Imbalances within in the Euro Area

14th FIW-Workshop
Rebalancing the Global Economy
OeNB, Vienna, 18 March 2011

Andreas Wörgötter
OECD Country Studies V Division

Key OECD Readings

- 2009 OECD Economic Surveys: Estonia

Zuzana Brixiova & Margaret Morgan & Andreas Wörgötter, 2009. "Estonia and Euro Adoption: Small Country Challenges of Joining EMU," OECD Economics Department Working Papers 728, OECD Publishing.

Zuzana Brixiova & Laura Vartia & Andreas Wörgötter, 2009. "Capital Inflows, Household Debt and the Boom-bust Cycle in Estonia," OECD Economics Department Working Papers 700, OECD Publishing.

- 2010 OECD Economic Surveys: Germany

Isabell Koske & Andreas Wörgötter, 2010. "Germany's Growth Potential, Structural Reforms and Global Imbalances," OECD Economics Department Working Papers 780, OECD Publishing.

- 2010 OECD Economic Surveys: Euro Area
- 2010 OECD Economic Surveys: Slovak Republic

Outline

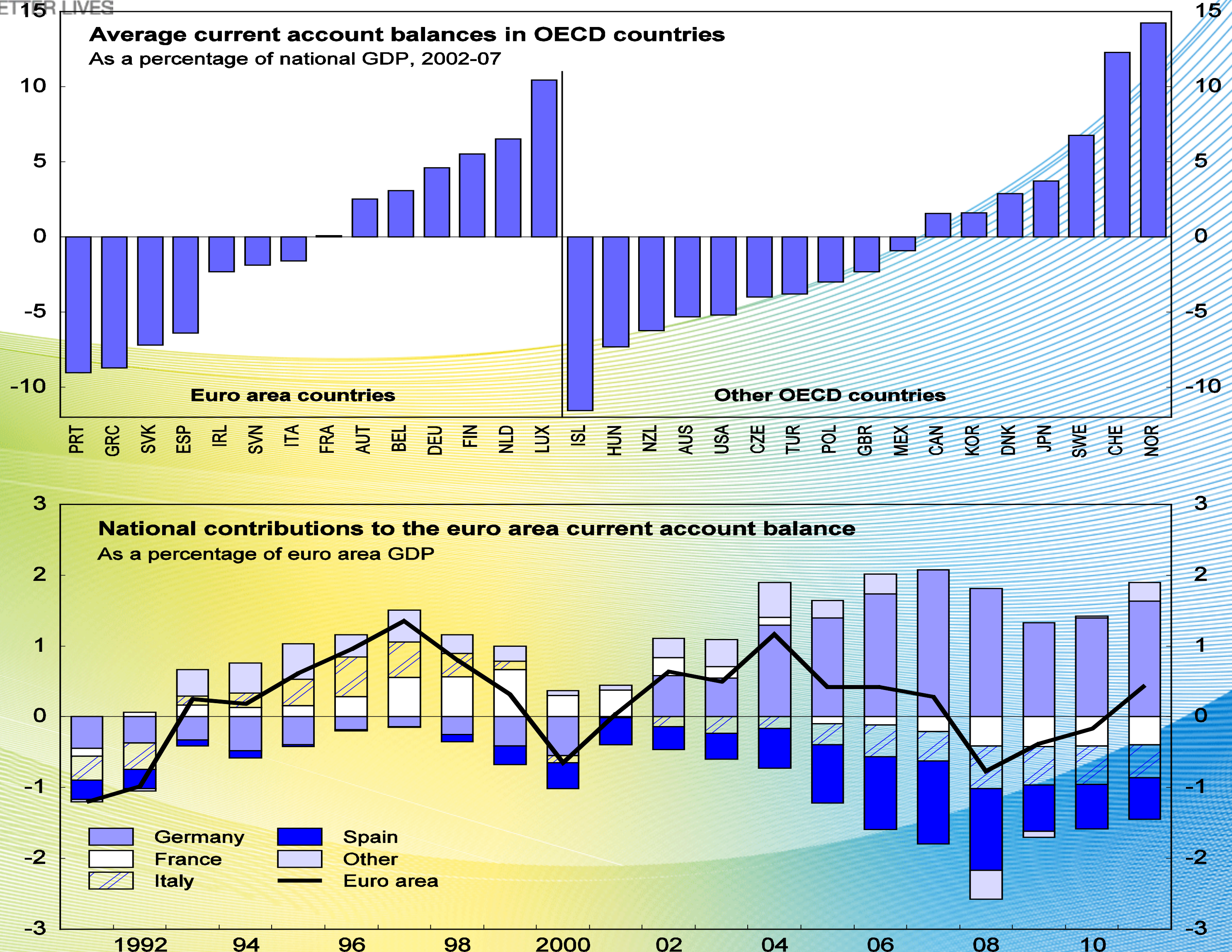
- What is the problem?
- Are euro-area imbalances big?
- Are all imbalances bad?
- Euro area imbalances: Is there a pattern?
- The role of structural reforms
- What could be the solution?

