



ECONOMIC POLICY NOTE 21/5/2015

## **The mirage of current account adjustment in the Euro-periphery**

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- Ongoing international financial integration and the introduction of the euro significantly improved borrowing conditions in the Euro-periphery countries and boosted their aggregate demand. Much of the growing private and public indebtedness financed net imports of goods and services.
- Although not all peripheral countries are alike, there is evidence that imports were extensively used for consumption rather than profitable investment purposes. As a consequence, current account deficits prior to the financial crisis were unsustainable. All this raises doubts about the ability to service the accumulated external debt in the future.
- The few signs of improvement in unit labor costs and productivity after 2010 are misleading. They represent transitory effects rather than long-term trends. Consequently, much effort is still needed to prevent the return of unsustainable current account deficits.
- The first crucial step should be the write-off of nonperforming loans, whose share in total loans has steadily increased since 2008. This would pave the way for new productive investment. Reemerging current account deficits would be self-correcting, as higher dividends from a larger stock of productive capital would raise national savings in the future.



## Apparent rebalancing of external positions

Due to the almost balanced current accounts in the Euro-periphery<sup>1</sup> since 2013 (Fig. 1), the economic discussion on the need of external adjustment has become more relaxed. The recent rebalancing, however, has been more in appearance than in substance, as the underlying causes of the past current account deficits haven't been properly addressed yet.

The scope of this paper is twofold. First, we discuss the drivers of current account deficits in the Euro-periphery. Second, we explain why the usual competitiveness indicators, especially unit labor costs, might be misleading for assessing progress in rebalancing the current account. Indeed, other indicators measuring the quality of investment suggest that the past current account deficits have been unsustainable and that external adjustment has not begun yet in earnest. External adjustment has to start with domestic rebalancing, in particular through the reduction of nonperforming

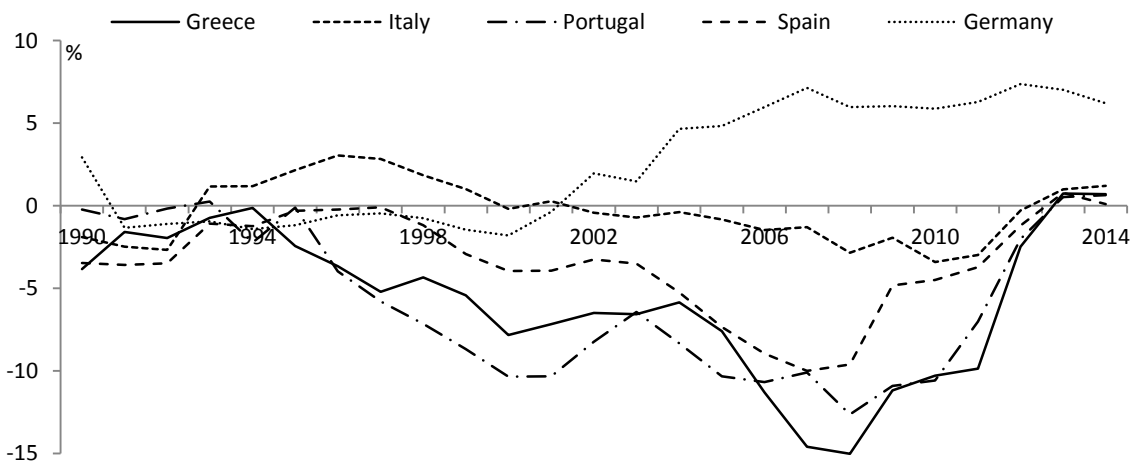
loans that have steadily increased since 2008. In addition, efforts are needed to assure that resources are invested in profitable projects. The welcome increase in investment may well lead to new current account deficits. But deficits caused by investment in productive capital will be self-correcting in the future, when higher capital dividends raise national savings.

## What caused the current account deficits?

In an open economy, the excess of domestic demand over domestic supply leads to a current account deficit. Global or regional financial integration eases the funding of these deficits. If the progressive removal of financial market imperfections contributes to a more efficient allocation of resources and permits market participants to more easily fund profitable investment opportunities, current account deficits lead to a larger stock of productive capital.

Starting in the early 1990s, the process of international financial integration accelerated

Figure 1. Current account balance in percent of GDP.

