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EU Policies Addressing Current Account Imbalances in the EMU: An Assessment

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Working Paper, No. 46/2015

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EU policies addressing current account imbalances in the EMU: an assessment

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Abstract:

To handle the sovereign debt crisis in general and macroeconomic imbalances in particular the leading EU institutions (the Troika) adopted two broad approaches: The short-term approach is based on enhancing the Stability and Growth Pact and to imposing fiscal austerity on crisis countries. The medium- to long-term strategy consists of internal devaluation via reducing wage costs. Both approaches were combined with structural adjustment programs in the spirit of the Washington Consensus. The Troika's policy implies an asymmetric adjustment process burdening only crisis countries. This led to the shrinking of demand and output in crisis countries comparable to the Great Depression and brought the European Monetary Union to the edge of deflation. Such policies increase the risk of Japan-style deflation with more than one lost decade.

Key words: current account imbalances, Euro area economic policies, internal devaluation, austerity

Journal of Economic Literature (JEL) classification: E60, E62, F41

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1. Introduction

Within the euro area current account imbalances widened in the years leading up to the Great Recession in 2009 and the sovereign debt crisis in the European Monetary Union (EMU). These developments also had to do with the incomplete institutional architecture of the EMU. As de Grauwe (2013) pointed out, in a monetary union the booms and the busts at the national level are exacerbated because, given the differences in the economic development of individual countries, a single interest rate for the currency union leads to a comparatively stronger boom in the booming countries and a stronger recession in crisis countries. In the EMU therefore, the common monetary policy meant that the boom in high-growth and high-inflation countries of Southern Europe and Ireland was amplified by relatively low real interest rates. Insufficiently regulated financial markets and low real interest rates stimulated unsustainable real estate bubbles in some of the countries. The boost of domestic demand in booming countries pushed up both prices and wages. The combination of relatively high growth and erosion of price competitiveness increased imports and led to rising current account deficits. At the same time, elsewhere in the euro area, low-growth and low-inflation countries for which the real interest rate was relatively high saw a stagnation of domestic demand accompanied by low growth and low wage and price increases. Germany in particular experienced below average growth performance in the EMU and stagnating nominal wages throughout most of the 2000s, meaning that its unit labour costs grew much below the euro area average. Relatively low GDP growth and increasing price competitiveness led to high German current account surpluses which were not kept in check by an appreciation of the domestic currency, as the D-Mark no longer existed. In the EMU both the real interest rate channel and competitiveness channel contributed in widening the gap between these two groups of countries. These developments were symmetrical and were sustained over several decades.

Current account imbalances are only possible when corresponding capital flows exist. Current account deficits could be easily financed by deficit countries as investors in surplus countries obviously expected that, within a monetary union, regional indebtedness would not pose a problem. Capital imports were financed via the EMU money market, direct loans to the enterprise sector or government bonds issued in current account deficit countries. The stock of debt was building up in domestic currency, however the debtor countries' governments had no control over their central bank as governments usually do. There was no lender of last resort for the governments, as for example in the United States, United Kingdom or Japan, in case it was needed.

Before the Great Recession, the build-up of current account imbalances was not considered a problem by the key European institutions and mainstream economists. On the one hand, economists were influenced by the standard neoclassical argument that current account deficits were an element of countries quickly catching-up and financing such deficits would not be a problem. Also adjustments of nominal unit labour costs were seen as a more or less smoothly working market process to correct imbalances within a monetary union. On the other hand, European institutions seem not to have understood that the EMU is a monetary union without sufficient institutional integration and therefore not comparable to a nation-state with a national currency. In the case of the EMU, the absence of the central bank's explicit commitment that it will function also as a lender of last resort for the governments undermined the credibility in the liquidity and solvency of individual nation-states within the EMU. This made the deficit countries vulnerable to sudden stops of capital inflows and panic in financial markets. In the EMU, private capital inflows to crisis countries stopped when the sovereign debt crisis broke out starting in Greece in early 2010. Official capital flows substituted private flows, in particular via the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM). In addition, TARGET2 (the Trans-European Automated Real-time Gross settlement Express Transfer System 2) played an important role. TARGET2 financing basically means that the European System of Central Banks (ESCB) refinances financial systems in crisis countries to enable them to fulfil all obligations vis-à-vis other regions in the EMU. In substance the ESCB financed current account imbalances and capital flight out of crisis countries without limit (Herr 2014).

This paper has the purpose to discuss how the EU handled the deep crisis of the EMU when, in 2010, spreads of deficit countries' 10-year government bonds relative to Germany's 'safe' 10-year bond exploded and even the promises of high yields did not stop the outflow of private capital or allowed the financing of public budgets in crisis countries. The panic in financial markets led to panic in political circles, especially at the European level. Policies to help the crisis countries, to overcome the crisis and prevent a similar crisis in the future came into the focus of political action and political debate. The EU policy package to solve the sovereign debt crisis, to increase the lost competitiveness of crisis countries, and to stimulate growth, at least in the medium term, consisted of the following:

- Fiscal consolidation with the aim of restoring investors' confidence became paramount and various austerity measures were endorsed by and/or imposed upon debtor-deficit countries. This can be considered a short-term policy, however, with the aim of a long-term balanced public budget.

- Internal devaluation was considered the key point to restore competitiveness. This included nominal wage cuts as a key element. This can be considered a more medium- and long-term policy.

- Structural reforms like liberalisation, privatisation and deregulation should bring back long-term economic growth and are partly included in the two policies mentioned above.

All these policies are based in the heart of neoclassical thinking and very close to what became known as Washington Consensus in the late 1980s (see Williamson 1990 for a summary of these policies). Paul Krugman (1995) called this policy a combination of sound money (restrictive fiscal and monetary policy) and free markets (radical reforms in the spirit that free markets would always be the best solution). The medicine the EMU crisis countries received or, better yet, had to follow, was more or less the same medicine that international institutions used to overcome crises in developing countries. The economic and social costs of these policies were enormous. It is fair to say that these policies pushed some of the EMU countries towards crisis comparable to the Great Depression of the 1930s. And worse, as of the date of this paper (2014), these countries seem to be on a road of long-term low growth or even stagnation producing more than one lost decade. In what follows, we analyse the policies followed by the EU to solve the crisis and explain why the whole policy design was misleading.

Section 2 describes the recent reforms in the EU governance which took shape since the outbreak of the crisis, with a particular focus on the Macroeconomic Imbalance Procedure (MIP). Policies of fiscal austerity as a short-term strategy (Section 3) and policies to enforce internal devaluation and structural reforms (Section 4) follow. Here the costs of such methods in dealing with the EMU crisis are also discussed; Greece, Spain, and Ireland are given special attention. The role of the ESCB in correcting the imbalances is mentioned in Section 5, before concluding.

2. Recent reforms in the EU governance

Overview of new governance institutions

The official aim of the new European economic governance, developed through various new regulations since the outbreak of the sovereign debt crisis, is to achieve a stronger and more binding coordination of economic policies among member states and prevent a similar crisis in the future. In 2010, with the adoption of ‘Europe 2020’¹ strategy, a yearly cycle of European economic policy

¹ Detailed description can be found under http://ec.europa.eu/europe2020/index_en.htm.

coordination was established – the so-called ‘European Semester’². More concretely, legislative reforms consist of the so-called ‘Six-Pack’ which refers to all EU Member States, and the ‘Two-Pack’ which is binding for the euro zone countries only. The ‘Fiscal Compact’, on the other hand, is not a European law, but is agreed upon by 26 Member States.

The *Six-Pack*, a nickname for 5 regulations and 1 directive concluded in November 2011, was designed to provide for tighter discipline on public finances. It basically recasts the rules of the Stability and Growth Pact, with the aim of making it more binding for Member States. Two of the 5 regulations deal specifically with macroeconomic imbalances, namely the Macroeconomic Imbalances Procedure and the Excessive Imbalance Procedure. These two are discussed more in detail below. The remaining 3 regulations consist of a so-called preventive arm, namely the ‘binding medium-term budgetary objectives’ and an ‘expenditure benchmark’, and a corrective arm which consists of the ‘Excessive Deficit Procedure’ (EDP) which entails financial sanctions of up to 0.2% of GDP in case of non-compliance. Finally, the directive specifies the accounting and other rules for the Member States for setting medium-term budgetary frameworks.

The *Two-Pack*, concluded in May 2013, refers to the euro area only and sets the stage for a regular close oversight of the public finances of each Member State. The issue of Reversed Qualified Majority Voting means that if a sanction is proposed for a non-compliant country, it will take a majority vote by other Member States to overturn the proposal. Basically, it becomes harder to disagree with the Commission’s decisions.

The *Fiscal Compact* is incorporated in the Treaty on Stability, Coordination and Governance. 26 member countries signed (UK and Czech Republic refused) and committed themselves to a lower limit for a structural deficit of 0.5% of GDP. The Fiscal Compact is essentially a restatement of the Stability and Growth Pact and the Six-Pack.

Amidst these, an open-initiative *Euro Plus Pact* was advocated by Germany and France in February/March 2011. Also known as the “Competitiveness Pact”, it refers to wages explicitly as the key adjustment variable in order to deal with imbalances and increase competitiveness.