The problem

- Imbalances (in the euro area or elsewhere) can cause distortions, increase volatility and possibly also reduce potential growth

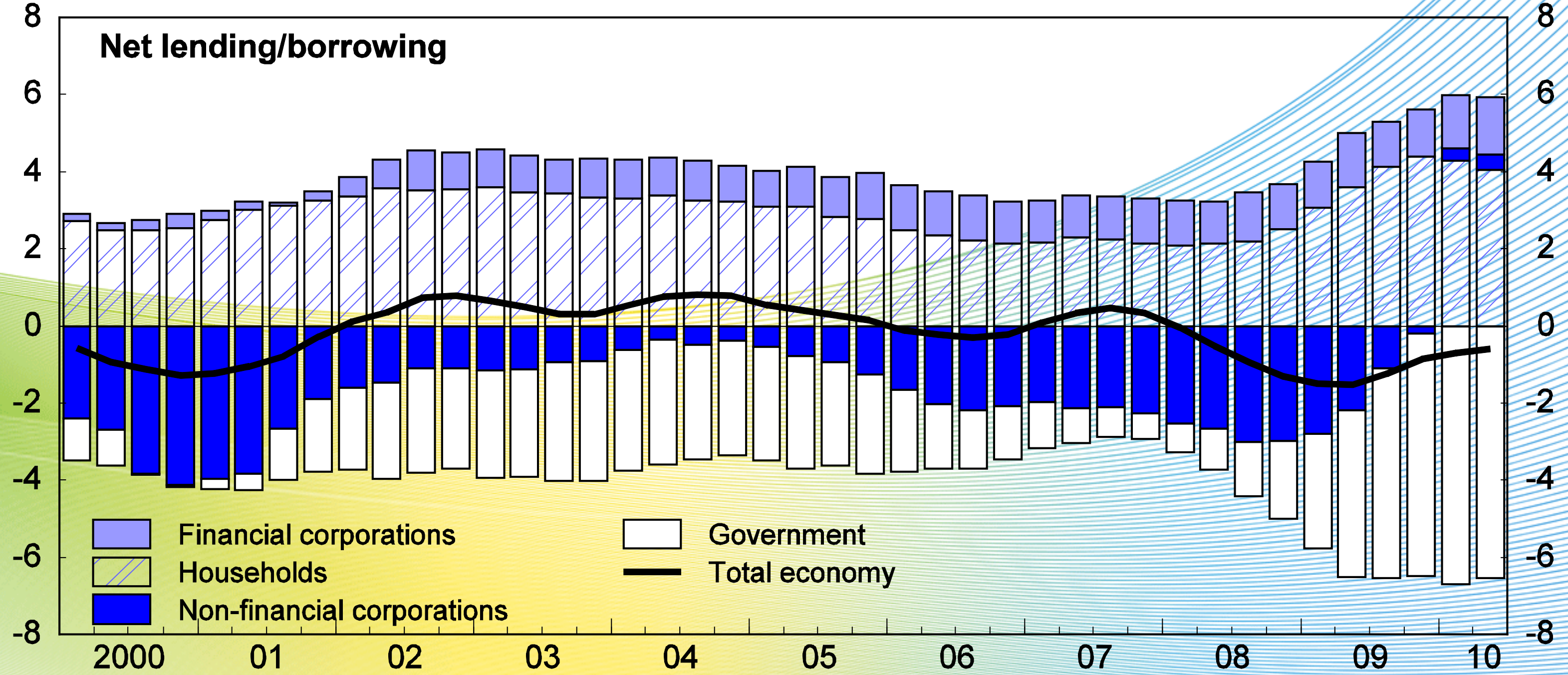
External imbalances in the euro area have been large and persistent

