



The importance of trade and capital imbalances in the European debt crisis

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Abstract

The European crisis has highlighted the role of intra-European payments imbalances for the survival of the EMU. Payment imbalances between the North and the South have contributed to the accumulation of large stock of foreign debt, while flows of foreign capital ceased to finance productive investments which might have contributed to debt repayments—preferring instead to finance consumption and a housing bubble. The *dynamic* interplay between current account imbalances and the accumulation of debt reveals that, once the system is driven into disequilibrium by a real exchange rate misalignment, the longer a payments imbalance persists the harder the eventual adjustment will be. Capital reversals, by shifting portfolio balances, lead the system toward instability, sovereign default, and the collapse of the exchange rate regime. Replacing private with public creditors may temporarily help us to stay away from the point where the system breaks down. But this is only a temporary expedient because the underlying imbalances need continued and escalating financing until equilibrium is restored by other means. One permanent solution is the ECB's official monetary transactions program, *if* the potential expansions to the central bank's balance sheet can be tolerated.

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1. Introduction

In¹ a decade the Economic and Monetary Union has been able to create increased trade space and to deliver both monetary policy credibility and price stability. On the other hand, its functioning has been hampered by serious flaws in institutional design. The asymmetry between the strength of the “monetary” pillar and the weakness of the fiscal and institutional framework has become apparent in the European debt crisis. In particular, the surveillance mechanism based on fiscal rules has failed to provide or enforce virtuous behavior².

Macroeconomic imbalances within the euro area – particularly those related to the external balances – add a further layer of difficulty. For example, introducing the euro allowed interest rates in the South³ to converge on the lower interest rates of the North⁴, encouraging spending and credit expansion. This then generated an increase in borrowing in both private and public sectors and contributed to investment distortions, with overinvestment recorded in certain sectors such as real estate. Different demand patterns between the North, where there were no interest rate falls, and the South, where there were, created diverging inflation rates and a fast growing competitive advantage in the Northern Euro countries.

The interplay between current account imbalances and the implied accumulation of foreign debt can be described by a dynamic model of current account and portfolio balances. It is shown that if the system gets into disequilibrium, the longer the imbalances persist, the larger and more painful the eventual adjustment will be. This is because an accumulated *stock* of debt has to be removed, which will take a larger real depreciation in the debtor country than the real exchange rate adjustments needed to eliminate each underlying (*flow*) imbalance. Such large adjustments in real exchange rates may not be politically feasible if they have to be achieved via an internal devaluation (wage-price deflation) in the debtor countries. But a symmetric adjustment, that is a joint internal devaluation and revaluation by debtors and creditors, would cut the adjustments needed for each player by half or more.

Public interventions (loans, bailouts, haircuts, forced restructuring, liquidity injections) can also help to force the system away from the point where it breaks down. This is only a temporary expedient however (“kicking the can down the road”) because the imbalances will need continuing and increasing financing until an underlying equilibrium is restored.

It is true that current account deficits have now fallen in a number of countries. But this has been due to falling incomes, and hence lower imports driven by spending cuts and austerity measures, rather than price effects (nominal exchange rates are fixed). Therein lies part of the problem: operating on one side of the trade balance, current account deficits may have come down but not to zero or a surplus—which means (foreign) debt is still accumulating and the crisis continues. To make the point another way, recent work shows that capital reversals, external imbalances and losses in competitiveness are at least as important in explaining the debt crisis as fiscal irresponsibility itself (Alessandrini et al., 2012). Hence, to understand which policy measures could be most useful for resolving the debt crisis, we need to model the interactions between current account and portfolio adjustments explicitly—in a framework that can show the effects of a change in incomes or relative prices.

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² See Visco (2011); also Bergsten and Kirkegaard (2012a,b).

³ South is the following group of countries: Greece, Italy, Spain, Portugal, Ireland, Cyprus.

⁴ North comprises: Austria, Germany, Belgium, Luxembourg, Netherlands, France, and Finland.

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