Axel A Weber: Macroeconomic imbalances in the European Monetary Union – causes and policy challenges

Speech by Professor Axel A Weber, President of the Deutsche Bundesbank, at the Kangaroo-Group/EPIC lunch, Strasbourg, 22 September 2010.

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1. Introduction

Ladies and gentlemen

First, I would like to thank you for your invitation. It is a pleasure to be here, and I am looking forward to discussing the problem of macroeconomic imbalances in European Monetary Union (EMU) with you. Intra-EMU divergencies and the resulting imbalances in current account positions are not a new phenomenon. In fact, they have existed since the beginning of the monetary union. However, in the pre-crisis years the associated problems were partly masked by strong global economic expansion and the continuing integration within the euro area. It was the financial crisis that revealed the structural nature of the divergencies, and they are now a prominent and controversial issue in public debate.

In my speech, I would like to provide a brief overview of the causes of the intra-EMU divergencies and imbalances. Having laid the groundwork, I would then like to discuss what policy options we have in dealing with the imbalances.

2. Causes of macroeconomic imbalances in EMU

2.1 Diverging current accounts are not per se a problem …

The public debate on divergencies within EMU focuses on the current account positions of member states; let us take a look at them first. Some member states such as Germany, Austria or the Netherlands have persistent current account surpluses. Other countries such as Portugal, Spain, Greece or Ireland show persistent current account deficits. In principle, a current account surplus or deficit reflects saving or borrowing at the national level. And, as for individuals, there is no reason why economies as a whole should not save or borrow. Consequently, there is no reason for current accounts to be balanced in equilibrium.

A current account surplus or deficit reflects a discrepancy between domestic savings and investment. Such a discrepancy is not necessarily a bad thing. Consider the following examples: countries with an ageing population usually save more than they invest as they face declining domestic investment opportunities. Hence, they have temporary current account surpluses. At the same time, countries that are catching up on economic development usually invest more than they save as they have ample investment opportunities but are usually short of capital. As a consequence, they run temporary current account deficits. The common feature in both these cases is that the current account serves to smooth consumption over time, and thereby raising welfare. Thus, it has an inherent intertemporal dimension.

As a result of the relationships I have just sketched, capital flows from countries with relatively large savings to countries with relatively high investment. In EMU this flow of capital was increased by the introduction of the euro. There were two reasons for this. First, exchange rate risk was eliminated, making cross-border investments less risky. Second, country default risks were increasingly perceived as converging towards a relatively low level. According to theory, the intra-EMU capital flows should reverse once investments in deficit countries start to pay off. However, in reality, diverging current account positions might also reflect underlying distortions – this was the case in EMU.

2.2 … but proved problematic in EMU

The main problem for member states with current account deficits was that the inflow of capital was not always allocated efficiently. In Spain and Ireland it went into booming real estate markets, in Greece it funded high government deficits and in Portugal it supported private consumption. This allocation spurred internal demand and, owing to inflexible labour markets, wages increased more than productivity. This, in turn, reduced the competitiveness of the countries in question. As a consequence, imports increased, exports dwindled and the current account deficit grew further.

Although these imbalances have domestic roots, the associated problems are not confined to the national level. Given spill-over effects in the closely integrated euro-area financial markets, they are also a problem for other member states and for the monetary union as a whole. The debt crisis in the first half of this year was a case in point. Its external effects mean the problem of divergencies and imbalances in EMU has to be solved. What are the policy options?

3. Policy options

A major dispute regarding policy options is the question of which group of countries has to adjust. In an asymmetrical approach only the deficit countries would act while a symmetrical approach would require economic policy in both deficit and surplus countries to adjust. As I just argued, the deeper causes of the imbalances are domestic factors within the deficit countries. Hence, it is mainly incumbent on them to act. A number of structural reforms are necessary to enhance the competitiveness of domestic companies by increasing productivity and keeping costs in check. At the same time, the deficit countries have to increase labour market flexibility and consolidate government budgets. In the end, domestic absorption will have to return to a sustainable level.

Proponents of a symmetrical approach say that surplus countries must also act. They claim that these countries have to boost domestic demand and, consequently, imports by using fiscal policy stimulus. It is also argued that surplus countries should raise wages, which would further increase domestic demand and at the same time reduce their competitiveness. However, when taking a closer look at these proposals, it becomes apparent that they are based on invalid assumptions.

To demand measures that would boost imports neglects the fact that trade flows are highly diversified. Given the current trade structure, an increase in German imports by 10% would improve the current account balance in Spain, Portugal and Greece by a mere 0.25 percentage point. The current account balance in Ireland would improve by 1 percentage point. The proposal of raising wages to support domestic demand and reduce competitiveness does not only neglect that wages are not a political control variable. Moreover, simulation studies show that the effects would be confined almost entirely to the home economy in the form of changes in employment. Finally, the argument that fiscal policy should be used to stimulate internal demand and imports overlooks the fact that public finances in surplus countries are also strained and that ambitious consolidation efforts are required in these economies as well to restore the sustainability of public budgets.

When looking at the international discussion, we must also bear in mind that the current account surpluses of China and, for instance, Germany are of a different nature – Germany does not manage its exchange rate nor does it impose capital controls. Nevertheless, what I just said does not imply that there is no need for reforms in surplus countries. Germany, for example, would benefit from more flexible labour markets and deregulated services and product markets. Improvements to the education system would also raise the economic potential. But these measures will not ease the need for adjustment in deficit countries.

4. Conclusion

Ladies and gentlemen, let me summarise my speech. The large current account imbalances in EMU are mainly due to structural domestic imbalances in deficit countries. Given spillover effects in integrated euro-area financial markets, the imbalances are a serious strain on the monetary union as a whole. They must therefore be corrected.

The relevant reform agenda has to centre on deficit countries. They will have to align demand and potential output more closely and, at the same time, consolidate government budgets. Compensatory measures by surplus countries would neither adequately address the problem nor would they bring notable relief to deficit economies.

What can European policymakers contribute? In the long run, procedures to ensure fiscal policy commitment will have to be strengthened, for example by enhancing the Stability and Growth Pact. More effective macroeconomic surveillance and the development of a crisis resolution mechanism would, at least in the medium term, also be helpful.

Thank you for your attention.