ORIGINS OF THE CRISIS



The pace of recovery will be moderate as the economy rebalances

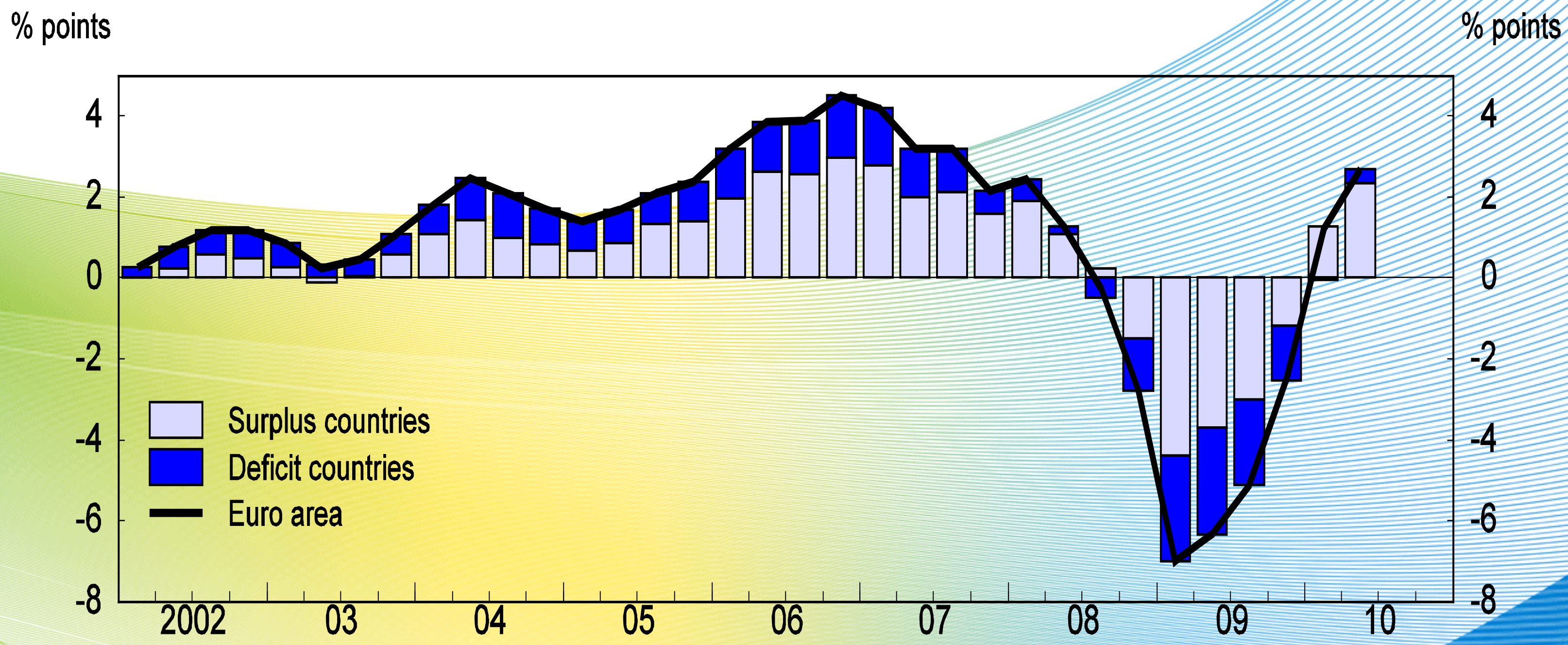
Euro area sectoral balances as % of GDP



Source: OECD Economic Outlook 88 database.

Prolonged adjustment in some countries will slow the pace of recovery

Contributions by deficit and surplus countries to annual GDP growth



Source: OECD Economic Outlook 88 database.

Good and bad imbalances

- Good: convergence (growth rates differ)
- Good: FDI (capital flows from countries with low rates of return to countries with high rates of return
- Good: Pre-saving for ageing (savings rates differ)
- Bad: capital inflow financed public or private consumption booms

Good imbalances: convergence

Growth differentials, which close income gaps
Income differentials in the euro area are wide:
2000: 81 (Greece) to 134 (Netherlands)
2009: 64 (Estonia) to 131 (Netherlands)
Up to 2007/8 convergence took place and new member countries posted impressive catch-up (1-2 ppt of EU27 average, however the previous cohort (GRE, ESP, POR) posted only half these growth differentials! The big recession reversed some of the convergence gains and the outlook for further catch-up is very uneven

Good imbalance: FDI Flows

- If countries which are lagging behind attract more FDI inflows then they can boost their productive potential
- Fidrmuc&Reiner(2011) find a positive relationship between exports, FDI on one side and growth on the other side. However, this relationship is not present everywhere:
  Export led growth: POL, ROM, SVK and SVN
  Domestic led growth: BLG, CRO, EST, HUN, LIT

Bad imbalances: Unsustainable capital inflows

- Capital inflows, which finance an increase of private or public indebtedness, which is not backed by correspondingly increasing income earning opportunities are not sustainable, distort economic structure and generate volatility at home and abroad. Subsequent deleveraging is among the reasons why recovery of private or public consumption after the bursting of such booms is slow.

Bad imbalance: non-neutral policy rates

- Divergence of the national business cycles in euro area member countries means that the ECB policy rate is not appropriate for the currency area as a whole, even if it might be appropriate on average.
- This stresses the importance of national fiscal policies for smoothing the cycle and structural policies to maintain and increase potential growth

Examples for euro area imbalances

- Germany – invest, but not at home
- Netherlands – to small for its big pension funds
- Estonia/Baltics – a loan financed bubble
- Slovak Republic – FDI driven

What are we talking about? - I

- Estonia is a former Soviet Union Republic, re-gained independence in 1991
- Location: South of Finland, East of Sweden, North of Latvia and West of St. Petersburg
- Estonia is the smallest of the Baltic Republics
- The macroeconomic policy framework is simple: No government debt and an at least balanced budget (Compare with US), the currency was first fixed to the Deutschmark, then to the euro and is now a member of the

What are we talking about? - II

- Estonia has embarked on an economic policy strategy, which favours economic growth and minimises redistribution of income or wealth
- Flat tax
- No corporate income tax on retained earnings
- Low income replacement rates of unemployment benefits (introduced only recently)

What are we talking about? - III

- The economy successfully re-oriented its trade flows from East (with Russia) to the West, in particular the European Union
- The crisis in 1997/8 was quickly overcome and a process of rapid convergence to European average income levels set in
- Estonia joined the EU in 2004, became a member of OECD in 2010 and joined the euro area at the beginning of 2011

What are we talking about? - IV

- Economic growth between 1999 and 2007 was high, but unbalanced with a current account deficit of around 20%
- Growth was fuelled by capital inflows financing housing and residential construction (housing), as well as other domestic demand related activities
- The boom went bust in the wake of the global financial crisis, which dried up wholesale refinancing

