

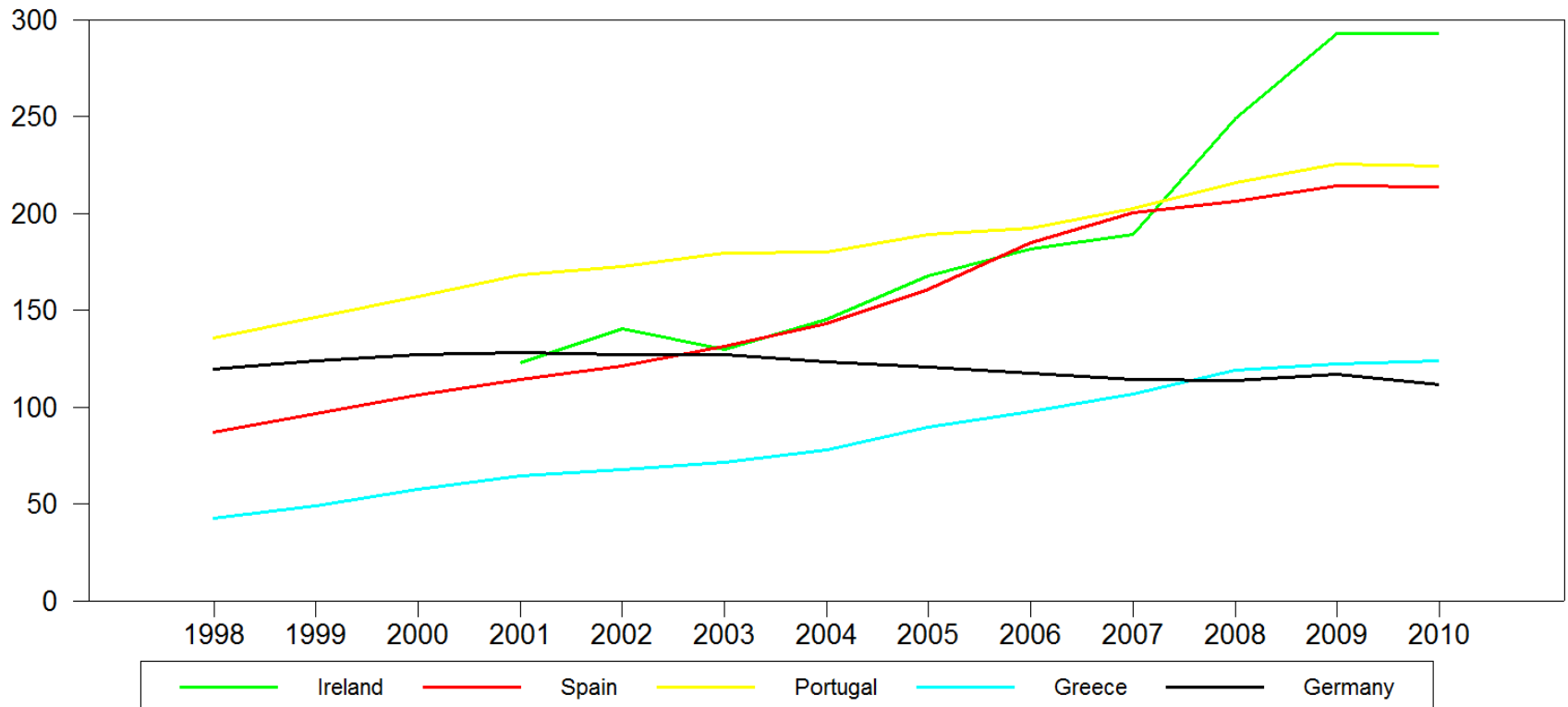
Macroeconomic Imbalances in the Euro Area

