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**Article — Published Version**

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Intereconomics

*Suggested Citation:* Busch, Berthold; Grömling, Michael; Matthes, Jürgen (2011) : Current account deficits in Greece, Portugal and Spain: Origins and consequences, Intereconomics, ISSN 1613-964X, Springer, Heidelberg, Vol. 46, Iss. 6, pp. 354-360,  
<https://doi.org/10.1007/s10272-011-0400-9>

This Version is available at:

<https://hdl.handle.net/10419/88892>

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Berthold Busch\*, Michael Grömling\*\* and Jürgen Matthes\*

## Current Account Deficits in Greece, Portugal and Spain – Origins and Consequences

In light of the shortcomings of the Stability and Growth Pact, there has been a recognition that a surveillance framework is needed which goes beyond fiscal issues to cover wider macroeconomic factors. The question arises whether the surveillance and connected reform criteria should be applied symmetrically, to all members of the eurozone, or whether they should specifically target countries with current account deficits.

Economic divergences in the euro area have been the focus of intense academic and policy oriented debates.<sup>1</sup> This article joins this discussion – against the background of important policy reforms which are underway. Particularly in the framework of the new macroeconomic surveillance mechanism for reducing and avoiding imbalances in the EU, the question has arisen whether the EU should impose more discipline symmetrically, on deficit and surplus countries alike, or asymmetrically, mainly on deficit countries. Therefore, it is important to understand the main reasons for the huge economic divergences within EMU. It will be argued that developments in Greece, Portugal and Spain themselves largely explain the huge build-up of current account deficits and foreign debts in these economies.<sup>2</sup>

The analysis is framed in an intertemporal view of current account balances.<sup>3</sup> Accordingly, current account deficits can be fundamentally justified if the (simultaneous) net capital inflows are used to foster growth and export capacities, so that in the future current account surpluses can be sustained and the formerly incurred debts can be repaid. Such a scenario is particularly relevant for poorer countries that tend to converge in economic terms towards richer countries. In contrast, when countries with sustained current account deficits increase consumption as a reaction to capital inflows and neglect to foster their export basis, debt sustainability can be at risk due to notoriously increasing net foreign debt positions. Therefore, the leading question of this article is how the three countries examined here have utilised low interest rates and high net capital inflows: mainly for investment or for consumption?

This analysis portrays current account balances from several perspectives (trade-income balance, absorption-production balance, savings-investment balance, borrowing-lending balance).<sup>4</sup>

All these different views are interconnected:

$$CA = X - M + Inc + CurTr \quad (\text{trade-income balance}) \quad (1)$$

$$X - M = GDP - A \quad (\text{with } A = C + I) \quad (2) \\ (\text{absorption-production balance})$$

$$CA = S - I \quad (\text{savings-investment balance}) \quad (3)$$

$$NBL = CA + CapTr \quad (\text{borrowing-lending balance}) \quad (4)$$

with

- 1 J. Matthes: Ten Years EMU – Reality Test for the OCA Endogeneity Hypothesis, *Economic Divergences and Future Challenges*, in: *Intereconomics*, Vol. 44, No. 2, 2009, pp. 114-128; G. Schnabl, H. Zemanek: Inter-temporal Savings, Current Account Trends and Asymmetric Shocks in a Heterogeneous European Monetary Union, in: *Intereconomics*, Vol. 46, No. 3, 2011, pp. 153-160; N. Holinski, C. Kool, J. Muysken: Origins of persistent macroeconomic imbalances in the Euro area, Maastricht University, May 2010; Deutsche Bundesbank: On the problems of macroeconomic imbalances, *Monthly Report*, July 2010, pp. 17-40; F. Jaumotte, P. Sodsriwiboon: Current Account Imbalances in the Southern Euro Area, *IMF Working Paper*, No. 139, June 2010; European Commission, Directorate-General for Economic and Financial Affairs: Surveillance of Intra-Euro-Area Competitiveness and Imbalances, *European Economy*, No. 1, 2010.
- 2 For arguments against the contention that Germany shares a substantial part of blame for the economic imbalances in the eurozone see B. Busch, M. Grömling, J. Matthes: Lebt Deutschland auf Kosten südeuropäischer Länder?, in: *Wirtschaftsdienst*, Vol. 91, No. 8, 2011, pp. 537-542.
- 3 O. Issing, K. Masuch: Zur Frage der normativen Interpretation von Leistungsbilanzsalden, in: *Kredit und Kapital*, Vol. 22, 1989, pp. 1-17; J.D. Sachs, F.B. Larraín: *Macroeconomics in the global economy*, New York et al. 1993.
- 4 J.D. Sachs, F.B. Larraín, op. cit.; M. Grömling: Ways to interpret Turkey's current account, in: *Intereconomics*, Vol. 40, No. 4, 2005, pp. 217-225; B. Busch, M. Grömling, J. Matthes: Ungleichgewichte in der Eurozone, *IW-Analysen* No. 74, Cologne 2011.

