the indicative threshold. Secondly the process has so far mainly been the result of adjustment in the deficit - vulnerable economies. Deficit countries have experienced an expansion of exports thanks to gains in competitiveness and a reallocation of resources towards export-oriented industries but particularly a strong compression of domestic demand and imports, while while developments in the Member States with large current account surplus has so far contributed marginally to the rebalancing of the euro area.



This does fit into the official policy approach, however, that spending must fall in the debtor countries, with no offsetting expansionary policy in the creditors. But if most Eurozone country governments cut spending at the same time, the deflationary effect on GDP is further magnified. As a consequence, growth has suffered and recession has hit all peripheral countries. But the present zero-sum-game approaches will be very risky for the stability of the euro area.

More symmetrical macroeconomic adjustment

The right approach must combine more symmetrical macroeconomic fiscal adjustment with microeconomic policy measures aimed at encouraging productivity increases (to narrow price and non-price competitive gaps across member states). It is very well known that to address intra-area imbalances requires two things. First, it requires a real depreciation on the part of the debtors and a real appreciation on the part of the creditors—that is, wages and prices in the deficit countries must fall relative to those in Germany. Second, as already pointed out, it requires a redistribution of spending, with the debtors spending less, while the creditors spend more.

As to the first adjustment, the competitive gap and the excess of private and sovereign debts requires, first of all, fiscal adjustments (austerity) and structural reforms in the highly indebted peripheral countries. There is no doubt that southern European countries would be well advised to take supply-side and microeconomic reforms more seriously than they did in the past. If they did, their productivity and living standards would rise over the medium to longer run. But given the very low growth and inflation of the Eurozone at the aggregate level, it is very risky that real exchange-rate adjustment will take place mainly through deflation in the deficit countries, which is both very difficult and has the effect of raising their debt burden relative to GDP. Excessive fiscal adjustment and deflation can thus ultimately be self-defeating and make the reforms to improve the southern European countries' competitiveness impossible to implement.

To be carried out and effective, these adjustment processes in the periphery need enough time and adequate macroeconomic context at the European level. That's why the second adjustment mechanism (symmetric burdens of adjustment) is crucial as well. Countries with current imbalances will have to demonstrate how they intend to close them, with the onus being as much on those running trade surpluses as on those with deficits. It is true that no successful rebalancing can take place without a sustained implementation of budgetary adjustments and structural reforms at peripheral country level. It is also evident that the euro area as a whole should contribute, too.

How to achieve a positive-sum-game policy approach

It follows that a smooth adjustment of intra-euro area macroeconomic imbalances requires a positive-sum-game policy approach in Europe. Policy coordination of some kind is needed. In other words, convergence and adjustment do not happen automatically in EMU, but need to be policy driven. New policy and governance priorities are thus required in the Eurozone that put more emphasis on cooperative games in convergence and competitiveness.

The new European economic governance devotes insufficient attention to policies capable of favoring these economic adjustments. The emerging framework remains weak in parts and incomplete in others. In this regard, neither the Commission nor the European Council, with their expanded jurisdiction and strengthened mandate, were able to put in place procedures and policy instruments that work. They are not details, but key elements that can affect the ability to cope with the current crisis, on the one hand, and to offer throughout Europe and the euro area a stable future growth path, on the other.

Central to the new mandate must be a new fiscal regime based on a symmetric imbalances procedure as outlined above. Big trade surpluses will thus remain a powerful drag on economic activity in the Eurozone and put a big obstacle in the way of the needed adjustments between member states.

In the background, however, must remain aware that economic integration as necessary is not sufficient. It takes in parallel political integration, by strengthening the democratic mechanisms . How to get there is to be determined; important, however, to reiterate that this is the ultimate goal to reach for a definite solution of the European debt crisis

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