Karl Whelan
University College Dublin
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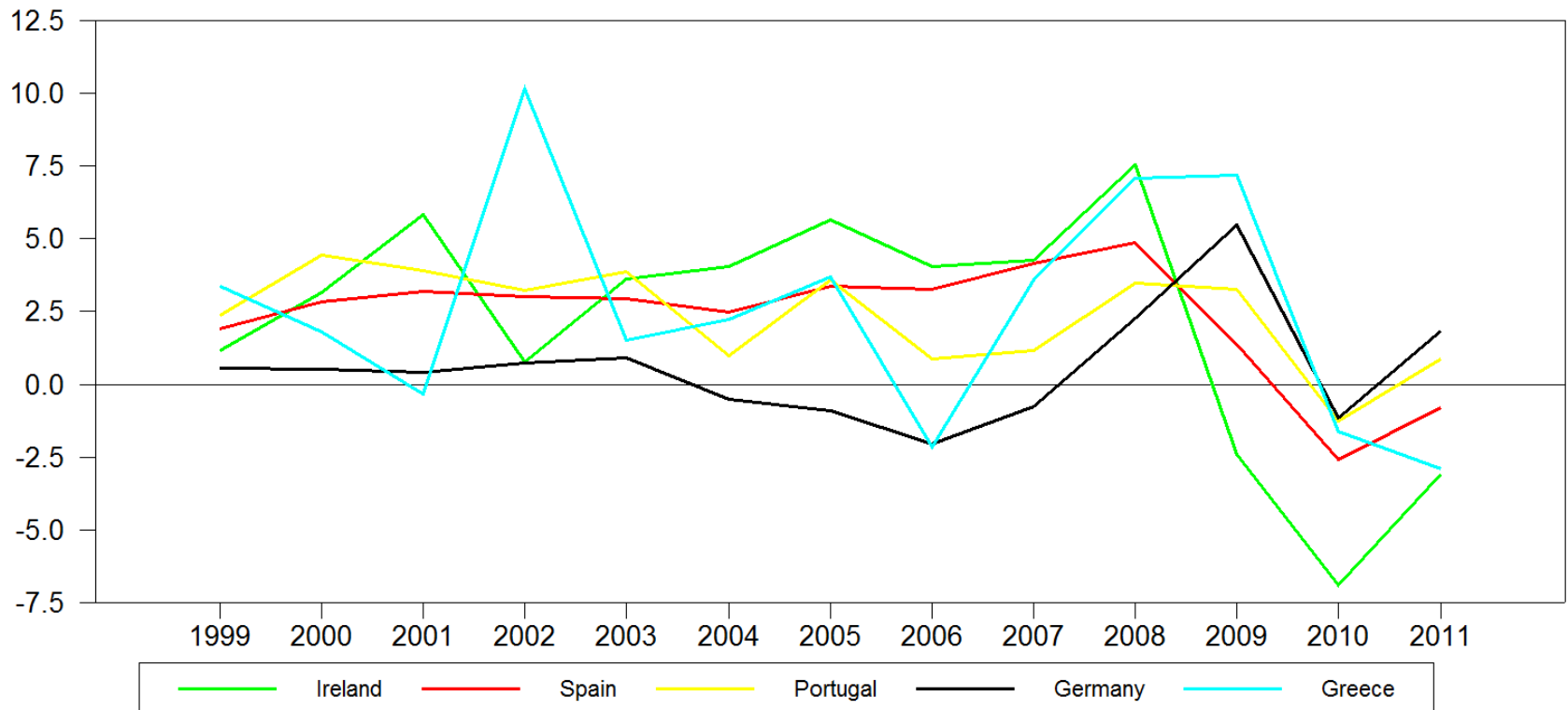
The Euro and the Development of Macroeconomic Imbalances

- EMU lead to
 - Large reductions in interest rates in periphery.
 - Disappearance of exchange rate premia.
 - (Mistaken) disappearance of sovereign risk premia.
 - Increased financial integration.
- The result
 - Easing of market discipline on governments.
 - Private sector able to take on larger debt burdens
 - Surge in aggregate demand in periphery.
 - Higher current account deficits and loss of competitiveness.