Macroeconomic Imbalance Procedure (MIP)

The implementation of the Macroeconomic Imbalance Procedure (MIP)³ is embedded in the European Semester via the ‘Six Pack’ and should form a coherent framework with other economic

² The European Semester was established with the primary aim of coordinating economic policies across the EU. It is a yearly economic governance cycle where the European Commission works with individual member states attempting to align policies so to achieve the Europe 2020 targets. The EU recommendations issued on a yearly basis should then be translated by the member states into national “reform programmes”

³ MIP was adopted in 2011 with the EU Regulation No 1176/2011 on the prevention and corrections of macroeconomic imbalances and EU Regulation No 1174/2011 on enforcement measures to correct excessive macroeconomic imbalances

surveillance tools (EC 2013a). According to the official EU documents the external and internal imbalances of the EU economies – primarily abundant credit expansion and excessive debt accumulation, large and persistent current account deficits and surpluses, and losses in competitiveness – were significant contributors to the recent crisis.⁴ Before discussing more in detail the MIP, a definition of what constitutes an imbalance – as seen by the official institutions – should be given:

“ ‘imbalances’ means any trend giving rise to macroeconomic developments which are adversely affecting, or have the potential adversely to affect, the proper functioning of the economy of a Member State or of the economic and monetary union, or of the Union as a whole.” – Regulation (EU) No 1176/2011, p. 28.

And furthermore:

“ ‘excessive imbalances’ means severe imbalances, including imbalances that jeopardise or risks jeopardising the proper functioning of the economic and monetary union.” (ibid)

In theory, any deviation from a desirable level can constitute an imbalance. In practice, those imbalances that raise concerns are the ones reflecting unsustainable dynamics such as a real estate boom, or are at very high levels (high debts) or there is a threat of ‘sudden stops’ (EC 2013b).

In the framework of the MIP, the European Commission publishes annually the Alert Mechanism Report (AMR) the scope of which is to identify those member countries with possible macro-economic imbalances and recommend them for further analysis.⁵ Further analysis is made in the so-called “In-Depth Reviews” (IDRs) and here the Commission determines whether imbalances exist.

To assess whether or not a country should be subjected to an IDR, the AMR relies on an indicator-based scoreboard. Threshold values are assigned to each of the indicators and serve as alert levels, thus any breach of threshold values becomes the first indication of concern. The indicators are chosen so that both external and internal imbalances can be monitored. The MIP scoreboard initially comprised 10 indicators, but in late 2012 an indicator detecting vulnerabilities of the financial sector⁶ was added.⁷ The indicators refer either to external imbalances and competitiveness (current account balance, net international investment position, real effective exchange rate, export market share, and

in the euro area.

⁴ See for instance EC (2013a) and EC (2014).

⁵ The AMR is not made for the countries that at the time receive official financial assistance, as their situation is already examined under respective economic adjustment programmes (EC 2013b).

⁶ There was some criticism raised (Bobeva 2013) regarding the financial sector vulnerability indicator, which can apparently “penalize” the catching-up of financial markets such as those of the new EU members.

⁷ As of 2013, the AMR is complemented with a set of auxiliary social indicators (for instance, rate of people at poverty risk) that are used for better interpretation of the scoreboard results (EC 2013b).

nominal unit labour cost developments), or to internal imbalances (changes in house prices, private sector debt and credit flows, general government gross debt, unemployment rate, and financial sector liabilities). It stands out from the first indicator already – the 3 year backward moving average of the current account balance as a percentage of GDP – that the European institutions are more concerned with current account deficits than with surpluses: the threshold for current account surpluses is 6 per cent of GDP, while for deficits it is 4 per cent of GDP. It is visible here that Keynes's (1942) ideas of a symmetric adjustment process of current account imbalances as expressed in his recommendation for the Bretton Woods System are not being followed.

The indicator for unit labour cost developments, furthermore, has an upper limit only; as it appears, there is no lower bound for excessively low wage increases or even drops in wages that could be considered alarming. This means, in other words, that no mechanism is put in place to prevent wage dumping strategies of countries or an eventual deflationary spiral.

Once a country is suggested for an IDR, the European Commission undertakes a country-specific analysis and ultimately assesses whether macroeconomic imbalances exist, and if they do, whether they are excessive or not (EC 2013b).⁸ The finding that imbalances do exist but are not excessive results in a preventative Country Specific Recommendation (CSR) addressed to the state in question by the European Council. Excessive imbalances, on the other hand, result in a corrective action plan – the Excessive Imbalance Procedure (EIP). In this case the member country needs to draft its plan of action, and its compliance is subsequently monitored by the Council. If the country in question fails to “correct itself” a financial sanction of 0.1 per cent of GDP can be demanded (EP 2013). In practice, no country has yet reached that stage, although – interestingly – most of the EU countries are on the list as experiencing imbalances.

The Alert Mechanism Reports and In-Depth Reviews have thus been published since February 2012, but it was only in November 2013 that the Alert Mechanism Report put two surplus countries on the list – Germany and Luxemburg. In the report on Germany published in March 2014, the Commission did underline the need to strengthen domestic demand in Germany and stimulate growth by means other than exports. It suggested a couple of ways to do so: by reducing income tax especially in the low-wage sector, diminish the burden of social contributions, and increase the incentives for working more hours by changing the favourable fiscal conditions of mini-jobs, more business-friendly corporate taxation to stimulate investment, etc. An increase in the German wage level as a policy to support the internal devaluation of other EMU countries was not included in the recommendations.

⁸ IDRs are published in the spring of each year and are later integrated into country-specific recommendations under the European Semester (EC 2013b).

Even the moderate recommendations for a more symmetric adjustment process by the Commission led to harsh opposition in Germany. The president of the Deutsche Bundesbank, Jens Weidmann, made his view clear in a speech shortly after the review of Germany was published. Among other things, he stated that “stimulating German demand cannot be a substitute for removing rigidities in the deficit countries” and that Germany’s current account surpluses stem from an interplay of various factors, most importantly “fundamentals” such as demographics and Germany’s stage of development, and are therefore not likely to change any time soon (Weidmann 2014). Given the weight of Germany’s role in defining EU policies, any relevant change of course seems unlikely.

In sum, both the “Six Pack” and the “Two Pack”, as well as the Euro Plus Pact, highlight the overarching concern with fiscal positions and budget consolidation. The problem of macroeconomic imbalances is seen by the European institutions to come about mainly as a result of “downward wage rigidities” (ECB 2012, p.9), which prevent the restoration of competitiveness in current account deficit countries. In addition, the new European system of economic governance introduced mechanisms and tools for intervening into national wage policies and collective bargaining agreements – for the first time in the history of the European Union.⁹ There were basically two approaches endorsed by the EU institutions in dealing with imbalances and crisis and they are expressed in the architecture of the new European economic governance: (i) an immediate enforcement of austerity policies of deficit countries, aimed at reducing government demand and ultimately resulting in shrinking GDP, unemployment and a sharp drop in domestic demand and thereby imports; and (ii) a more long-term adjustment process consisting of an internal devaluation in current account deficit countries combined with (neoclassical) structural reforms. Both approaches imply an asymmetric adjustment process, with the burden of adjustment to be borne by deficit countries.

3. Short-term approach: Fiscal austerity and effects on imbalances

The EU policy of fiscal austerity and internal devaluation has three levels of enforcement. The first one takes the form of recommendations and, to a degree, other subtle ways on applying pressure on countries to conform to EU-specified targets. These country-specific recommendations are not

⁹ Schulten and Müller (2013) point out that the Treaty on the Functioning of the European Union (TFEU) in Article 153.5 states explicitly that the EU will have no competences in the area of national wage policies. Although the topic of wage policy did become part of the discussion at the EU level – notably in the Macroeconomic Dialogue where it was considered jointly by the Council, the Commission, the ECB, and the European employers’ and trade union organisations – never until now has had any legally binding power for nation-states.

legally binding, but with the introduction of the European Semester have definitely gained in importance by strengthening the authority of the EU institutions.

Secondly, the European Central Bank (ECB)'s Outright Monetary Transactions programme (OMT) – concluded in September 2012 following Draghi's promise to "do whatever it takes" (Draghi 2012) – will operate on a *quid pro quo* basis. The ECB will engage in OMTs provided that the countries apply to the European Stability Mechanism (ESM) which would imply further austerity measures.

The most straightforward and legally binding channel, however, affects those countries benefitting from financial assistance from the European Commission, the ECB and/or International Monetary Fund (IMF) building together the so-called Troika. Countries under such programmes are obliged to conform to a set of policies required by the Troika. The conditionalities imposed by the Troika when supporting countries affected by the sovereign debt crisis consist of fiscal, financial, and labour market reforms. The typical demands are: fiscal consolidation; current expenditure reduction; cuts in unemployment benefits and family allowances; a decrease in health spending and public investment; privatisation of the transport, energy, communication and insurance sectors; a push for firm-based wage negotiations (and sectoral negotiations); reducing the role of legal extension mechanisms of wage bargaining; no increase or cut in statutory minimum wages, relay dismissal protection, etc. as well as a general reduction of state participation in industries; reforms of the public administration and reductions in public employment; increases in personal income tax and so on (Hermann 2013; Vaughan-Whitehead 2014).

Greece, Ireland and Portugal were the most affected countries by these policies because they needed help from the Troika. In these countries the GDP sharply contracted; in fact, the stricter the austerity measures implemented, the greater the contraction of GDP (see Figure 1a). Figure 1b furthermore shows that, if the aim of cutting public expenditures was to improve the debt-to-GDP ratios, the strategy did not work. Budget deficits in spite of strict austerity measures did not improve as hoped (see Figure 2). In Greece in fact, budget deficits as percentage of GDP increased again after 2012. Even worse, debt-to-GDP ratios strongly increased in the countries that endorsed austerity policies (see Figure 3).