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CA	= balance on current transactions with the rest of the world
X and M	= exports and imports of goods and services
Inc	= net primary income from the rest of the world
CurTr	= net current transfers from the rest of the world
A	= absorption
C	= consumption (private and government)
I	= investment (private and government)
S	= savings
NBL	= net borrowing from, or lending to, the rest of the world
CapTr	= net capital transactions with the rest of the world

Looking at the economic imbalances from these different angles<sup>5</sup> renders it possible to deduce meaningful insights for the policy debate.<sup>6</sup> In a first step, the analysis focuses on the economy as a whole and later also on individual sectors (government, corporations, households). The focus is laid on the period 1999 to 2007, as from 2008 onwards the impact of the financial crisis could be felt. From 1999 to 2007 the current account deficits in the three countries increased, culminating in Spain and reaching near climaxes in Greece and Portugal.

### Trade-Income Balance: Excessive Wage and Price Increases

A brief look at the trade-income balance (equation (1)) clearly shows that a large share of the current account deficits can be explained by a self-inflicted loss of competitiveness due to rapidly and excessively increasing labour costs and export prices.

5 To be able to portray all these aspects, we have to draw on data from national accounts (NA) and not from balance of payments statistics (BOP). For Spain and Portugal, the stated current account deficits (BOP) do not differ significantly from the balance of current transactions with the rest of the world (NA), as should be the case due to the fact that both indicators basically capture the current account balance. Due to obvious data problems, however, this is not the case for Greece, where the balance on current transactions with the rest of the world (NA) is substantially larger than the current account balance (BOP) for most years covered here. Obviously, problems with Greek NA statistics also prevail here. Nevertheless, in order to use common terminology, the term "current account balance" will be used throughout the article also to capture the "balance of current transactions with the rest of the world".

6 Several other studies which focus on the structural determinants of current account imbalances are also highly policy relevant. Among other things, they point to factors like net foreign assets, convergence effects, real interest rates, fiscal balances and financial deepening, which also play an important role in our article. See S. Barnes, J. Lawson, A. Radziwill: Current Account Imbalances in the Euro Area: A Comparative Perspective, OECD Economics Department Working Paper, No. 826, Paris 2010; C. Cheung, D. Furceri, E. Rusticelli: Structural and Cyclical Factors behind Current-Account Balances, OECD Economics Department Working Papers, No. 775, 2010; J. Degressin, E. Stavrev: Current Accounts in Currency Union, IMF Working Paper, No. 127, June 2009.

Competitiveness is less important for the balance of primary incomes (Inc) and current transfers (CurTr), but highly relevant for the trade component (X - M) in equation (1), as a loss in competitiveness tends to impede exports and foster import growth. Therefore, it is important to ask what role the trade component plays for the current account deficit CA. In fact, negative net exports of goods and services – which only to a rather limited extent result from trade with Germany<sup>7</sup> – account for the bulk of the current account deficit in the depicted countries in 2007. In Spain about two thirds, and in Portugal and Greece nearly four fifths, of the overall deficit result from the trade deficit (Figure 1). Within this balance, highly negative net exports of *goods* are only partially compensated by positive net exports of *services* which are largely related to trade in travel services (and in Greece also to a large extent to trade in sea freight transport).