Macroeconomic and financial indicators

	Foreign bank credit (% of host GDP)	Current account balance (% of GDP)		Reserves to short-term external debt	Net external position *vis-à-vis* BIS-reporting banks (% of GDP)	Private-sector credit	Inflation
	End-2007	2007	2008[1]	End-2007		Year-on-year, 2008[2]	
Estonia	**161.7**	**-18.1**	**-10.8**	**0.2**	**-78.7**	**21.5**	**11.1**
Bulgaria	90.4	-21.4	-24.4	1.1	-29.0	54.5	14.5
Hungary	87.0	-5.0	-5.5	0.9	-54.1	18.0	6.7
Latvia	125.5	-22.9	-15.1	0.3	-72.5	22.2	16.7
Lithuania	92.4	-14.6	-14.9	0.9	-45.6	36.4	12.2
Poland	51.1	-3.8	-4.7	0.8	-17.1	29.5	4.8
Romania	50.6	-14.0	-13.8	0.9	-36.4	62.0	9.0

Sources of the domestic demand boom

	Domestic demand/GDP	Investment/GDP			Consumption/GDP		
		Total	Private	Public	Total	Privat e	Public
Estonia	**4.8**	**9.1**	**8.8**	**0.3**	**-4.2**	**-2.3**	**-1.9**
Czech Republic	-7.2	-2.4	-3.6	1.3	-4.8	-3.7	-1.1
Slovak Republic	-7.4	-2.4	-1.2	-1.2	-4.9	-2.0	-2.9
Slovenia	0.9	6.3	5.9	0.4	-5.4	-3.9	-1.5
Finland	4.7	2.5	2.7	-0.1	2.2	1.3	0.9
Sweden	-0.9	2.0	2.7	-0.7	-2.9	-2.4	-0.5

Composition of Estonian FDI stock

	2000	2001	2002	2003	2004	2005	2006	2007
Manufacturing	21.6	20.7	18.8	16.9	16.8	14.9	17.4	14.6
Trade	15.6	13.2	13.5	14.8	10.0	8.8	10.3	13.4
Transport	21.5	22.5	21.4	16.4	5.2	3.5	7.0	4.2
Financial intermediation	**24.3**	**25.2**	**28.0**	**26.2**	**31.5**	**38.8**	**28.3**	**33.2**
Real estate	**7.8**	**7.6**	**9.5**	**18.0**	**30.8**	**27.8**	**29.7**	**26.8**
Other	9.1	10.8	8.7	7.7	5.7	6.2	7.3	7.8

Questions about the sustainability of private debt (not public debt)

- Sustainable private debt needs to be backed by an increase in the future income raising capacity of the household:
  - A student loan can be services from the increased income of a graduate
  - A loan for a car could be paid back with the higher income earned because of higher mobility
- However, if a loan has to be paid back by reducing consumption in the future, then the associated growth is not sustainable

Elements of policy debate

- Germany replaces the exchange rate (which it cannot move) by wages as the instrument in its "beggar-thy-neighbour" policy
- German labour market policies are keeping wages low, which depresses disposable income and consumption and therefore imports
- G20 taking "concerted actions to sustain the recovery, create jobs and achieve stronger, more sustainable and more balanced growth"
-

How to link low growth with imbalances

- It is still useful to think in terms of the absorption approach:
  $X-M=(S-I) + (T-G)$
- An obvious candidate for a link between growth and imbalances is investment, and indeed Germany has the lowest investment rate of all G7 countries
- But will more investment not mean higher export capacity and hence higher current account surplus?

Excursion I: What makes the German export sector so successful?

- Focus on manufacturing (Germany has the biggest manufacturing sector among G7)
- Vocational school system
- Stable employment with on-the job training possibilities
- Firm-specific incremental innovation
- Possibility (and managerial ability) to outsource cost sensitive production steps

Excursion II: Why is the German non-traded sector not more dynamic?