Figure 1a: Austerity and GDP growth 2011-2012

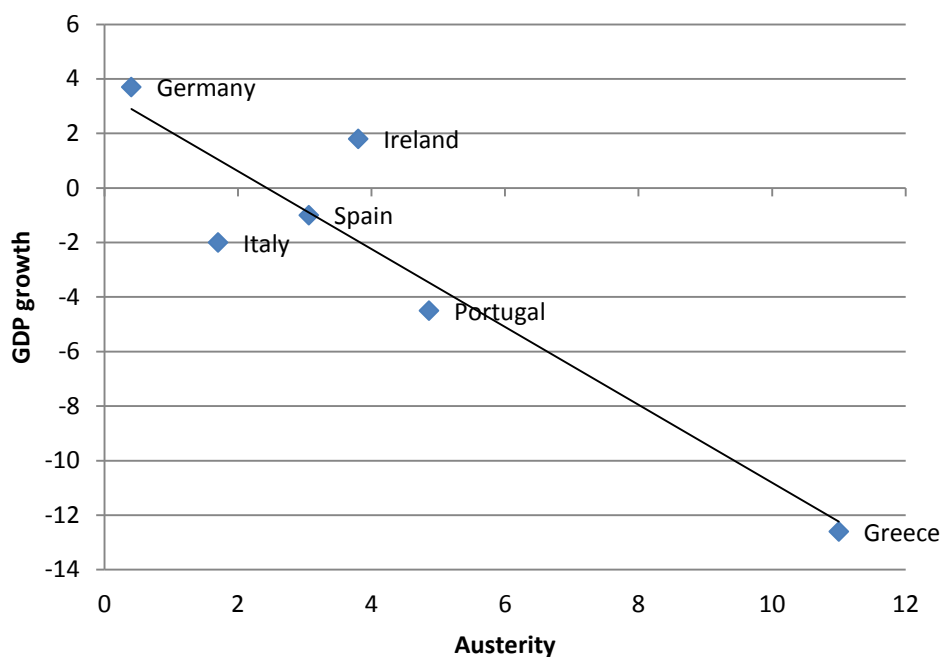
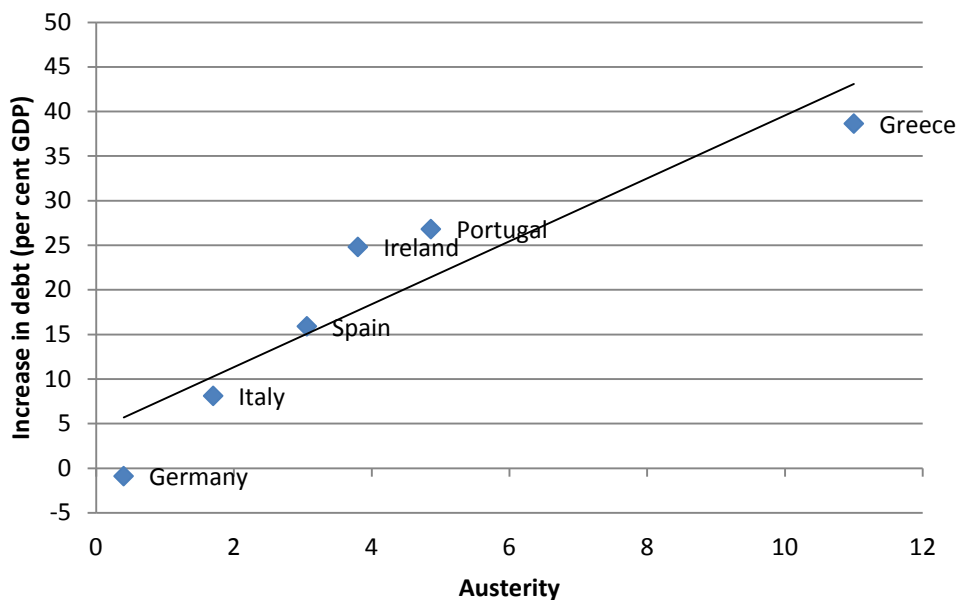


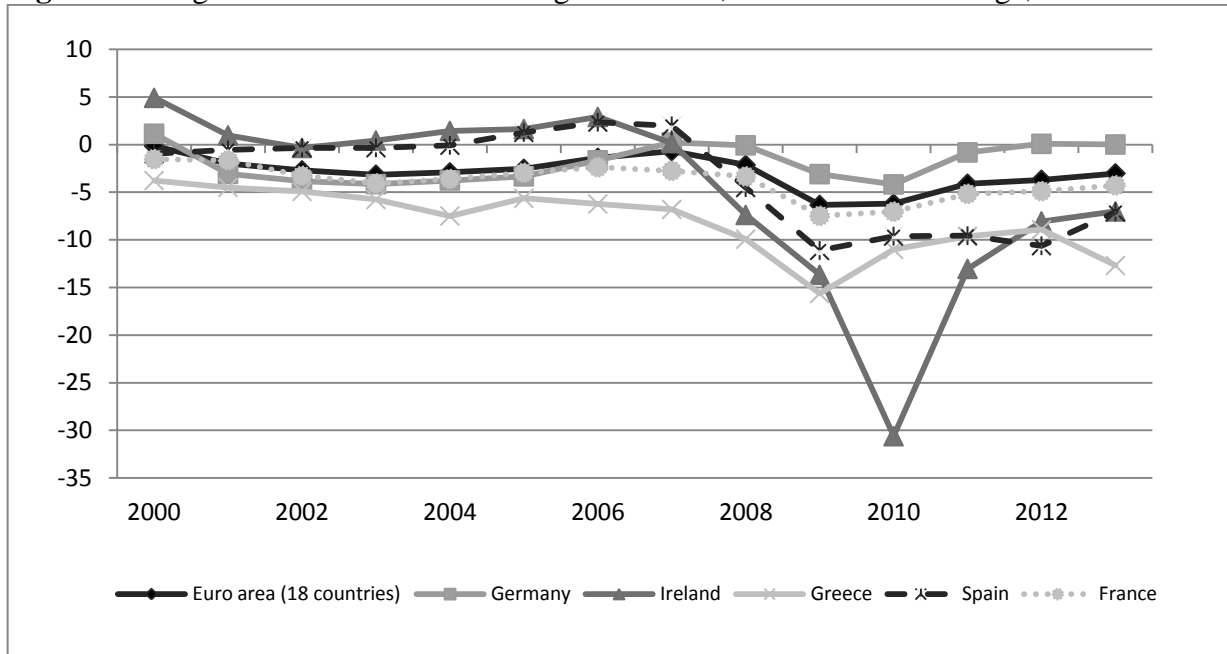
Figure 1b: Austerity and increases in debt-to-GDP ratios



Source: de Grauwe and Yuemei (2013), data from Financial Times and Datastream.

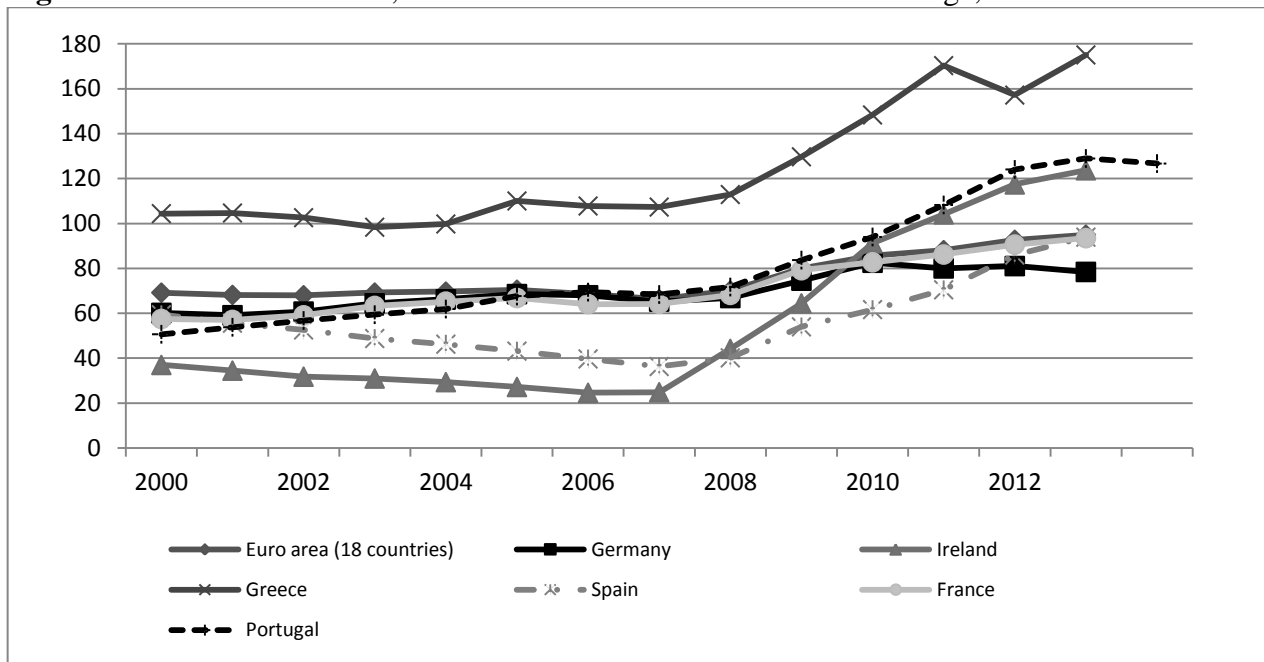
Note: Austerity stands for the intensity of austerity measures implemented in 2011 and is expressed in percent of per capita GDP. In Figure 1b, the Greek debt ratio excludes the debt restructuring of end 2011 that amounted to about 30% of GDP.

Figure 2: Budget balances of selected EU governments, incl. euro area average, 2000-2013



Data: AMECO (2014)

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



Data: AMECO (2014)

Of course, this should hardly come as a surprise. Basic Keynesian economics teaches us that a further reduction of spending in times of crisis can result only in a deeper recession, due to a negative goods market multiplier. With the shrinking of domestic demand, investment drops even

more because decreasing capacity utilization is poison for investment.¹⁰ Unemployment reaches ever-higher levels and, amidst depressed aggregate demand, government receives less tax revenues but is at the same time confronted with increasing social contribution expenditures, which it attempts to cut further. A downward spiral is the result. This is a very straightforward description of the failure of the austerity strategy.