The loss of price competitiveness can be strikingly illustrated by looking at the development of unit labour costs and their underlying drivers. Figure 2 clearly shows – for the economy as a whole – that the increase in labour compensation in 1999-2007 by far exceeded the growth of labour productivity. This resulted in significant increases in nominal unit labour costs. As the trading partners of Greece, Spain and Portugal had a better control over their unit labour cost increases, the real effective exchange rate (REER) based on unit labour costs increased – according to data from the European Commission – in Spain by 15%, in Portugal by 10% and in Greece by 8% in 1999-2007. A similar finding is obtained when broader cost developments are included by considering the REER based on export prices of goods and services.<sup>8</sup> This measure increased by 15% in Spain, 11% in Greece and 5% in Portugal. The decrease in competitiveness resulted in losses of export market shares. The OECD indicator of export performance measures the development of export volumes relative to the specific (weighted) import growth of a country's export markets. It shows a decline in export performance by Greece of 16%, by Portugal of 12% and by Spain of 7% between 1999 and 2007.

### Absorption-Production Balance: Living Beyond One's Means

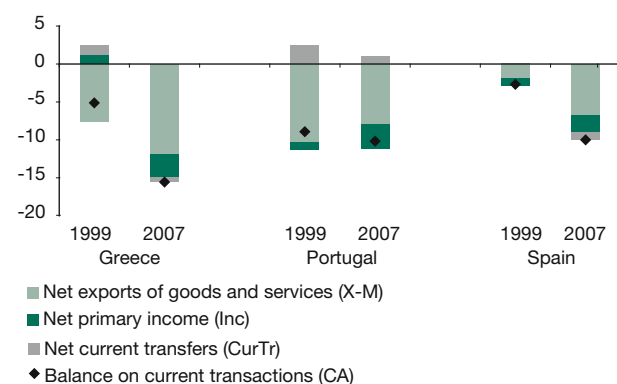
The loss in competitiveness on the one hand weakened the production basis in the three countries. On the other hand domestic expenditure (absorption) boomed. Thus, domes-

7 See B. Busch, M. Grömling, J. Matthes: Lebt Deutschland auf Kosten südeuropäischer Länder?, op. cit.

8 For a discussion of the pros and cons of various real exchange rate indicators see J. Matthes: Zunehmende Ungleichgewichte im Euroraum – Gefahr für die Europäische Währungsunion, in: Institut der deutschen Wirtschaft (ed.): Zehn Jahre Euro, IW-Analysen No. 43, Cologne 2008, pp. 119-147.

Figure 1  
Balance of Current Transactions with the Rest of the World

in % of GDP



Sources: European Commission (AMECO database); own calculations.

tic absorption exceeded production for a prolonged period. In other words, the three countries continuously lived far beyond their means.

Referring to the current account context, this balance between production (GDP) and absorption ( $A = C + I$ ) equals net exports of goods and services (see equation (2)).<sup>9</sup>

Figure 3 depicts  $A$ ,  $C$ ,  $I$  and  $S$  and shows that  $A$  exceeds the 100%-line by exactly the amount of the deficit of net exports of goods and services as a percentage of GDP (compare Figure 1). Particularly in Greece and Portugal, consumption contributed mainly to the high level of absorption. Nominal consumption lay at 90% of nominal GDP in Greece and at 85% of GDP in Portugal in 2007 while in Spain it amounted to 76% (about the same level as in Germany). Between 1999 and 2007 Greece kept its consumption ratio at this astonishingly high level whereas in Portugal it even increased.

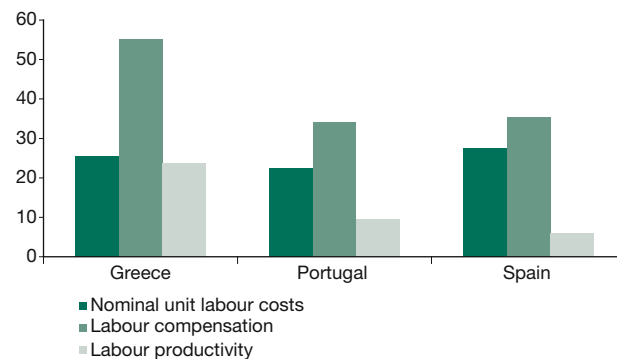
Several main drivers of this consumption and absorption boom can be identified. First, we focus on economic policy failures:

- Excessive wage policy fostered the growth of disposable incomes on a broad scale relative to productive capacity.
- The monetary policy of the ECB was too lax for the countries under examination so that real short-term interest rates became negative for several years between 2002 and 2005.