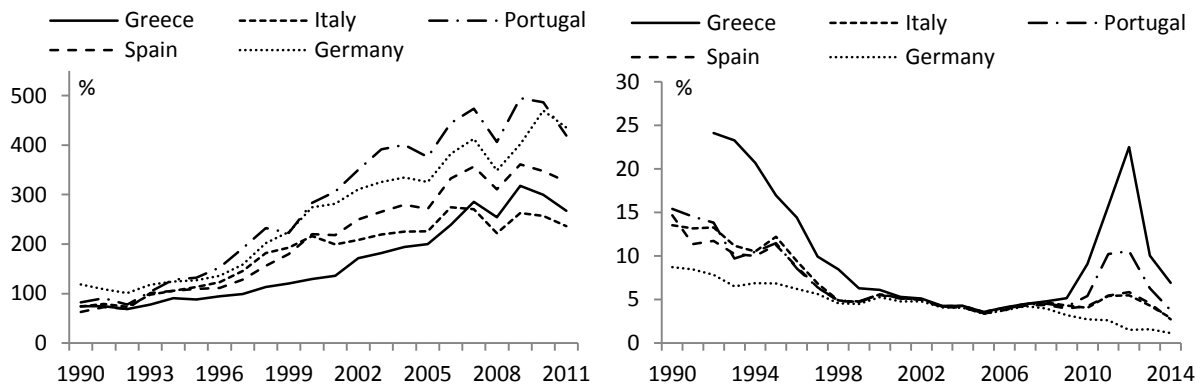


Source: WEO April 2014.

<sup>1</sup> Under Euro-periphery, we refer to Greece, Italy, Portugal and Spain. In order to allow for comparisons with the Euro-core, we show data for Germany. In our discussion, however, we concentrate on the Euro-periphery.



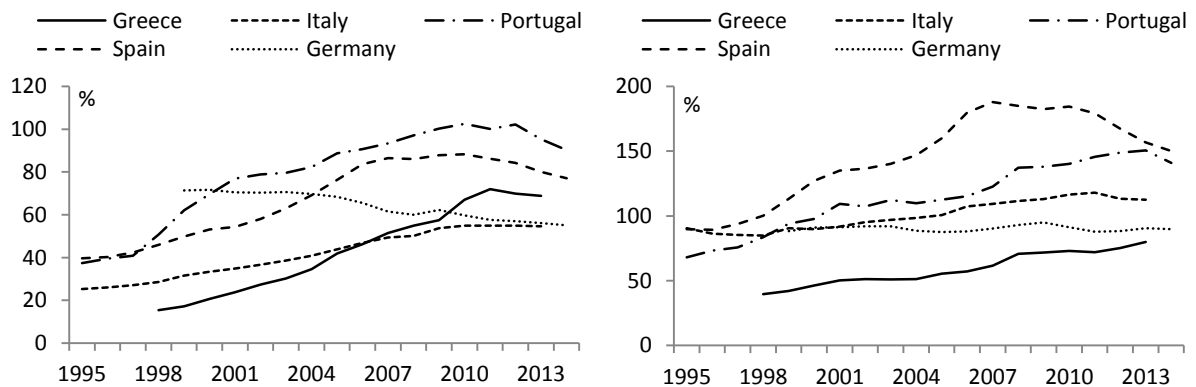
**Figure 2. International financial integration\* (left graph); EMU government bond yields (right graph).**



\*Note: International financial integration is measured in terms of a percentage share of the sum of total external financial assets and total external financial liabilities in GDP. This is a standard, although not the only indicator of international financial integration. For a detailed discussion regarding the measurement issues, see Gehringer, A. 2014. Financial liberalization, financial development and productivity growth – An overview, *International Journal of Monetary Economics and Finance*, 7(1): 40-65. EMU government bond yields data refer to the Maastricht interest rate convergence criterion.

Source: Financial integration measure is based on an updated version of the External Wealth of Nations Mark II database by Lane and Milesi-Ferretti (see Lane, P.R. and Milesi-Ferretti, G.M. 2007. The external wealth of nations mark II: Revised and extended estimates of foreign assets and liabilities, 1970-2004, *Journal of International Economics*, 73(2): 223-250); data on bond yields are taken from Eurostat.

**Figure 3. Debt outstanding of households and non-profit institutions serving households (left graph) and of nonfinancial corporations (right graph), as a % of GDP.**



Source: Haver.

in the euro area (Fig. 2, left graph).<sup>2</sup> The preparation for and the introduction of the euro gave a further boost to the financial integration among EMU participants.<sup>3</sup> As a conse-

quence, spreads between Euro-periphery and German bonds diminished fast and almost disappeared in the course of the first decade of EMU (Fig. 2, right graph). The narrowing of

<sup>2</sup> For details on the measurement of international financial integration, see note to Figure 1.