One explanation for this completely dysfunctional restrictive fiscal policy in a constellation of current account deficits, collapsing investment demand and shrinking consumption demand can be the belief in neoclassical arguments such as, for example, the argument of “crowding in” of fiscal contraction or that structural reform spontaneously triggers growth processes. Another plausible explanation is that the panic in financial markets in 2010, following the “sudden stop” of capital inflows into crisis-hit countries and exploding interest rate spreads, also led politicians to panic and either themselves opt for, or immediately agree to, austerity measures. Thus, pressure from financial markets when the central bank could not or would not act as lender of last resort for the governments made fiscal policies pro-cyclical and ultimately turned a liquidity crisis into a solvency crisis and then a deep recession (de Grauwe 2013). Another explanation is that politicians, especially in the surplus countries, saw their chance to enforce neoliberal reforms in Europe which before could not be realized.

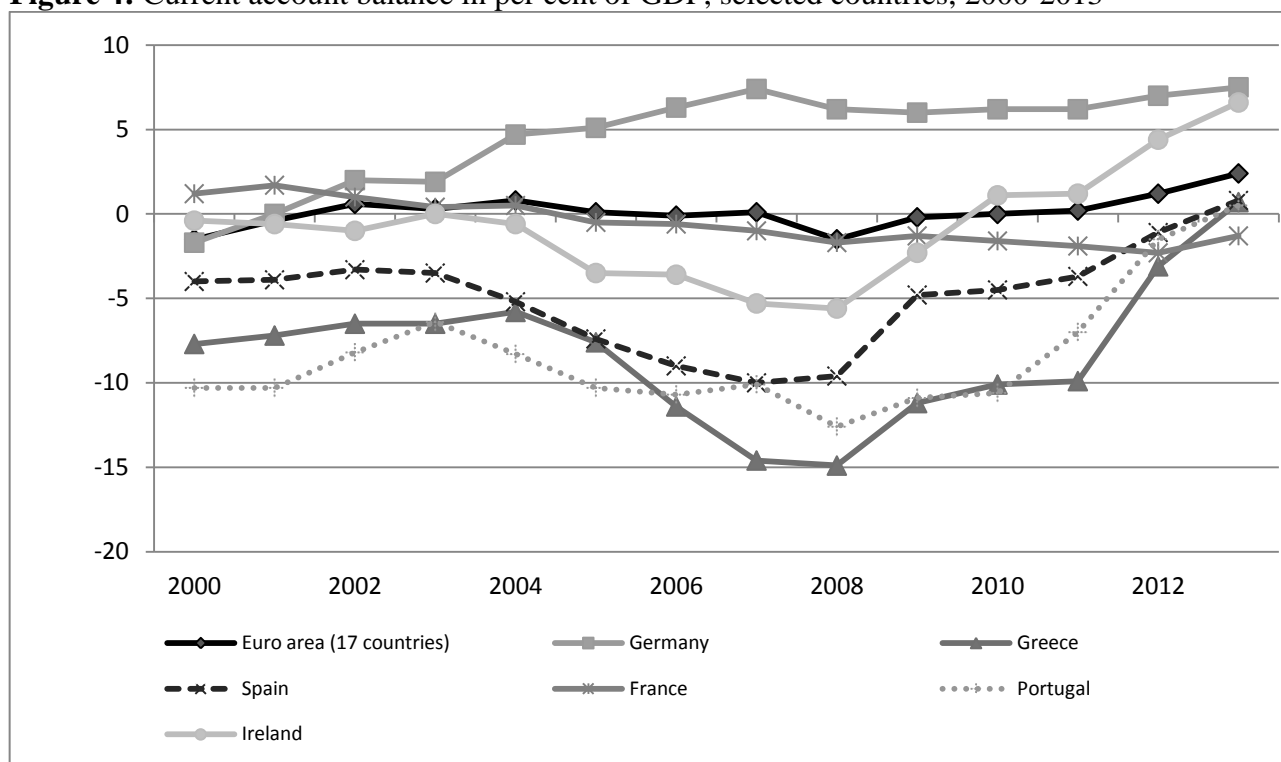
4. Medium- to long-term approach: Internal devaluation and effects on imbalances

Policies to cut wages

The backbone of the more long-term adjustment process was the enforcement of an internal devaluation in crisis countries. Indeed, current account deficits in the later crisis countries increased sharply until 2007 whereas Germany realised one record in its export surpluses after the other (see Figure 4). As a devaluation of the exchange rate is not possible in a monetary union, the increase of price competitiveness according to the Troika should take place via a reduction of nominal costs, especially nominal wages.

¹⁰ What we have here is a negative accelerator which is much more likely than a positive accelerator.

Figure 4: Current account balance in per cent of GDP, selected countries, 2000-2013



Source: Eurostat (2014)

The EU institutions used three main arguments to legitimise their interventions in wage policies. The first one has to do with the debt crisis and the need for substantial cuts in public expenditures in order to improve governments' fiscal positions. This directly affects wages of public sector workers. In fact, austerity-marked national reform programs all contained demands for wage cuts and/or wage freezes in the public sector. The second argument is, as outlined throughout this paper, the view that macroeconomic imbalances are partly a result of differences in competitiveness among states and thus require correction of unit labour cost developments. Based on a lack of comprehensive thinking about the functioning of a currency union and/or political pressure from surplus countries, changes of relative price competitiveness should only be achieved by nominal cost cuts in deficit countries and not by symmetric adjustments in deficit and surplus countries. The third is a more micro-oriented argument and comes from the neoclassical view that involuntary unemployment is due to institutional rigidities in the labour market, which thus needs to be deregulated and flexibilised (Schulten and Müller 2013).

With these underlying premises, policies enforced by the Troika and forcefully recommended to countries not directly depending on the Troika via the new EU governance institutions selected labour market reforms as one of the key reform areas (Blanchard et al. 2013). Policies consisted of labour market deregulation, direct intervention in wage policy – in particular in the public sector – for instance via cuts or freezes of public sector wages as well as statutory minimum wages. Greece,

Ireland and Portugal which were the recipients of official ‘bail-out’ programmes had to sign so-called ‘Memorandums of Understanding’ with the Troika.¹¹ In all these cases labour market reforms and wage policy recommendations from the Troika were legally binding. In Ireland the minimum wages have been frozen since 2008, as well as in Portugal since 2012. Spain was obliged to commit to extensive reforms in labour market regulation. In Greece minimum wages were cut and there were either cuts or freezes in both the public and the private sector wages. Greece also had to agree to further decentralise collective bargaining and apply stricter rules for the extension of collective agreements. Italy, to give an example from a country not under the dictate of the Troika, was subject to covert¹² pressures to radically decentralise its collective bargaining system (Schulten and Müller 2013; Hermann 2013; ETUI 2014).

As a result of these policies, together with a substantial weakening of trade unions by high unemployment and external political pressure, nominal unit labour costs have seen an asymmetric adjustment. Figure 5 shows that before the Great Recession increases in unit labour costs in current account deficit and later crisis countries like Greece, Spain or Ireland were substantially above EMU average and in countries like Germany unit labour cost increases were below EMU average. As a norm, to realise the EMU inflation target (which is slightly below two per cent) and not to change regional price competitiveness in the EMU, wages should increase according to the inflation target of the ECB plus the regional increase of productivity. Taking this norm, before 2007 wage increases in Germany and in later crisis countries missed the ideal wage norm by largely the same extent (Herr and Horn 2012). After the outbreak of the crisis, unit labour costs in Germany, the most important current account surplus country by far, increased slightly, whereas unit labour costs have fallen sharply in Ireland, Greece and Spain. What we see here is an overall asymmetric adjustment process focusing on wage cuts in crisis countries.

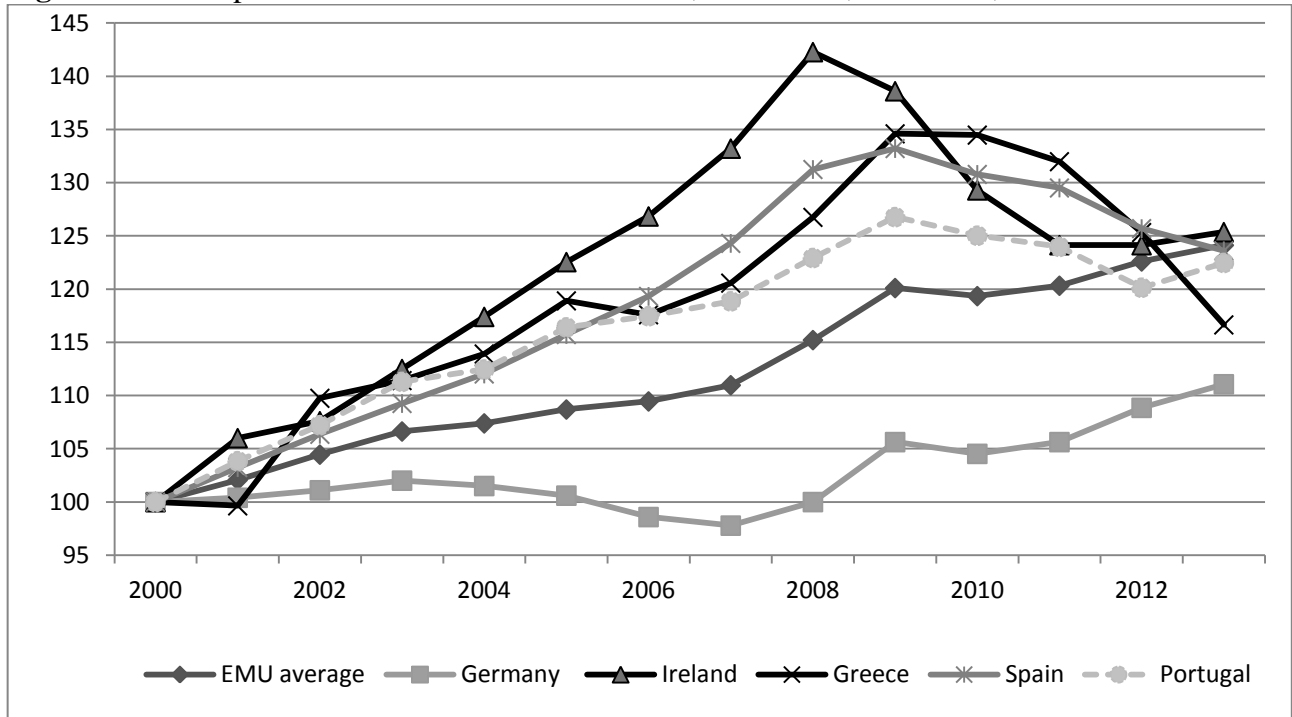
Before the Great Recession, average unit labour costs growth rates in the EMU were close to the wage norm and the ECB more or less achieved its inflation target. After the Great Recession, average unit wages cost increases in the EMU became very low. As unit labour costs are the most important medium-term factor to determine the price level (Keynes 1930; Herr 2009a) it is not a surprise that the EMU experienced very low inflation rates in the years after the outbreak of the sovereign debt crisis. Greece already suffered from deflation in 2013, and Spain and Ireland stand on the edge of deflation (see Figure 6). In 2014 a deflationary development in the whole euro area