9 A similar relation is  $CA = Y - A$  with  $Y = GDP + Inc + CurTr$ . However, here equation (2) is chosen because in this depiction the amount by which  $A$  exceeds GDP (in relation to GDP) exactly equals  $X - M$  (in relation to GDP).

Figure 2  
Unit Labour Costs and their Drivers

percentage change 1999 to 2007



Note: Unit labour costs per hour for the total economy; Portugal: per employee.

Sources: OECD; own calculations.

- Fiscal policy did not sufficiently counter the monetary policy impulses and the consumption boom by improving budget balances, which could have dampened consumption appetites (and could also have contributed to sound fiscal balances). Instead, increasing government transfers and consumption even supported the spending booms in Greece and Portugal (see below).

An additional – and highly important – driver of the consumption and absorption booms was massively declining real interest rates due to entry into EMU. In the early 1990s, particularly nominal, but also long-term real interest rates in Greece, Portugal and Spain were rather high. In the course of the 1990s, monetary and fiscal policy became more stability oriented in order to fulfil the Maastricht criteria. Inflation decreased substantially and exchange-rate bindings became more credible. Thus, interest rate risk premia also declined significantly.

In addition, after EMU entry a real interest rate effect prolonged the interest related economic impulses. As financial markets (mistakenly) demanded only very limited risk premia, long-term nominal interest rates for Greece, Portugal and Spain were only slightly higher than for Germany. Thus, with similar long-term *nominal* interest rates and higher inflation rates in these three countries, *real* long-term interest rates were very low – and briefly even negative in Spain. This led to credit booms which were not sufficiently dampened by financial supervisory authorities. As a consequence, particularly in Greece and Spain, the economic booms – and the growth contributions of domestic demand – were substantially reinforced.<sup>10</sup>

10 For a further elaboration of these mechanisms see J. Matthes: Ten years EMU..., op. cit.

### Savings-Investment Balance: a Lack of Productive Investment

Low real interest rates also contributed to a decline in savings absolutely and relative to investment (Figure 3). As the current account deficit can also be expressed (from a total economy viewpoint) as the difference between savings and investment (equation (3)) this perspective allows us to view economic imbalances from a more fundamental perspective.

The development of savings and investment differs among the three countries. In Spain, total gross savings (relative to GDP) remained fairly constant between 1999 and 2007, while the ratio of total gross investment increased substantially, but went partially into a real estate build-up of questionable sustainability.

In contrast, in Greece and Portugal the savings ratio declined significantly between 1999 and 2007 (and further up to 2009) and ended up at rather low levels below 10% of GDP, particularly in Greece. At the same time, the investment ratio stagnated in Greece relative to GDP and even declined substantially in Portugal. Bearing in mind the interest rate impulses, this lack of investment momentum is striking.

### Borrowing-Lending Balance: Building Up Foreign Debts

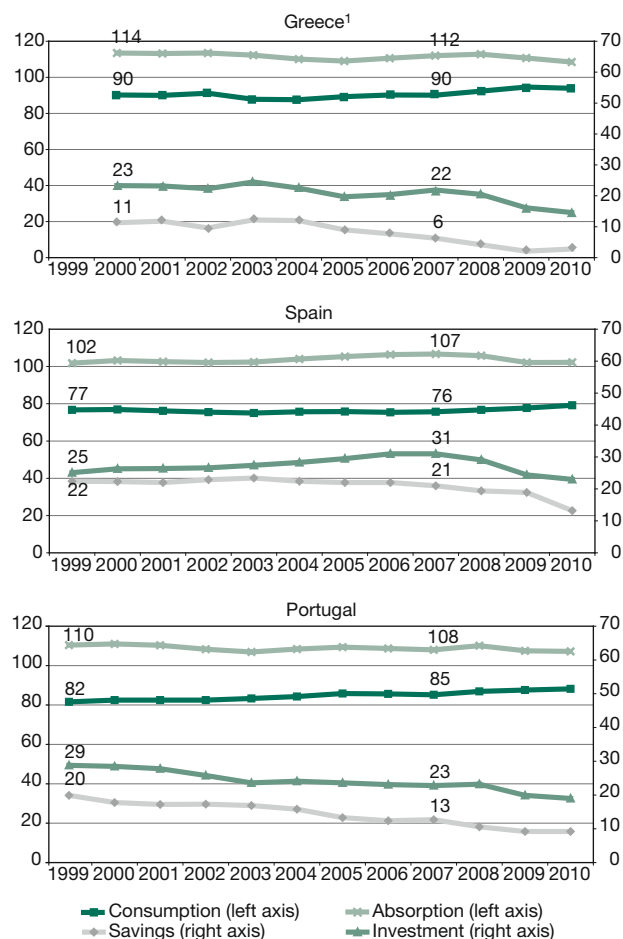
The deficit between savings and investments – i.e. the current account deficit (CA) – must be covered by net capital inflows. This is reflected in the net borrowing-lending balance (NBL) with the rest of the world, for which a negative sign implies a net capital import. NBL is defined as CA plus net capital transactions with the rest of the world (CapTr) which are positive in the countries examined here. As CA is negative, a positive CapTr renders NBL less negative for the depicted countries (equation (4)).