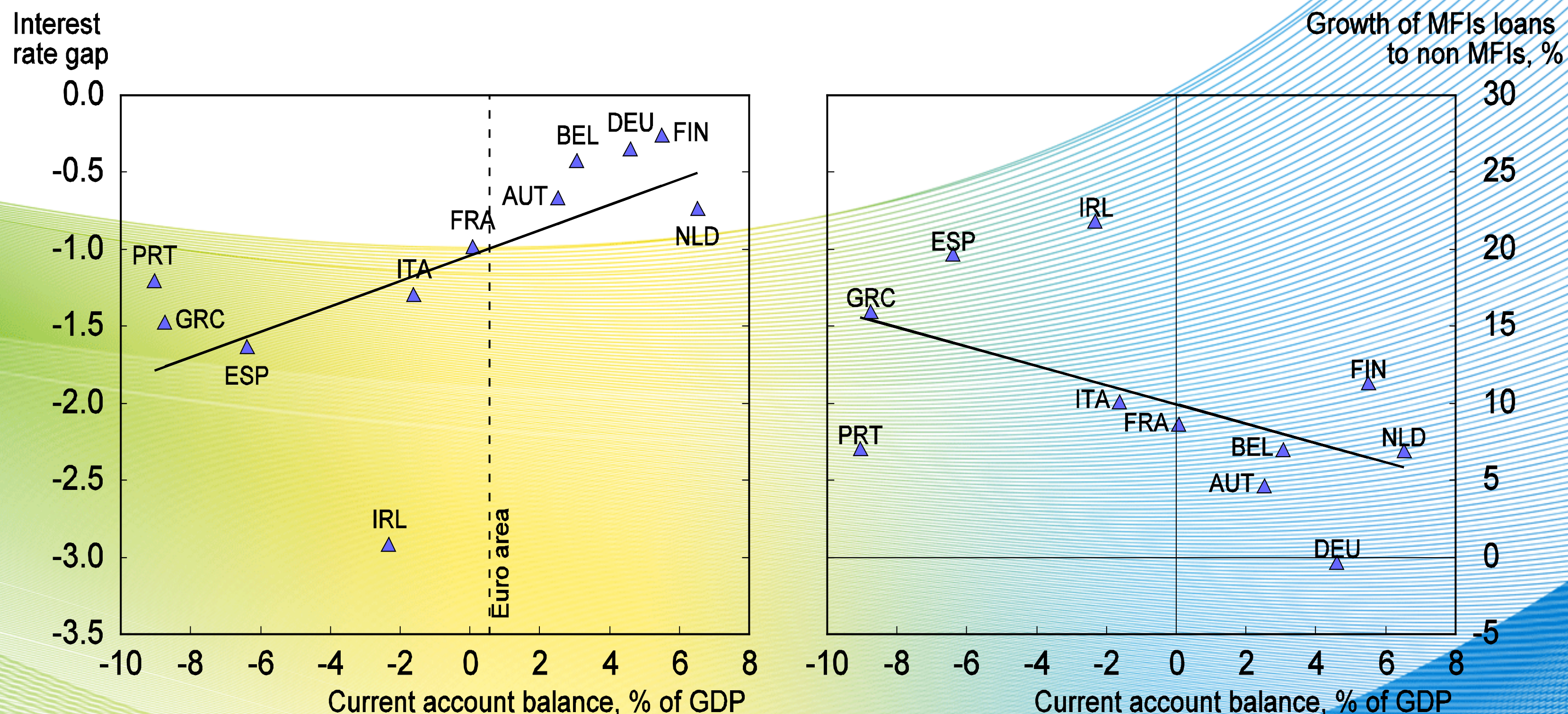
- PMR is relatively strict (in particular in professional services)
- The workforce with tertiary education is relatively low
- Skills bottlenecks are difficult to overcome
- Conclusion: Introduce policies, which boost the non-traded sector, while not damaging the export sector

Not every CA ≠ 0 is out of equilibrium

- Globalisation should reduce the constraint on local investment being financed by local savings. CA imbalances become a problem if they are linked with a solvency/sustainability problem. In other words, if a CA imbalance is linked with a Ponzi-scheme then the wind is blowing from all directions simultaneously

Diverging real interest rates were destabilising, sparking credit cycles

Period averages 2002 to 2007

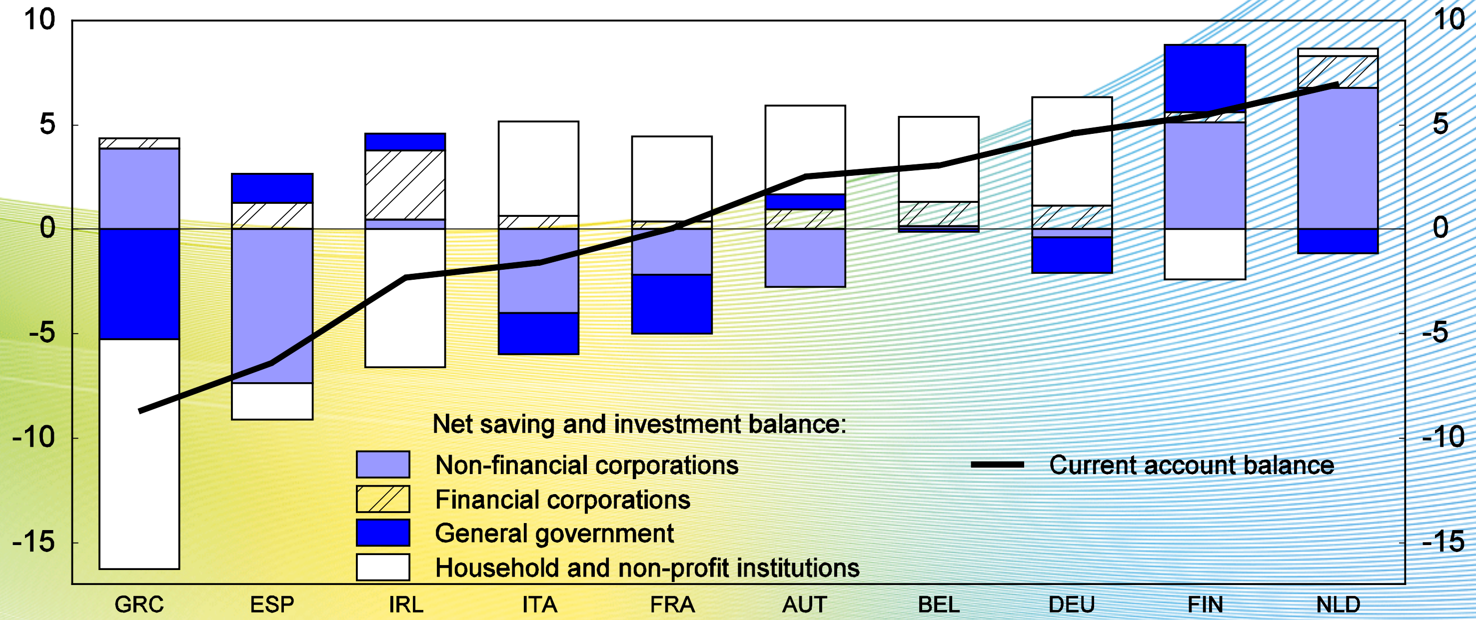


Source: OECD Economic Outlook 88 database.