¹¹ Hungary, Latvia and Romania were subject to ‘Stand-By Agreements’ with the IMF.

¹² A confidential letter from the ECB to the Italian government was leaked in autumn 2011, containing requests for various far-reaching labour market reforms (Schulten and Müller 2013; see also Dragi and Trichet 2011).

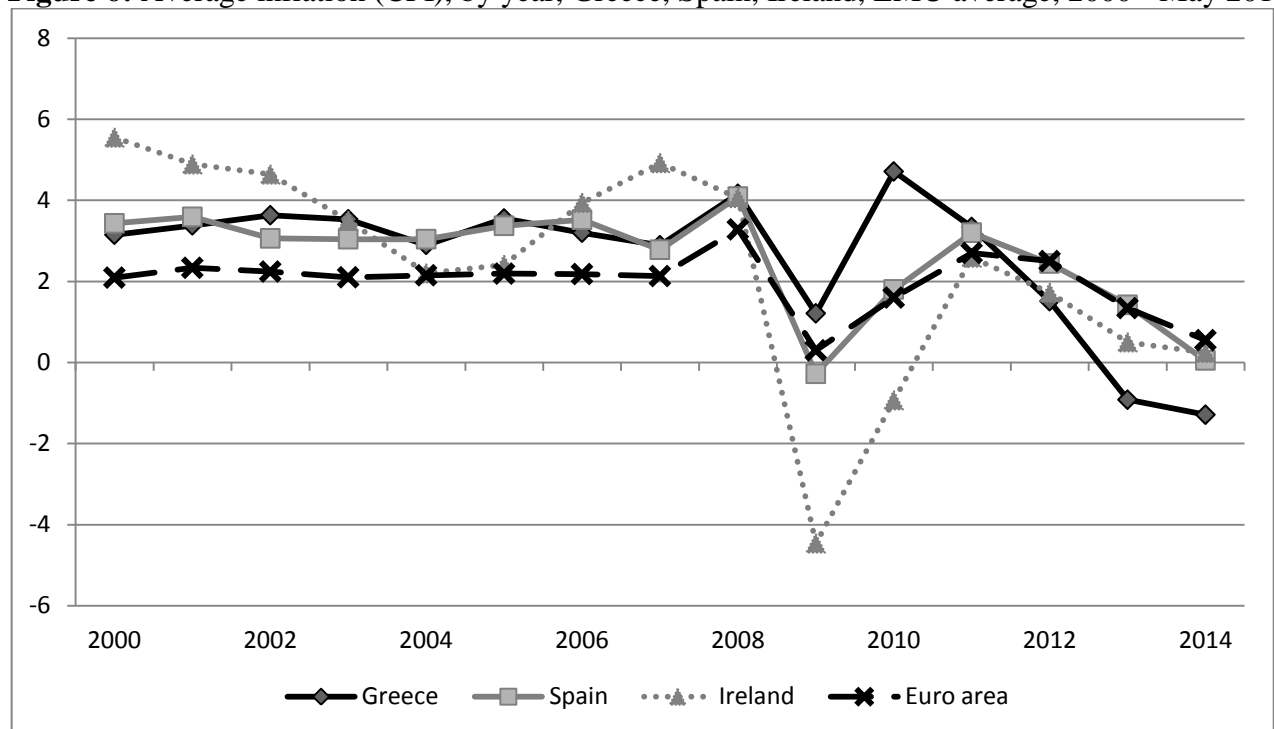
became a real danger. This was also understood by the ECB when it cut its main refinancing rate in September 2014 to 0.05%.

Figure 5: Developments in nominal unit labour costs, 2000-2013, 2000=100, selected countries



Source: EUROSTAT (2014), own calculations

Figure 6: Average inflation (CPI), by year, Greece, Spain, Ireland, EMU average, 2000 - May 2014.



Source: Inflation.eu and EUROSTAT (2014)

Deflation, in combination with high indebtedness, a constellation existing in the EMU, bears the threat of getting out of control.¹³ Deflationary expectations reduce consumption and investment demand. Consumers shift the purchase of durable goods into the future and companies do not want to compete with other companies that buy capital goods for a cheaper price and thus shift the purchase of investment goods into the future, too. Even more importantly, deflation increases the real debt burden. It becomes nearly impossible to successfully restructure financial markets in countries suffering from deflation. The Troika shot itself in the foot when it forced countries like Greece or Spain to do everything to cut wages and create a deflation when, at the same time, this policy led to a further permanent creation of new non-performing loans and the erosion of financial markets, demand and confidence in these countries.

Did internal devaluation work?

Despite the improvement of the current accounts in EMU crisis countries (see Figure 4), these adjustments were one-sided and came at a great cost to the crisis countries, which bore the entire burden. It is worthwhile mentioning that the build-up of imbalances in the pre-crisis period was relatively symmetric in the euro area whereas the rebalancing is not (Ederer 2013, Carrasco and Peinado 2014). The reduction of current account deficits was combined with a substantial reduction of output and employment. The main factor leading to reduced deficits was the shrinking income in the crisis countries, which reduced imports. The fall of output was much larger than what would have been needed to reduce deficits if the adjustment process would have been more symmetric (OFCE, IMK and ECLM 2014).

The downward adjustment of current accounts in surplus countries was minimal. Germany and Netherlands, in fact, have seen their surpluses increase since 2010. Given the developments in (former) current account deficit countries, this means that the euro area as a whole has become a surplus region. Germany and other surplus countries managed to shift from shrinking exports to EMU crisis countries to the rest of the world. Germany, for example, was extremely successful to export cars and machinery to the rest of the world and in this way stabilised domestic output and employment. The high surpluses of Germany and other surplus countries with the rest of the world were a double-edged sword for the deficit countries. On the one hand, the surpluses added to the relative strength of the euro vis-à-vis other currencies. This undermined the efforts of the EMU's deficit countries to increase their price competitiveness as their position relative to non-euro area markets has weakened. On the other hand the relatively good economic performance in Germany

¹³ See the seminal paper by Fisher (1933) explaining the Great Recession, and see also Dodig and Herr (2014).

increase imports from the crisis countries. However, a domestically based economic growth stimulus in surplus countries as part of a symmetric adjustment process of current account imbalances would have been much less harmful for the deficit countries.

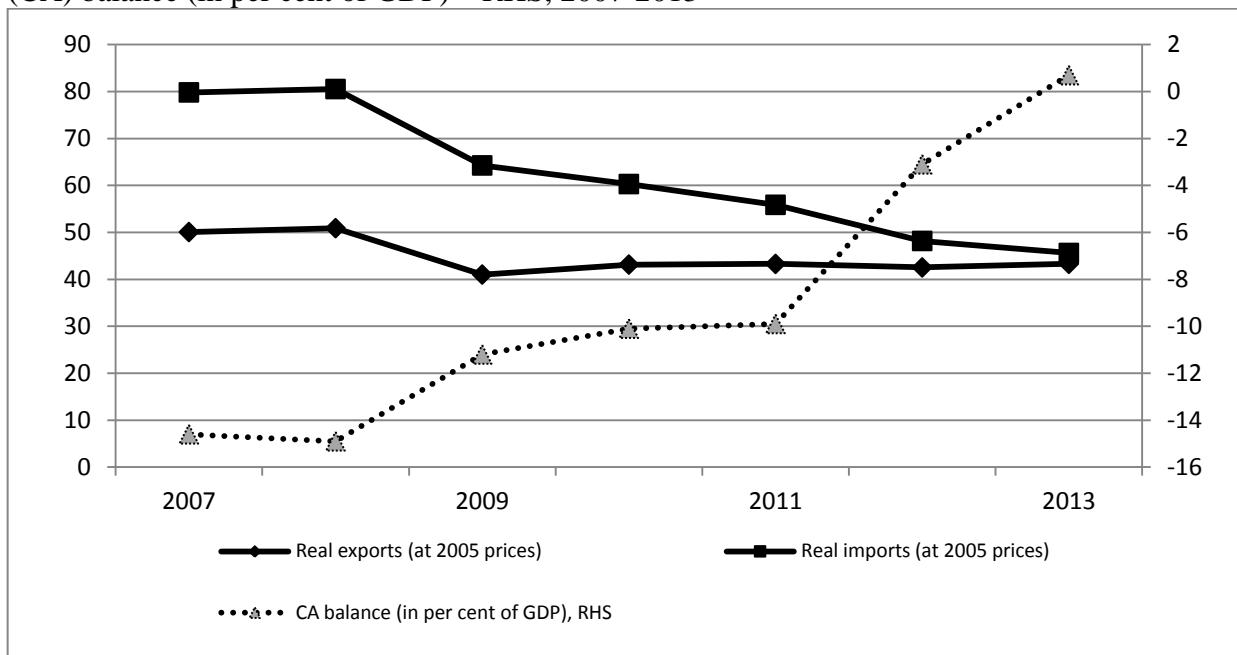
Cutting costs and prices will improve price competitiveness. However, price elasticities of imports and export may be low in a number of crisis countries. This means that even if the Marshall-Lerner condition holds, big changes in real exchange rates may be needed to improve the current account as a result of increasing price competitiveness.