Nevertheless, a constantly negative NBL over time results in a significant build-up of foreign debts. Thus, this view of the current account balance shows that Greece, Portugal and Spain constantly lived on credit between 1999 and 2007 (Figure 4).<sup>11</sup>

What is more, the combination of this and the former current-account perspectives illustrate bluntly that the net capital inflows largely flowed into consumption instead of invest-

<sup>11</sup> This aspect is mirrored by a closer financial market integration in EMU, as pointed out by B. Schmitz, J. von Hagen: Current Account Imbalances and financial integration in the Euro Area, CEPR Discussion Paper, No. 7262, London 2009; and C. Waysand, K. Ross, J. de Guzman: European Financial Linkages. A new look at imbalances, IWF Working Paper, WP/19/295, Washington DC 2010; and Philip R. Lane: International Financial Integration and the External Positions of Euro Area Countries, OECD Economics Department Working Paper, No. 830, Paris 2010.

Figure 3  
Consumption, Absorption, Savings and Investment  
in % of GDP



<sup>1</sup> Data available only from 2000 onwards.

Sources: Eurostat; own calculations.

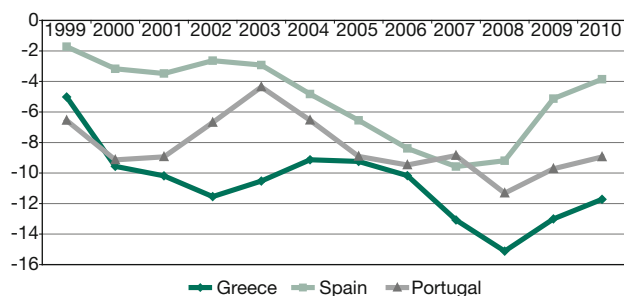
ment in Greece and Portugal. They were hardly used to increase the productive capacity of their economies. Thus, the main precondition for the inter-temporal sustainability of prolonged current account deficits – which is the overriding focus of this article – has not been met in these countries.

### Borrowing-Lending Balance by Sector: a Mixed Picture

Up to now we have been looking at the economy as a whole. In the following, a more disaggregated look is cast at the role of government, corporations and private households in contributing to the net borrowing balance of Greece, Portugal and Spain.

Government fiscal balances have contributed rather differently. Up to 2007, in an environment of rapid growth and falling unemployment, Spain even achieved a surplus position (and

Figure 4  
Total Net Lending (+) or Net Borrowing (-)  
in % of GDP



Sources: European Commission (AMECO database); own calculations.

is therefore not further considered here). On the other hand, it is well-known by now that in Greece, although the country similarly profited from an economic boom, fiscal profligacy led to highly negative financial balances. In Portugal, deficits increased up to 2005, but were reduced significantly by 2007 – despite a lagging economy with growth rates significantly below those in Greece and Spain. This accomplishment is often neglected.