<sup>3</sup> Note that the measure of international financial integration in the left graph of Figure 2 is likely influenced by

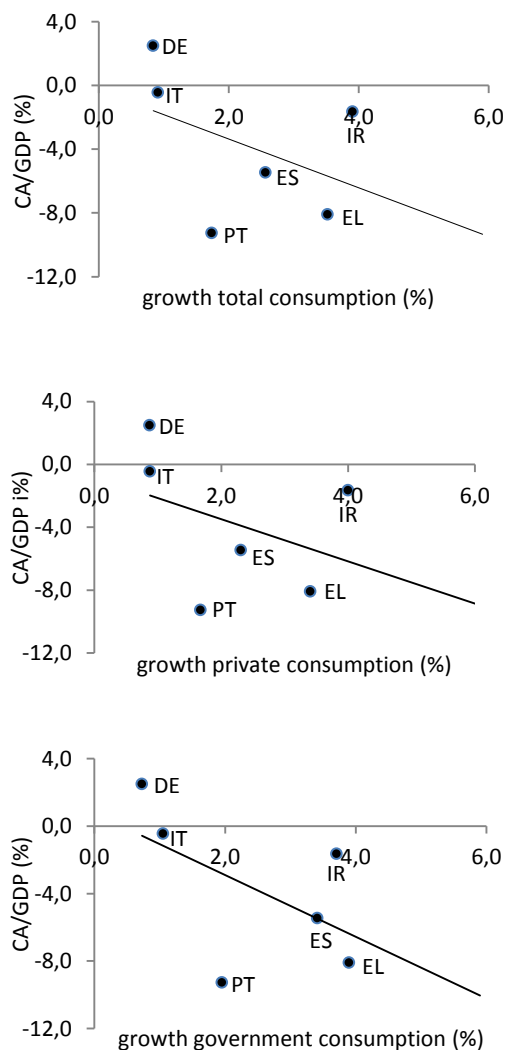
the introduction of the euro, as the adoption of the common currency further eased borrowing and lending conditions in international financial markets.



spreads among EMU countries was significantly influenced by disbelief in the no-bail-out provision of the EU Treaties.

The advantageous borrowing conditions translated into booming credit markets and in turn into growing indebtedness. Figure 3 shows the development of the outstanding debt of households and of private companies in percent of GDP. Whereas both ratios slightly decreased or were stable in Germany, they continuously grew in the Euro-periphery at least up to 2007.

**Figure 4. Current account balance in percent of GDP and consumption growth, average values for the period 1999-2007.**



Source: AMECO Macroeconomic database.