We take a closer look at the developments in Greece, Spain and Ireland since the Great Recession to find out whether increased price competitiveness or the shrinking of GDP caused the reductions of current account deficits.

As can be seen in Figure 7, Greece is, unfortunately, a very good example of the negative economic effects of austerity and the difficulties of internal devaluation. Despite wage cuts and other labour market reforms, Greek exports actually declined in real terms by 14 per cent between 2007 and 2013. The major current account adjustment came from a sharp drop in imports. Real imports almost halved in Greece in the 2007-2013 period. Thus, in the Greek case, it seems safe to conclude that the fiscal austerity and a related dramatic drop in domestic demand were the major contributors in bringing the Greek current account slightly over zero in 2013. Furthermore, the Greek example highlights the difficulties of internal devaluation. Price elasticities may be so low that extreme nominal wage cuts, losses of terms of trade and a reduction of the domestic living standard is needed to such an extent that the process is socially and politically difficult to imagine in a monetary union. In extreme cases, the Marshall-Lerner condition might not be fulfilled and a real depreciation increases the current account deficit. As we will see also in the two other cases, imports are relatively easy to crush. Bringing a country into a recession with austerity policies will surely result in shrinking imports. An increase in competitiveness is much more difficult to achieve.

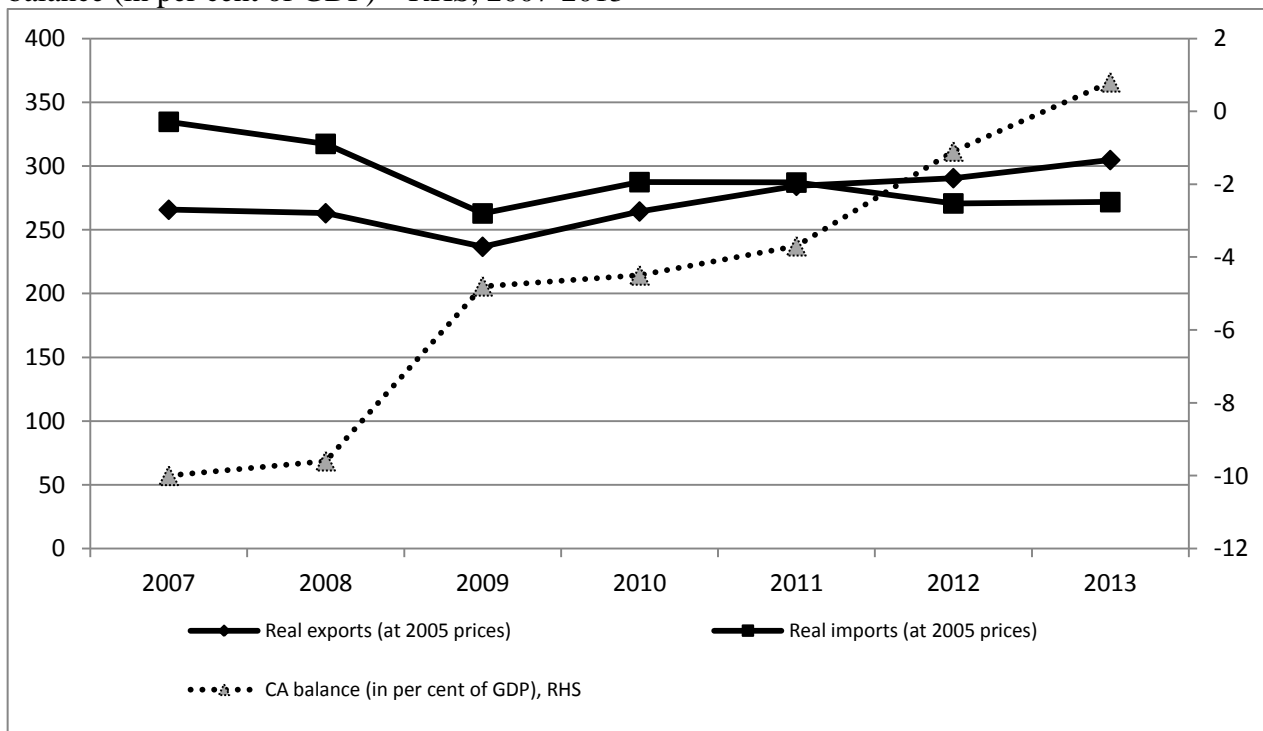
Between 2007-2013 real exports increased in Spain by almost 15 per cent, however real imports shrank by about 19 per cent at the same period (Figure 8). Both developments brought the Spanish current account into surplus in 2013. But, even in this case, it is visible that policies depressing Spanish aggregate demand had a much larger effect than those aimed at increasing competitiveness. It should also be pointed out that, despite an impressive export performance by Spain, it still – as do the other EMU countries – lags behind Germany. German real exports between 2007 and 2013 increased by close to 16 per cent (AMECO 2014).

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



Source: AMECO (2014)

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

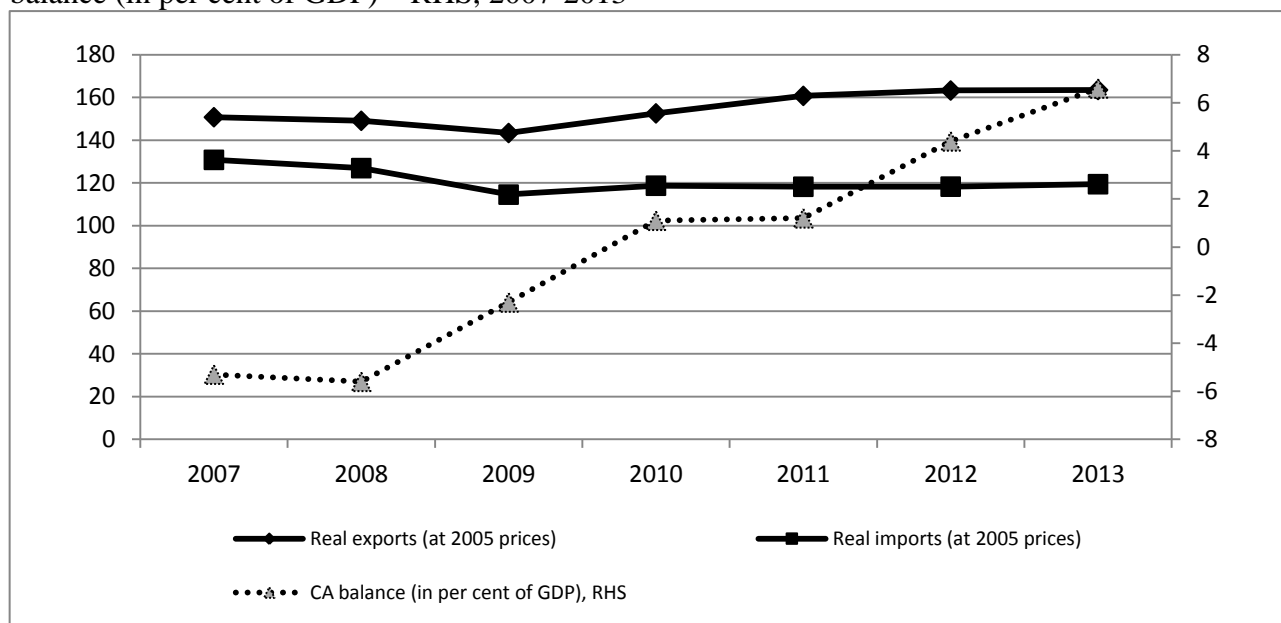


Source: AMECO (2014)

Looking at the situation in Ireland (Figure 9), we can see the improvement in exports in real terms by about 9 per cent in the 2007-2013 period. Real imports declined by approximately the same

percentage. This was enough for Ireland to bring its current account to a surplus of 6.6 per cent of its GDP in 2013, and earn praise by EU institutions. But to estimate which country, if any, deserves praise, one needs to look deeper into the economic development of these countries.