Initial conditions are difficult

REFORMS - IMBALANCES

Net saving and investment balances and the current account, % GDP 2002-07

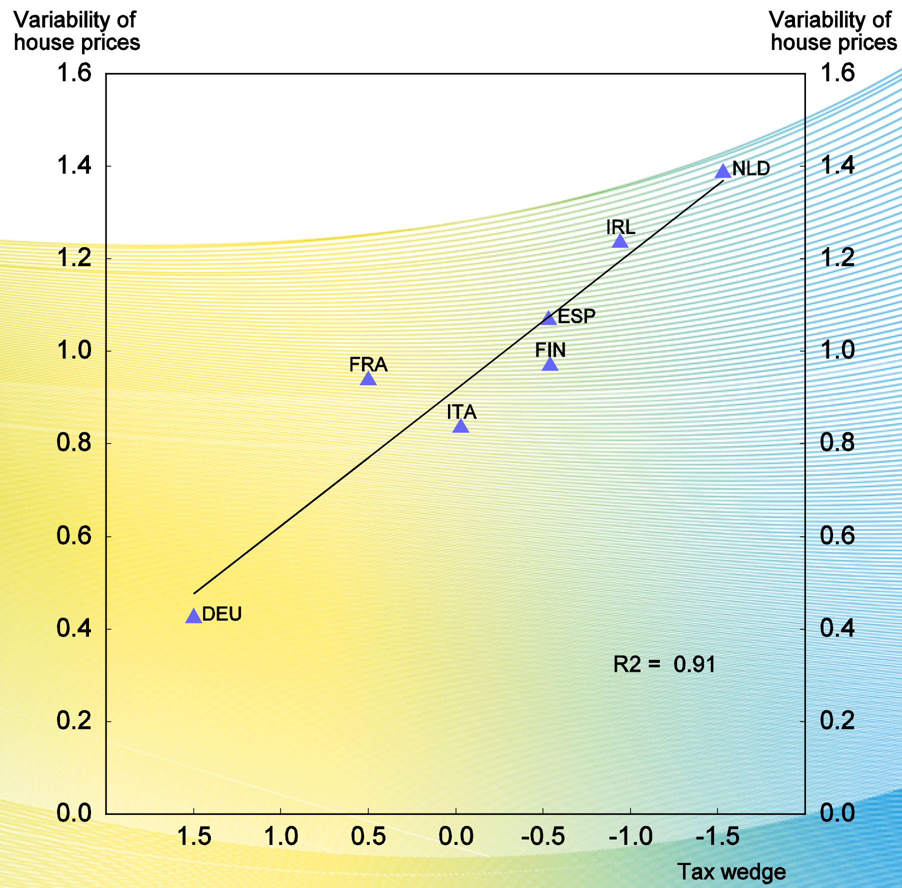


Source: OECD Economic Outlook 88 database.

Distorted housing markets encourage bubbles

REFORMS - STRUCTURAL

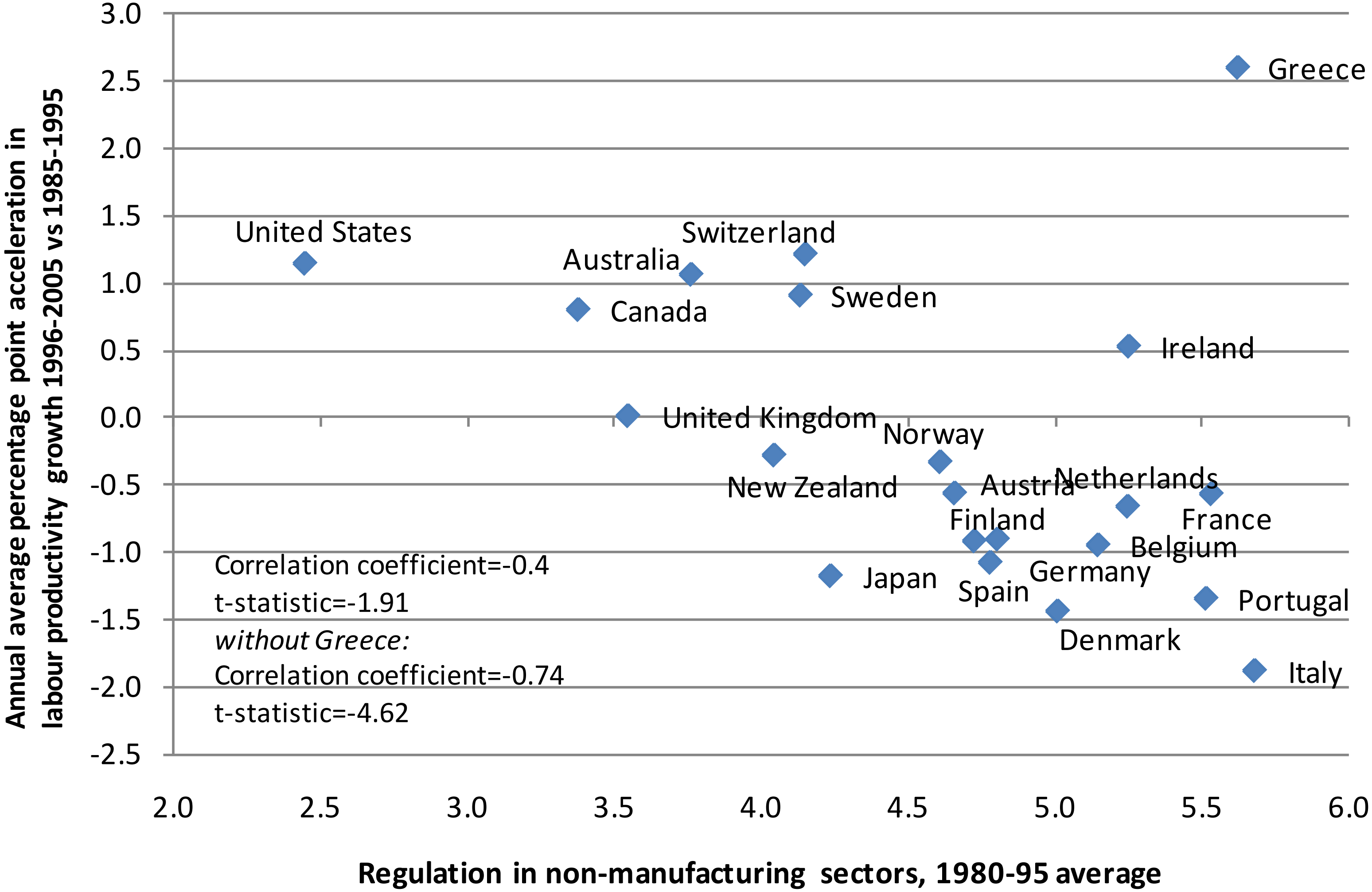
House price volatility and the tax treatment of housing