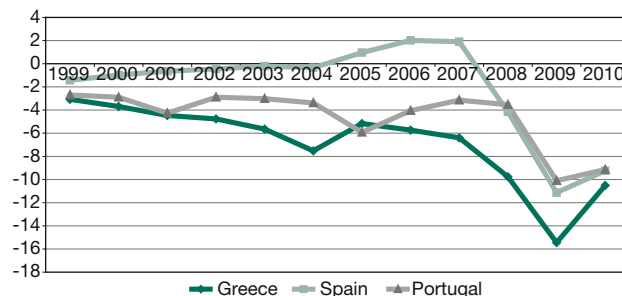
Nevertheless it is worth taking a closer look at the development of government expenditure in Portugal and Greece. Governments in both countries – as well as in Spain – significantly benefited from lower interest rates. Government interest rate expenditure in Portugal fell from more than 8% of GDP in 1991 to below 3% in the mid-2000s. In Greece, the decline was even larger, from nearly 12.5% in 1994 to slightly above 4.5% of GDP in 2005 to 2007. This should have given room for a substantial consolidation of government finances.

Instead, the share of total government expenditure remained largely constant in Greece – fluctuating around 45% of GDP up to 2005. However, between 2006 and 2008 nominal increases of more than 11% per year led to a sharp rise in this ratio to nearly 50% in 2008. In Portugal, government expenditure as a share of GDP declined somewhat after the mid-1990s, when EMU entry was on the agenda, but rose considerably up to 2005, when a phase of moderate consolidation began. The hike after 2008 is largely due to the impact of the financial crisis on GDP.

Looking deeper into important categories of government expenditure, in both countries<sup>12</sup> mainly consumption related expenditures were increased:

12 For a deeper analysis of public finances in Greece see Thomas Moutos, Christos Tsitsikas: Whither Public Interest: The Case of Greece's Public Finances, CESifo Working Paper No. 3098, Munich, June 2010; and Michael Mitsopoulos, Theodore Pelagidis: The Real Cause of Greek Debt: Taxation and Labour Market Distortions in Greece, in: *Intereconomics*, Vol. 46, No. 2, 2011, pp. 112-120.

Figure 5  
General Government Net Lending (+) or Net Borrowing (-)  
in % of GDP



Sources: European Commission (AMECO database); own calculations.

- This pertains to a limited extent to the category compensation of government employees. In Greece, a slight and fairly continuous rise led to a level of more than 11% of GDP in 2007 (and 13% in 2009). In Portugal there was an increase to more than 14% in 2002 which was reversed to around 12% of GDP for 2007 onwards. These are very high ratios e.g. in comparison to Germany, where the compensation of government employees only amounted to about 7% of GDP in 2007 (down from around 9% in the early 1990s).
- Much more pronounced was the increase in the share of social transfers. In Greece, this ratio rose massively from 17% in 1991 up to nearly 25% in 2007 (and to more than 28% in 2009). A similarly huge increase of nearly 8 percentage points of GDP (and to about the same level) was attained by Portugal between 1991 and 2007.

To sum up and put it in a nutshell, the governments in Greece and Portugal more or less used savings from interest expenditures to finance substantial increases in consumption-related social transfers or for public employment. Thus, the above-mentioned high level of the consumption ratio (total economy) to GDP was partly sustained by government policies.

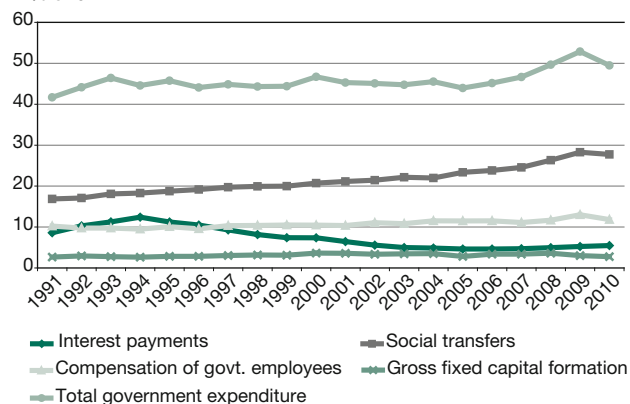
A closer look at the financial balances of the private sector (corporations and households) also reveals striking differences among Greece, Portugal and Spain:

- For Spain, Figure 8 shows again that in 2007 the government did not contribute to the economy-wide net borrowing from the rest of the world. On the other hand, private households and, above all, corporations were large net borrowers from the rest of the world. Both these sectors also solely contributed to the change in the financial balance between 1999 and 2007.
- In Greece, however, corporations hardly borrowed any longer from the rest of world in 2007, but still did so to

Figure 6

**Greece: Categories of General Government Expenditure**

in % of GDP



Sources: European Commission (AMECO database); own calculations.

a significant degree in 1999, so that the contribution of this sector to the change was even positive. When looking at 2007, both the government and private households shared equally in the negative financial balance. As private households boasted a surplus in 1999, their contribution to the change in the financial balance was more negative than that of the Greek government.

- In Portugal, it is partly the government, but even more so corporations, which were responsible for the negative financial position in 2007. Private households, on the other hand, even had a small positive balance. Between 1999 and 2007, in contrast to the other two countries, the sectoral contributions did not change very much – reflecting the relatively small change in net borrowing from the rest of the world in this period (Figures 4 and 8).

This insight makes it clear that the private sector is mainly – and, in Spain, alone – responsible for the rise in the net borrowing balance up to 2007. Thus, fiscal consolidation strategies can only be one part of rendering the economic courses of these countries sustainable in the medium to long term.

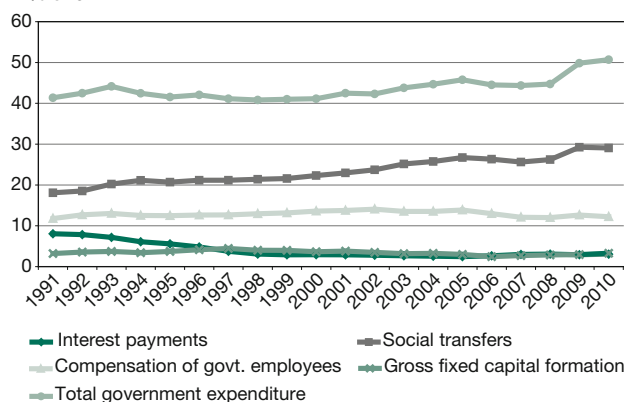
**Sustainability of Foreign Debt Burdens**

As a consequence of continuously negative net borrowing balances from the rest of the world, Greece, Portugal and Spain built up a considerable amount of foreign debt. Figure 9 shows that their net foreign asset position deteriorated substantially from around -30% of GDP in 1999 to -85% in Greece, -93% in Spain and -109% in Portugal in 2009.

Figure 7

**Portugal: Categories of General Government Expenditure**

in % of GDP



Sources: European Commission (AMECO database); own calculations.

In this context, the question arises whether the high foreign indebtedness of these three countries is still sustainable. In fact, there were significant hopes that the poorer eurozone countries would rapidly converge in economic terms towards the living standards of the richer eurozone countries. This would have enabled them to repay their debts out of the growth premium.

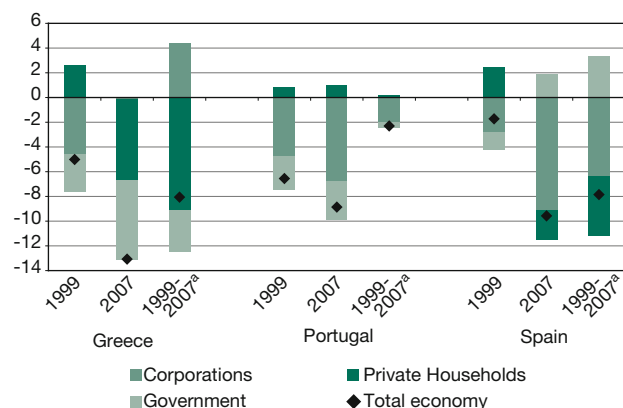
However, such hopes have proved too optimistic. Much of the high growth over the last decade was driven by unsustainable credit bubbles. After the crisis set in, the ensuing deep and enduring recessions cut off former convergence effects to a substantial degree and will probably continue to do so.

One important reason for the disappointed hopes lies in the above-mentioned lack of productive investments. This is the case mainly in Greece and Portugal. Both countries neglected to lay the foundations for a successful and reliable course of economic convergence. In Spain, the increase in the investment ratio was mainly driven by an overheated real estate boom<sup>13</sup>, so that the sustainability of this contribution is to a certain degree in some doubt.