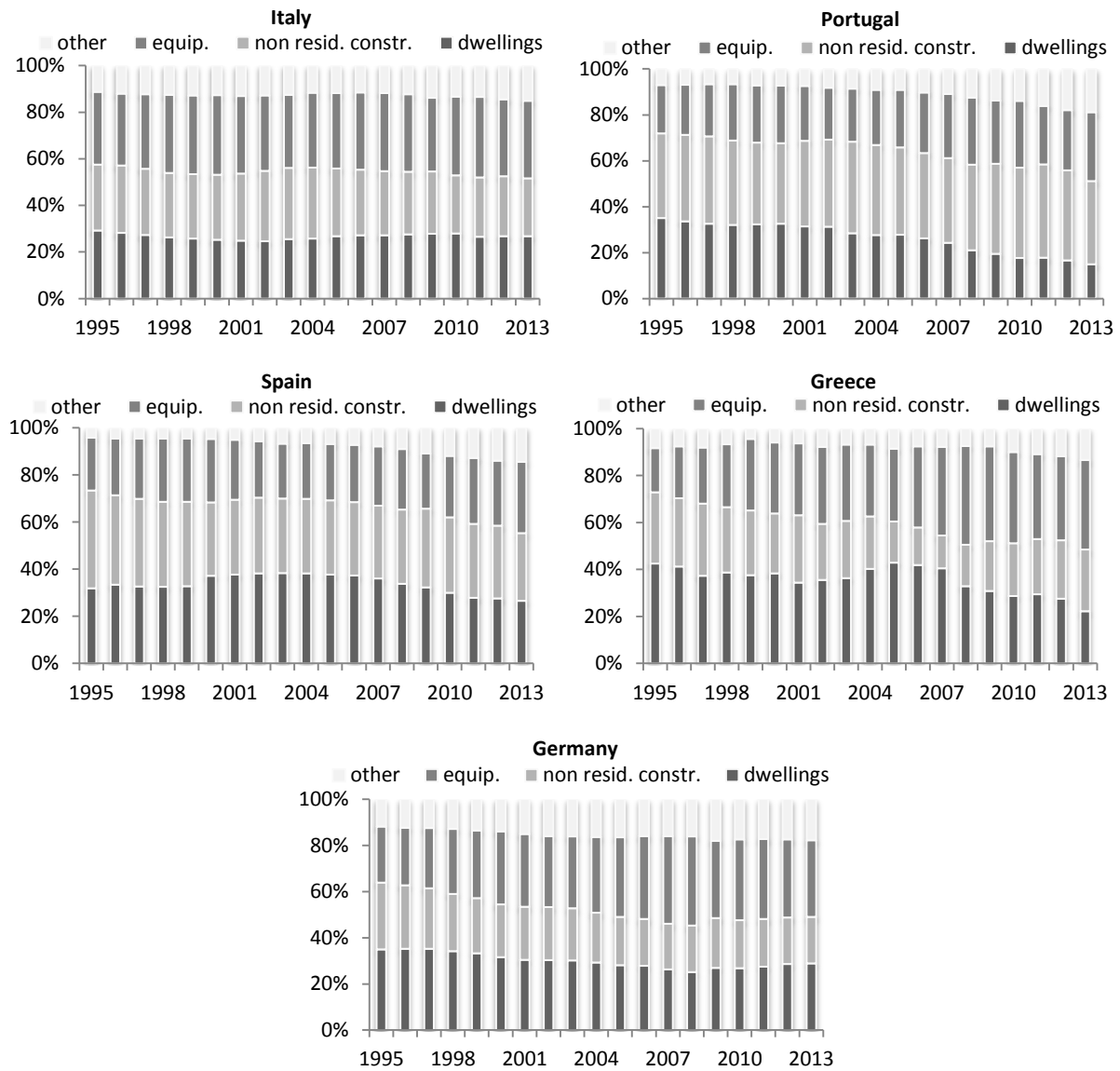
Credit to the private and public sector funded to a high degree private and public consumption. Fast growth of consumption boosted imports, which, together with slower export growth, resulted in current account deficits. The influence of consumption growth on the current account is apparent from the negative correlation between the average growth rates of consumption and the average current account balance in the period 1999-2007, as shown in Figure 4.

The analysis of consumption developments delivers a crucial, although only partial, insight into the explanation of the increase in current account deficits. Given that by definition the current account reflects the difference between domestic supply on the one side and consumption and investment on the other, the latter is the second crucial component for the analysis of the current account balance.

The sectoral composition of gross fixed capital formation in Figure 5 shows that the share of investment in equipment remained broadly unchanged over the years. This suggests that imports were in general not used to increase the productive capital stock. The only exception here is Greece. At the same time, there is clear evidence, both in Greece and in Spain, of a residential construction boom, as dwelling investment rose considerably in the years preceding the financial turmoil. Moreover, in all periphery countries, and especially in Portugal and Spain, the share of aggregate investment in construction (dwelling and non-residential investment) is and remains relatively high compared to the share of investment in equipment. Although investment in construction, especially in nonresidential construction, can have positive knock-on effects for the rest of the economy, the figures for the Euro-periphery raise doubts whether the high



Figure 5. Gross fixed capital formation by sector of activity.



Note: Equipment comprises transport equipment as well as metal products and machinery; other investment refers to investment in the primary sector as well as in computer software, entertainment, literary or artistic originals and other intangible fixed assets.

Source: Ameco.