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



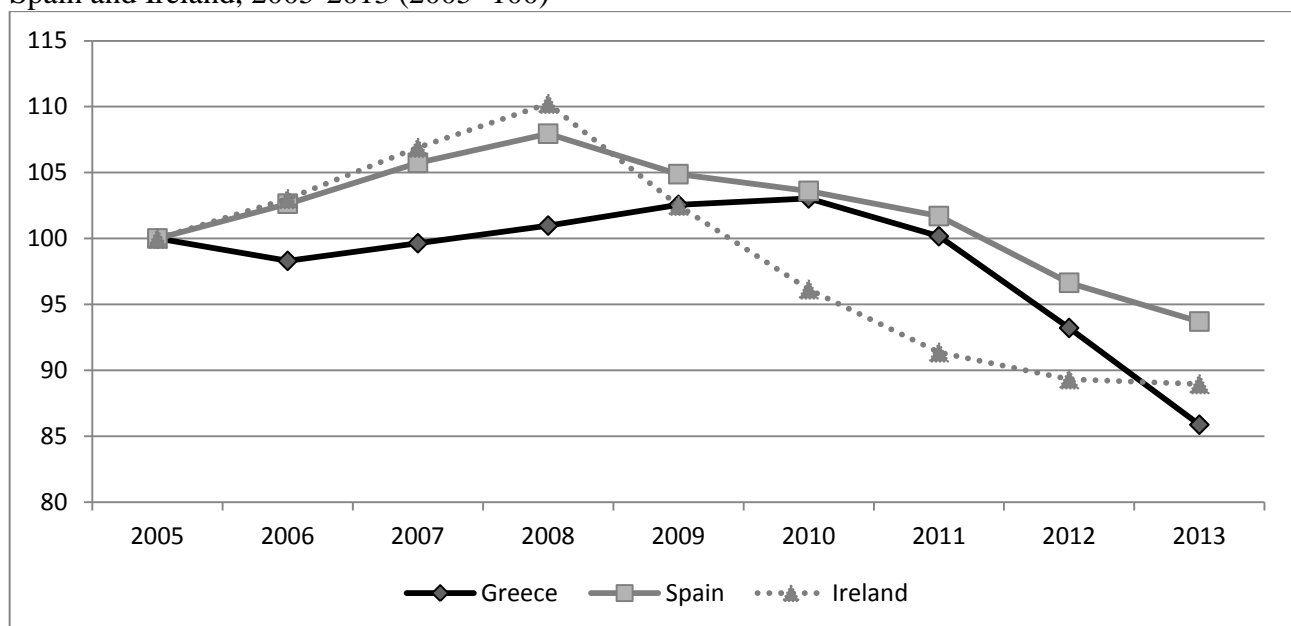
Source: AMECO (2014)

Two related developments are interesting. Firstly, prices of export goods in crisis countries increased in recent years much more than import prices. In Greece, export prices increased by 15 per cent from 2007 to 2013, in Ireland, Spain and Portugal by 7-8 per cent in the same period. Germany saw a roughly 4 per cent increase in export prices in the same period, thereby gaining relatively in competitiveness with respect to the three countries (OFCE, IMK and ECLM 2014). In the face of declining unit labour costs in those countries, this means that firms at least in the export sector did not cut prices according to cuts in wage costs. Such developments also mean that it is likely to see an increase in the share of profits in value-added in these countries (see OFCE, IMK and ECLM 2014). There are several possible explanations for this development. The most plausible seems to be that due to competition, profits of the export sector in these countries had been squeezed during the period before 2007 when wage costs in these countries increased substantially and that firms opted to regain their profitability. In addition it may need some time until the process of competition brings prices down when costs decrease. An upward turning wage-price spiral may be faster than a downward turning one.

Secondly, Figure 10 shows the real effective exchange rate deflated with nominal unit labour costs of the three countries under discussion. It can be seen that in all three countries there has been a

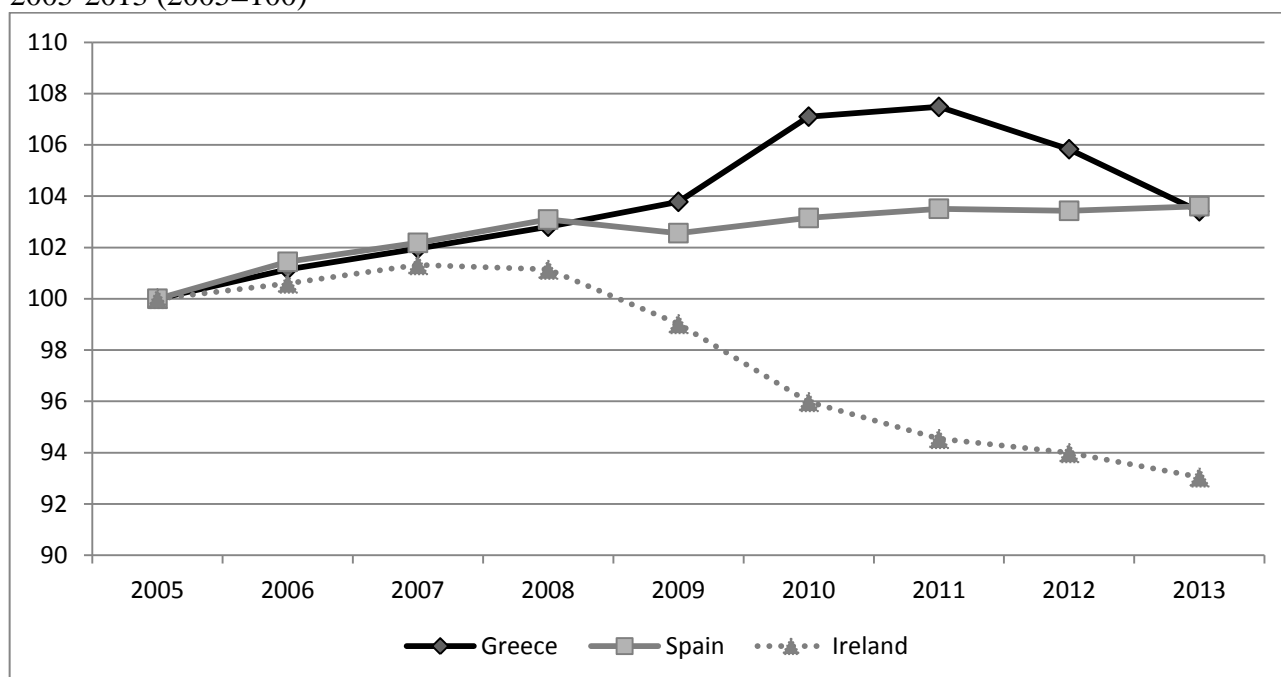
substantial depreciation of the real effective exchange rate reflecting the development of unit labour costs in these countries. Looking at the real effective exchange rate deflated with the (consumer) price index (see Figure 11) it becomes clear that Greece and Spain did not gain much price competitiveness because prices did not decrease much. The situation is different in Ireland which increased its price competitiveness substantially. Figure 11 also explains why Ireland quickly reduced current account deficits and achieved current account surpluses. This analysis supports the argument that for many countries it is an illusion to reach international price competitiveness with moderate wage cuts.

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



Source: EUROSTAT (2014)

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



Source: EUROSTAT (2014)

5. The role of the ECB

The central bank is the only institution that can, by stepping into the role of a comprehensive lender of last resort, prevent a panic in sovereign bond markets. It also can curb the power of financial markets, including rating agencies, to threaten whole countries. Central banks can buy government bonds infinitely. In a crisis with deflationary tendencies, such a policy does not prevent a central bank from fighting against inflation because the potential danger of high inflation does not exist. The ECB did not take over the function of a lender of last resort for the governments early enough (De Grauwe 2011). It acted only in a phase of great instability of capital markets in the EMU. The ECB's purchase of government bonds from crisis countries began in 2011 via the *Securities Markets Program*. However, bonds were purchased on secondary markets only and it was announced that this would be limited in volume and in time. It was essentially a half-hearted attempt by the ECB to solve the sovereign debt crisis (Herr 2014).

Things changed in July 2012, when it became clear that there would be no quick economic recovery in the EMU. At the same time the instability of EMU capital markets exploded again, shown in increasing interest rate spreads for government bonds in EMU crisis countries – even those not under the umbrella of the Troika - compared to German government bonds. Mario Draghi, President of the ECB since November 2011, realized that only an unconditional commitment by the

ECB could prevent the breakdown of the euro area. At that time, Germany, which was always against such a promise, gave up its resistance against such a policy. At the Global Investment Conference in London, on July 26th, Draghi famously declared he will do “whatever it takes” (Draghi 2012) to save the euro. The ECB finally stated that it would purchase unlimited amounts of national debt on secondary markets – however, provided that the countries in question agree to reform programs negotiated with the Troika. EMU capital market calmed down after this promise.