The high foreign debt position has an important negative side-effect which renders it more difficult to reduce the debt burden in order to make it sustainable. Foreign debts have to be serviced, e.g. via interest payments, and the related negative flow of the net primary income (Inc) is part of the current account balance (CA) and pushes it further into the red (see Figure 1). The same is true – to a lesser extent – for negative net current transfers (CurTr) to the rest of world (except for Portugal). Thus, to reduce the

<sup>13</sup> European Economic Advisory Group: EEAG Report on the European Economy, Munich 2011.

**Figure 8**  
**Net Lending and Borrowing**  
in % of GDP



<sup>a</sup> Change in percentage points.

Sources: European Commission (AMECO database); own calculations.

debt burden by means of a positive current financial balance vis-à-vis the rest of the world (NBL), it does not suffice for net exports to become positive, as the following equation shows (the signs of the relevant items are noted below).

From equations (1) and (4) it follows:

$$\text{NBL} > 0 \quad \leftrightarrow \quad X - M > -\text{Inc} - \text{CurTr} - \text{CapTr}$$

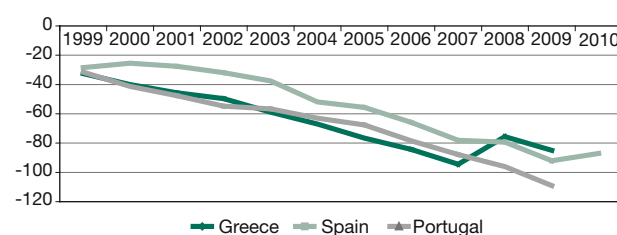
(-)    (-)    (+)

Taking (positive) net capital transactions (CapTr) also into account and looking at the data for 2010, net exports would have to reach more than +1.7% of GDP in Spain, +1.6% in Greece and +1.3% in Portugal to bring down foreign debts in these countries.

### Economic Policy Implications

This analysis has shown that the responsibility for high current account deficits can largely be assigned to the three countries analysed themselves. Surplus countries, like Germany, have certainly benefited from the economic boom in these countries and have, via international financial markets, partially provided the required financing for their net borrowing balances. Moreover, stability-oriented structural reforms – like wage moderation to reduce unemployment, consolidation to bring down government deficits and higher private saving to provide against old-age income shortfalls – led to an improvement in international competitiveness and current account surpluses in Germany. However, to maintain that this was the main driver of the current account deficits in Greece, Portugal and Spain does not appear to be appropriate.

**Figure 9**  
**Net Foreign Asset Position**  
in % of GDP



Sources: Eurostat; own calculations.

The loss of competitiveness was mainly self-inflicted because wages increased faster than (often very low) productivity growth. Moreover, Greece and Portugal continuously lived beyond their means, as private and government consumption were excessive in comparison to productive capacity or government revenues. At the same time, investment ratios fell, putting into question the sustainability of the persistent build-up of foreign debts. Spain fares considerably better in these respects, but here an investment boom which was mainly driven by a real estate bubble was the main driver of the rising current account deficits, as the savings ratio stayed relatively constant.

The current account imbalances in the euro area as well as the unpalatable economic situation in the three countries examined here have led to new reform initiatives. A new framework for macroeconomic surveillance is in the making. The question arises whether the surveillance and connected reform criteria should be symmetrical, i.e. whether countries with current account surpluses and deficits would have to submit to the same discipline. Bearing in mind the results of this study, it appears more appropriate to rely mainly on asymmetrical discipline in the future, as the largest policy failures happened in current account deficit countries.

This analysis has also shown that structural reforms (entailed by the conditionality of the assistance programmes) in Greece and Portugal are indispensable. While fiscal consolidation certainly acts as a short-run drag on the economy, the room for cutting government expenditure is large as both countries have substantially raised government consumption, above all social transfers, in the wake of the crisis. Thus, as soon as the economy gathers momentum again, the strain which fiscal consolidation exerts on the social fabric in these countries should be tolerable. Moreover, productivity enhancing structural reforms – imposed from the outside against notoriously strong vested interests – are an important lever for these countries to regain lost competitiveness in the medium term.