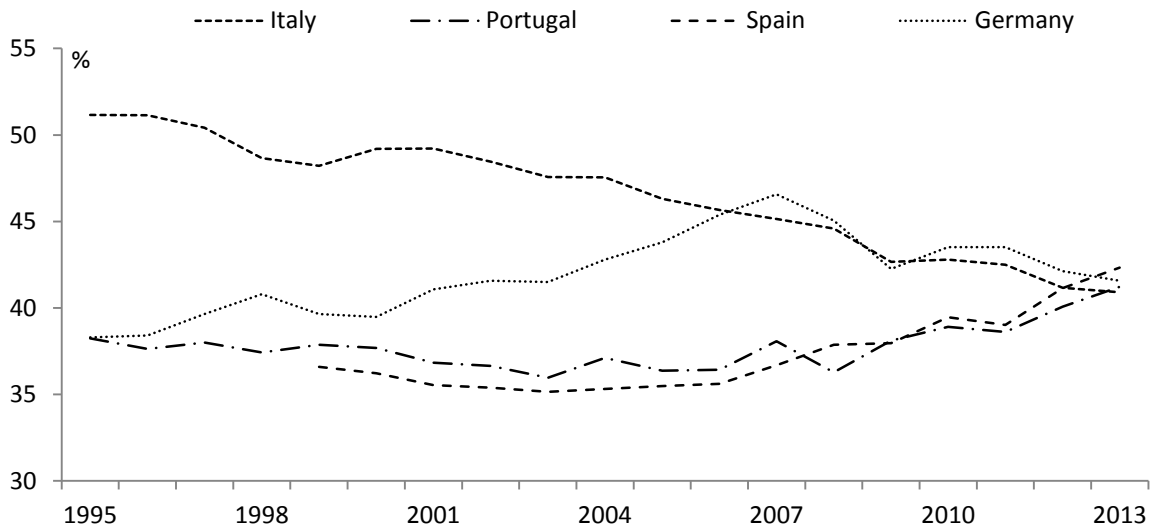
share of such investment is economically justifiable.

The picture becomes even more worrisome, when further indicators are considered. Specifically, gross profit shares of nonfinancial corporations – an indicator of the remunera-

tion of capital – suggest that the profitability of invested capital in the Euro-periphery was quite disappointing, especially during the years of high current account deficits (Fig. 6). Only after 2008, there is a sign of recovery in Portugal and Spain, presumably due to a partial disinvestment of unprofitable inventories.



Figure 6. Gross profit share of non-financial corporations.



Note: Data for Greece are not available. The gross profit share of non-financial corporations expresses a share of gross operating surplus over value.

Source: Eurostat.

Not only was capital productivity growth weak, but labor productivity growth also lagged behind wage growth in 1995-2008. Hence, unit labor costs rose in all countries of the Euro-periphery (Fig. 7).<sup>4</sup> Specifically, if a rise in unit labor cost is driven by an increase in wages higher than the increase in labor productivity, this can be viewed as a loss in cost competitiveness.<sup>5</sup> In the Euro-periphery, this is what happened: in the years 1995-2008, the average growth of labor compensation of employees was 5.1 percentage points higher than the growth of labor productivity.<sup>6</sup> Final-

ly, even though there were signs of recovery in the years 2010-2012,<sup>7</sup> they were of a temporary nature, as unit labor costs have started to increase again.

### What next?

The almost balanced current accounts in the Euro-periphery create a false sense of security. Very low interest rates and easy credit could again attract borrowing for consumption and unprofitable investment, as it happened before the crisis. In this regard, the high level of nonperforming loans is especially worrisome (Fig. 8). New borrowing from abroad to refinance these loans would only postpone adjustment and lay the ground for a new debt crisis.

<sup>4</sup> According to the OECD methodology, unit labor cost is defined as the ratio of total labor compensation to real GDP. Alternatively, it can be calculated as the ratio between labor compensation per labor input (per hour worked or per employee) and output per labor input.

<sup>5</sup> Growth of labor cost higher than growth of labor productivity could be compensated by a reduction of other costs of production. In this case, cost competitiveness wouldn't decline.