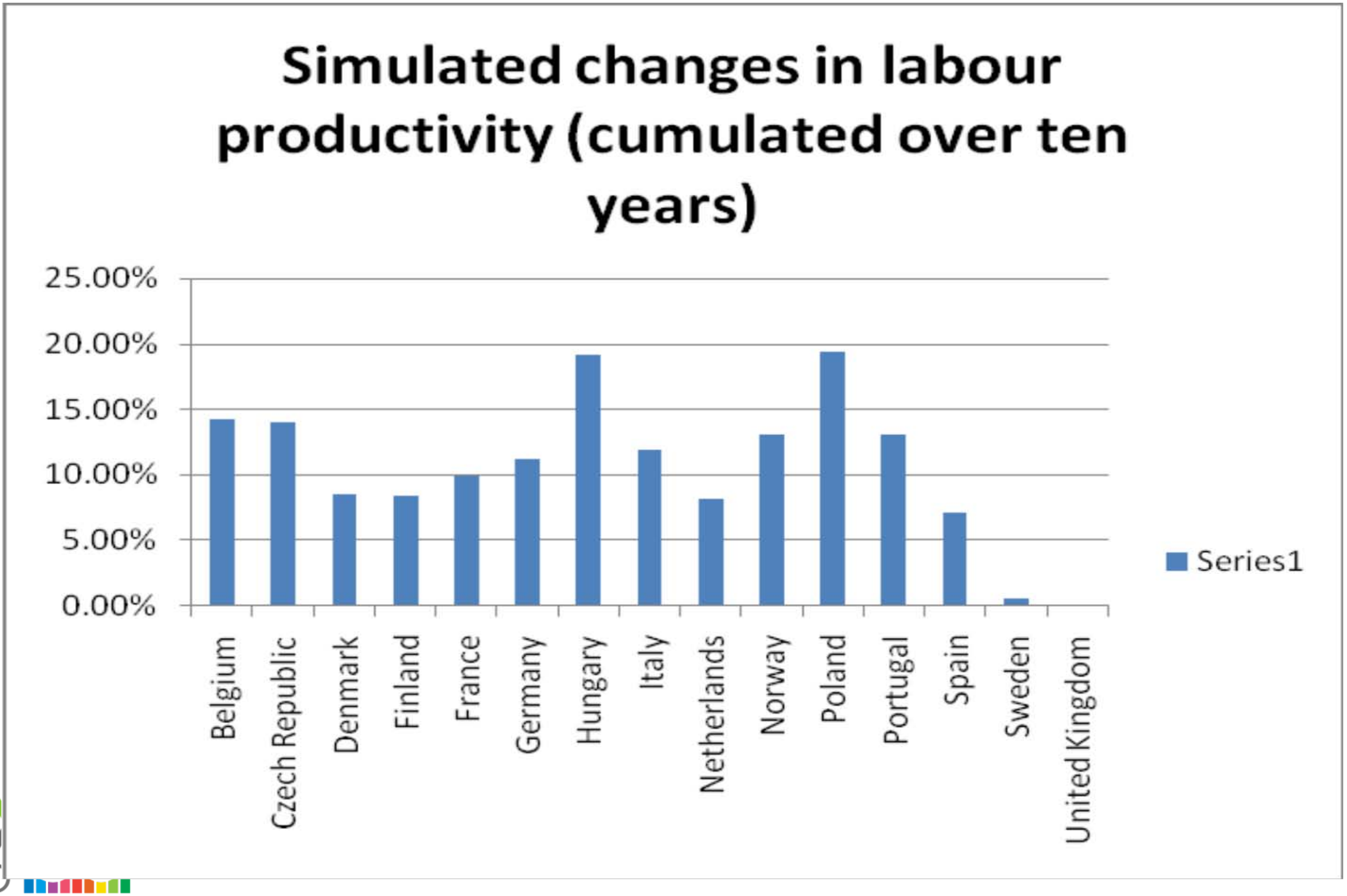
A little bit of theory

- Absorption approach – looking at flows
  CA = Exp-Imp = Tax-Gov+Sav-Inv
- A framework to link structural reforms, potential growth and the current account (work in progress)