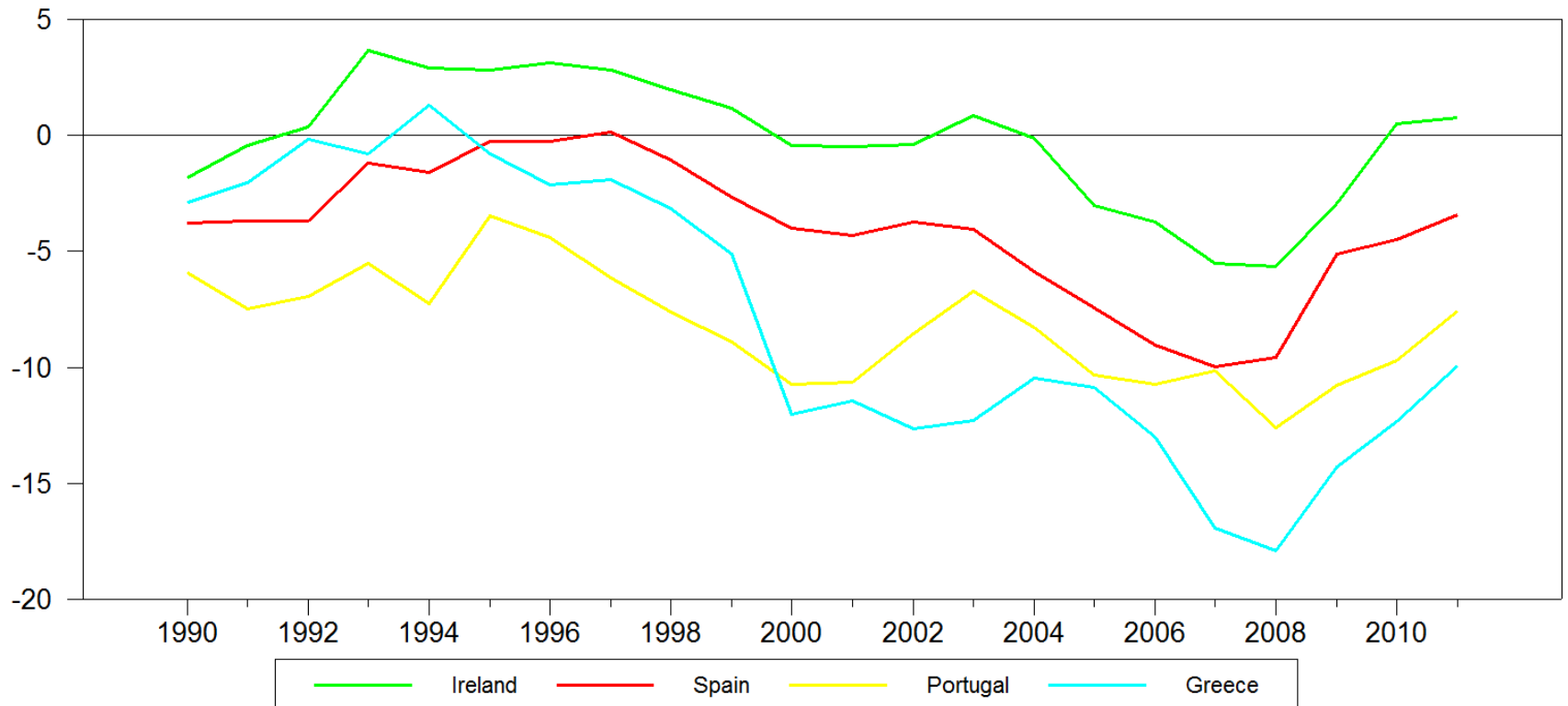
High Private Debt-GDP Ratios



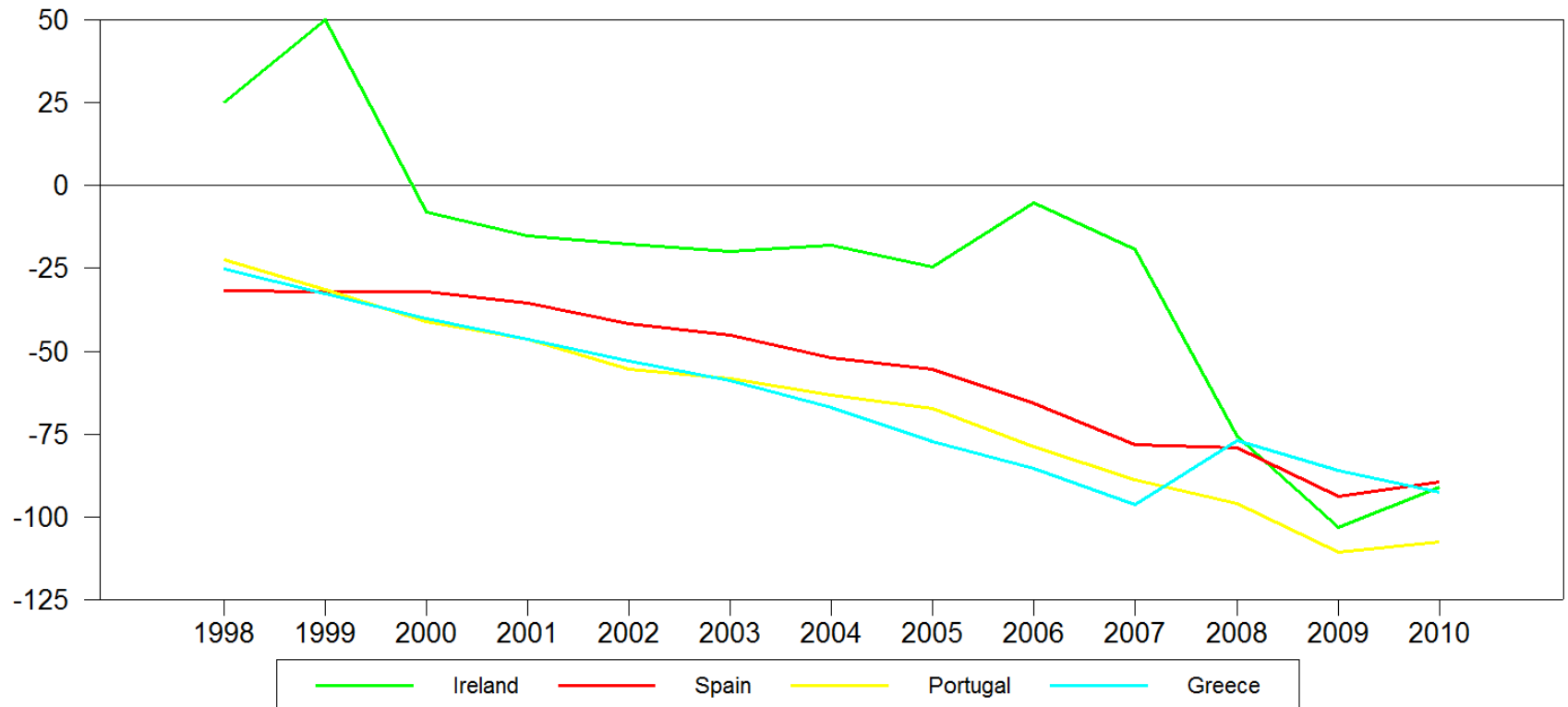
Unit Labour Cost Growth



Current Account Balances



Net International Investment Positions



Why Current Accounts Matter Now

- In a closed economy the sum of public sector and private sector surpluses equals zero.
- In an open economy both public and private sector can run surpluses if current account balance is positive.
- Barriers to large peripheral current account surpluses:
 - No exchange rate adjustment
 - Low Euro area inflation target makes competitiveness catch-up slow.
 - Macro-policy formulation in core countries.

Reforms Are Not Enough

- Official EU stance: Reforms will produce productivity increases and cost reductions to restore competitiveness.
 - Link between reforms and productivity are uncertain.
 - Reforms often disruptive in the short-term and can undermine buy-in to fiscal adjustment.
 - Reforms not a magic wand that undoes downward nominal wage rigidities that apply in all modern economies.
 - Nominal wage cuts exacerbate debt deflation problem for highly indebted households.

Two Sided Adjustment Required

- Regulation introducing the MIP states that for member states with large surpluses should “*identify and implement measures that help strengthen their domestic demand*”
- But the MIP Scorecard fails to identify Germany as having an excessively large current account surplus.
- And other elements of the scorecard are all asymmetric, promoting cost reductions and exports.
- Commission call this “intelligent symmetry”.
- I don’t agree. I view this as a lost opportunity.

Current Account in Germany and GIPSI Countries

Billions of Euros