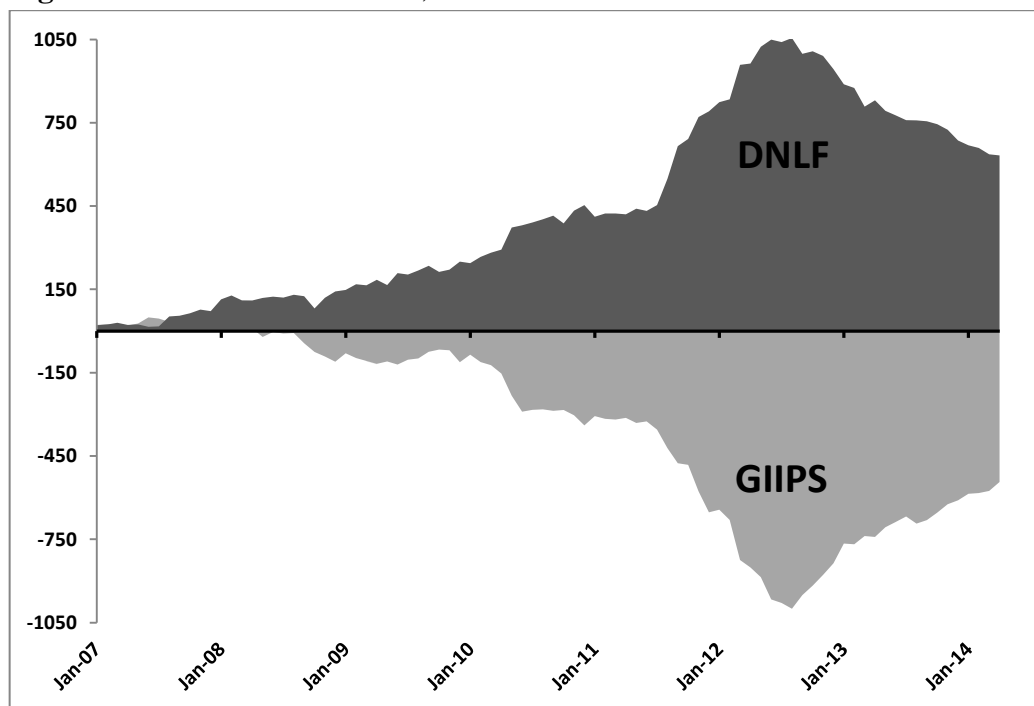
One of the most important policies of the ESCB dealing with the crisis in the EMU has been the *TARGET2* financing. Monetary transfers between EMU banks are carried out via *TARGET2*. For example, a Spanish bank has to balance its financial obligation daily, vis-à-vis a German bank. When, for example, deposits are shifted from a Spanish bank or a Greek bank to a German bank, the Spanish and Greek banks have to settle their accounts and transfer money to the German bank. With the outbreak of the sovereign debt crisis, capital flows to crisis countries stopped and capital flight from crisis countries to stable countries in the EMU started. The boom phase of capital inflows, which financed the high current account deficits, turned into a bust phase with net capital outflows. As Spanish or Greek banks were cut off from the EMU money market, the only possibility left for these banks was to ask for refinancing from their national central banks. The national branches of the ECB refinanced their banking systems without limit as part of their lender of last resort function. Within the ESCB this was reflected in *TARGET2* imbalances, as for example surpluses of the German Bundesbank and deficits for the central banks in Spain and Greece. To legally allow the refinancing of banks in crisis countries, the quality of collateral for the refinancing process was reduced in such a way that banks in crisis countries always had sufficient collateral for open market operations and other instruments of refinancing.

This process eventually caused an explosion of *TARGET2* imbalances shown in Figure 12. In absolute values, Germany is by far biggest *TARGET2* surplus country, followed by the Netherlands and Luxembourg, whereas the biggest deficit countries are Spain and Italy. In short, after the outbreak of the sovereign debt crisis cash-flow imbalances within the EMU have not been financed by private capital flows. Instead, imbalances have been financed by increasing refinancing through the central banks in crisis countries (Bindseil and König 2012). In substance, the ESCB finances via *TARGET2* transfers the capital flight from EMU crisis countries *and* their current account deficits. If the national central banks in the EMU would not have financed the banking systems in crisis countries, the financial systems would have broken down in the EMU and whole monetary union. Improvements of *TARGET2* balances during the last years reflect first of all the improvement of current account balances in the crisis countries.

The central bank money created by this process flooded the banks in surplus countries, which had no need for it, as they did not want to expand credits sufficiently and/or there was a lack of credit demand from good debtors. Banks in surplus countries kept the created central bank money as excess reserves with the central bank. Excess reserves increased to roughly the same extent as the refinancing of the ECB did.

The ECB's policy of low interest rates and several Lender of Last Resort measures undertaken since 2009, including TARGET2 financing, managed to offset, to a certain degree, the crisis intensifying effects of Troika policies. It was the ECB which prevented the collapse of the euro. The role of Mario Draghi as President of the ECB has arguably been very important in these developments, as he appears to be more aware of the need of a comprehensive Lender of Last Resort and the danger of deflation in the EMU than other representatives of EU institutions (Financial Times 2013; Draghi 2014).

Figure 12: TARGET2 Balances, 2007-2014



Source: Euro Crisis Monitor (2014)

Note: DNLF countries: Germany, Netherlands, Luxembourg, and Finland.

GIIPS countries: Greece, Italy, Ireland, Portugal, and Spain.

6. Conclusions

In 2009, after the outbreak and the consequences of the US-subprime crisis in 2007 and its intensification in 2008, all countries in the EMU fell into a deep recession. From the beginning of the EMU in 1999 until 2007, Southern European countries and Ireland manoeuvred themselves in a constellation of high current account deficits. Countries like the Netherlands and Austria, but most notably Germany, realised current account surpluses with the result of increasing current account imbalances within the EMU. Imbalances developed as current account deficit countries saw unit labour costs increases outstrip those in surplus countries *and* deficit countries realised higher GDP growth rates (with the exception of Portugal) than surplus countries. High GDP growth in the deficit countries was to a large extent driven by real estate bubbles, which were allowed to develop alongside credit driven consumption. Budget deficits in these countries were often low (with the exception of Greece) or the countries even realised budget surpluses.

When the Great Recession hit Europe, all countries followed an expansionary fiscal policy. Fiscal stimulus, together with costly bailout-packages of banks and other financial institutions, increased budget deficits considerably in 2009 and 2010. In early 2010 and later, in all Southern European countries and Ireland interest rates for public debt started to increase to unsustainable levels. In addition, a general change in fiscal policy was introduced, led by Germany and the EU Commission. Budget consolidation, rather than fiscal stimulus, became the policy priority.

The crisis countries found themselves in a very difficult constellation. Price competitiveness vis-à-vis Germany and other surplus countries in the EMU was lost, real estate bubbles had collapsed, all private demand elements shrank and expansionary fiscal policy was no longer possible as financial markets restricted any fiscal expansion or led even to the insolvency of governments. In such a situation, the crisis countries had to ask for external help.

External help was organised by EMU surplus countries and the IMF and executed by the Troika. The Troika strategy consisted of the following elements:

- Fiscal austerity was seen as the main instrument to regain fiscal autonomy and to solve the sovereign debt crisis. A whole new governance body in the EMU was established to enforce fiscal discipline in general. Policies allowing the central bank to, as in the other countries, guarantee the liquidity and solvency of governments was rejected. Fiscal austerity pushed countries into an ever deeper recession with high economic and social costs.

- Internal devaluation was seen as the key instrument to regain international competitiveness. The cut of unit labour costs was seen as the main instrument to achieve the internal devaluation. As productivity cannot be increased quickly, the cut of wages was in the centre of this policy. Current

account deficits in the crisis countries improved after 2010. However, the main contribution came from a shrinking GDP which led to lower imports. Depending on the country, cuts in unit labour costs leading to a real depreciation stimulated exports which also contributed to reduce current account deficits.

- Fiscal austerity and wage cuts were seen as only possible solutions in a framework of fundamental structural reforms in a neoclassical spirit. Also medium-term growth should be guaranteed by structural reforms which reached from the deregulation of labour markets to privatisations.

What we see here is a completely asymmetric adjustment process which served only to burden the crisis countries with adjustment costs. The outcome of this strategy to solve the EMU crisis is a disaster and has been maximising the costs to solve the crisis.

In spite of fiscal austerity, budget deficits in the crisis countries could not be reduced as planned as fiscal austerity reduced the tax base via a shrinking GDP and increased the social costs of the crisis. Public debt in per cent of GDP increased in spite of austerity. In the end, only the late promise by the ECB in 2012 to guarantee for public debt ended the sovereign debt crisis – not austerity policy. The ECB could have given such a promise already in 2010. Of course the same effect could have been achieved if all EMU countries together would have guaranteed for public debt in crisis countries. Had the ECB, together with the European Commission and EMU surplus countries like Germany, guaranteed the Greek public debt and at the same time enforced needed structural reforms in Greece – structural reforms not in a neoclassical spirit – the European debt crisis likely never would have happened.

The way the internal devaluation in current account deficit countries was enforced was a disaster as well. It is not understandable to force countries to induce wage cuts in a deflation when these countries suffer from high stocks of debt. It should have been clear that such a policy exacerbates the problem of non-performing loans and represses investment and consumption demand even further. This policy, together with fiscal consolidation in a situation of shrinking private demand, pushed the EMU to the edge of a deflation – a danger that should have been seen as early as 2009 (see for example Herr 2009). In summer 2014 the ECB started to warn about the serious danger of a deflation in the EMU – a paradox given that the ECB also sits in the Troika.

Overall there were two fundamental misconceptions in the handling of the crisis in the EMU. Crisis countries were forced to follow an asymmetric adjustment process. Sharing the burden with current account surplus countries and countries with no refinancing problems would have been necessary to prevent the deep crisis in the EMU. Keynes's (1942) ideas as expressed in his recommendation for the Bretton Woods System were completely forgotten and EMU countries

followed their short-sighted individual interests without thinking about the EMU as a whole. Such a policy was, in the end, also harmful for the surplus countries, which also do not show a convincing growth performance.

The second fundamental mistake was to believe that fiscal consolidation may slightly reduce growth in the short-term but structural reforms will unfold market forces spontaneously and will lead to a recovery and full employment. This policy, which is based on the Washington Consensus, does not care for any demand stimulation (Herr and Priewe 2005). There was no element of demand creation in the Troika's recommendations at all.

What would have been needed is a symmetric process to overcome the crisis. This would have meant, without going into details, higher wage increases and fiscal stimulus after the Great Recession in surplus countries like Germany, as well as a European wide program of demand stimulation, for example in the framework of a green new deal, a cautious consolidation of public finances and no wage cuts in crisis countries, and a guarantee of public debt in crisis countries at the beginning of the sovereign debt crisis (also see Hein/Detzer 2014). In addition, a quick further integration of the EMU would have been needed, which goes beyond mechanisms to control public sector balances and warn for macroeconomic imbalances. For example, an EMU fiscal centre with own taxes and active fiscal policy is needed alongside new institutions to coordinate wage development in the EMU (for example European minimum wages regionally differentiated) or elements of an EMU social safety net (for example an EMU unemployment insurance starting on a low level).

All this was not done. As of the beginning of 2015, it looks as if the EMU as a whole is not only heading for one lost decade, but for even longer stagnation. A Japanese deflationary scenario cannot be excluded with huge regional differences within the EMU and further erosion of social standards.

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