Regulation and productivity acceleration are negatively correlated

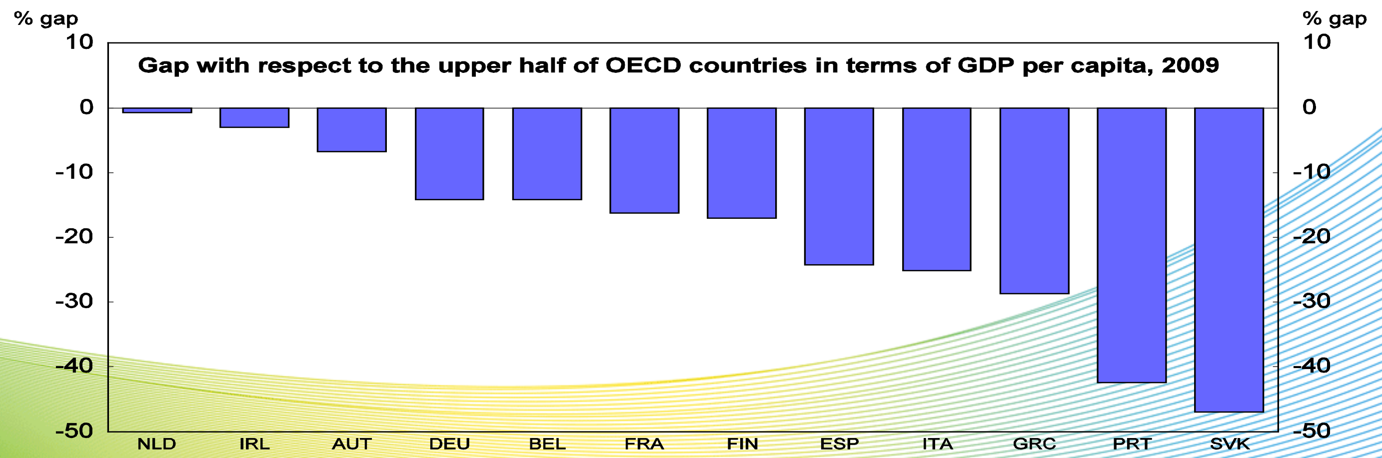


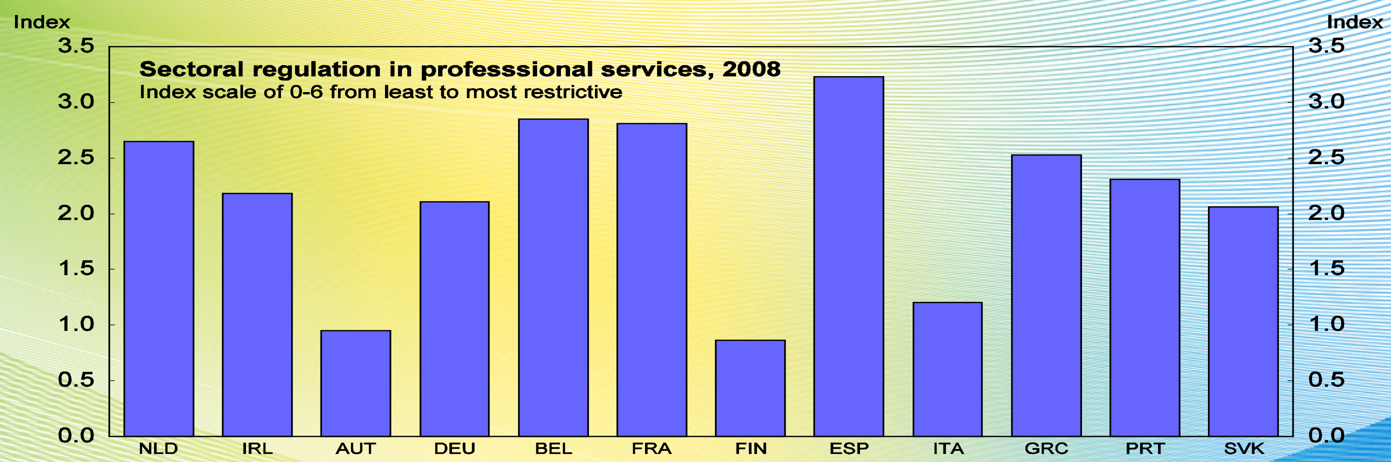
The impact of lighter PMR on labour productivity



REFORMS - STRUCTURAL

Structural reforms would encourage more sustainable growth





Source: OECD, *Going for Growth 2010*

What could be elements of the solution

- Sustainable fiscal policies
- Avoiding pro-cyclicality/strengthening counter-cyclicality
- Prudent lending to private households
- Structural reforms which reduce bad imbalances and increase potential growth

FURTHER INFORMATION

[www.oecd.org/eco/surveys/euro area](www.oecd.org/eco/surveys/euroarea)