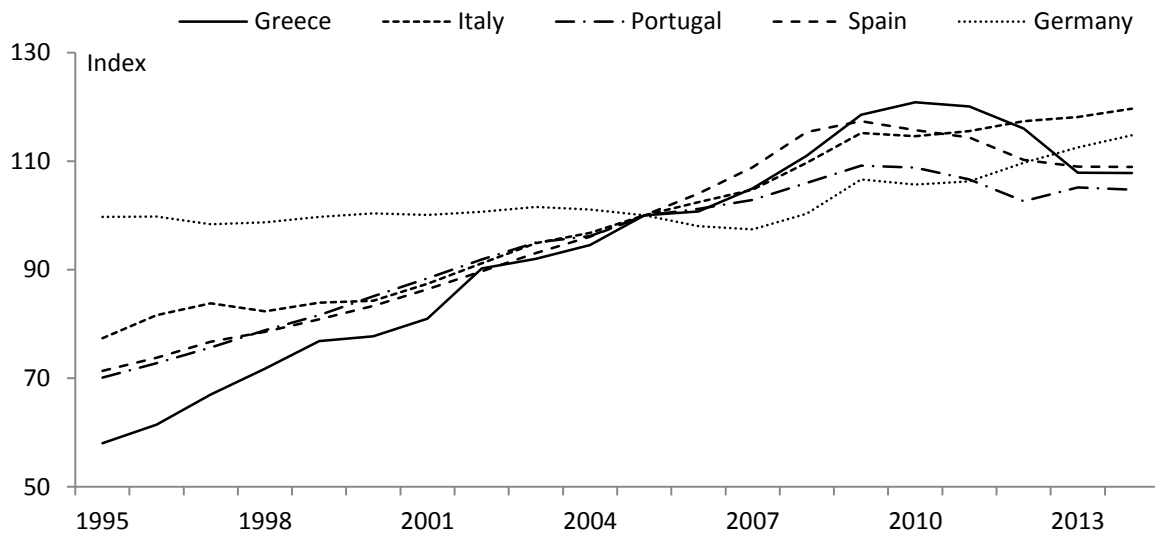
<sup>6</sup> In Greece, average growth rate of labor compensation was equal to 7.8% against 2.0% growth of labor productivity. The corresponding numbers were 4.1% against

0.4% in Italy, 4.6% against 1.1% in Portugal, 7.2% against -0.2% in Spain and 1.7% against 0.9% in Germany.

<sup>7</sup> See Buti, M. and Turrini, A. "Slow but Steady? Achievements and Challenges in Competition Disinflation within the euro Area", ECFIN Economic Brief, Issue 16, November 2012.

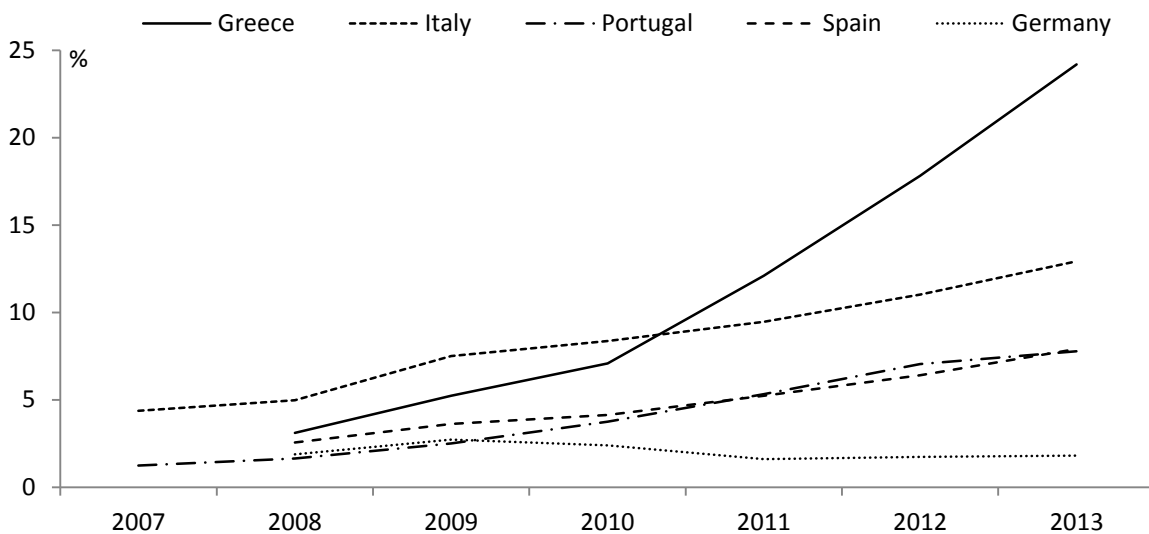


Figure 7. Unit labor cost, index (2005=100).



Source: Haver.

Figure 8. Nonperforming loans in percentage of total loans.



Source: Haver.

What is urgently needed is the write-off of these loans, so as to create a sound base for new productive investment.<sup>8</sup> When invest-

<sup>8</sup> Recently, the European Commission (precisely, the DG Competition) started to investigate on the possible state-aid problem of the so called deferred tax asset (DTA) schemes, which allow banks to obtain future tax credits from credit losses. Clearly, DTAs give incentives for the write-off of nonperforming loans, although it is

ment takes off, current accounts may fall into deficit again. But if the investment leads to an increase in the productive capital stock, high capital dividends will raise national savings and current account deficits will disappear again.

debatable whether they should count as regular equity in bank balance sheets.



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