Tjalling C. Koopmans Research Institute

Universiteit Utrecht

Utrecht School of Economics

Tjalling C. Koopmans Research Institute
Utrecht School of Economics
Utrecht University

Kriekenpitplein 21-22
3584 EC Utrecht
The Netherlands
telephone +31 30 253 9800
fax +31 30 253 7373
website www.koopmansinstitute.uu.nl

The Tjalling C. Koopmans Institute is the research institute and research school of Utrecht School of Economics.
It was founded in 2003, and named after Professor Tjalling C. Koopmans, Dutch-born Nobel Prize laureate in economics of 1975.

In the discussion papers series the Koopmans Institute publishes results of ongoing research for early dissemination of research results, and to enhance discussion with colleagues.

Please send any comments and suggestions on the Koopmans institute, or this series to J.M.vanDort@uu.nl

ontwerp voorblad: WRIK Utrecht

How to reach the authors

Please direct all correspondence to the second author.

Nils Holinski
Clemens Kool*
Jan Piplack
*Utrecht University
Utrecht School of Economics
Kriekenpitplein 21-22
3584 TC Utrecht
The Netherlands.
E-mail: c.j.m.kool@uu.nl

This paper can be downloaded at: http:// www.uu.nl/rebo/economie/discussionpapers

Utrecht School of Economics
Tjalling C. Koopmans Research Institute
Discussion Paper Series 14-05

After the Fall: Euro Area Adjustment

Nils Holinski
Clemens Kool[a]
Jan Piplack

[a]Utrecht School of Economics
Utrecht University

March 2014

Abstract
Macroeconomic adjustment in the Southern countries of the euro area after the financial crisis appears well under way as external imbalances in these countries have almost disappeared. However, in this paper, we argue the underlying strctural problems persist and recovery is fragile. Both sovereign debt and external debt are approaching sustainability thresholds and indications of substantial structural reform are insufficient yet for the Southern countries. Prospects for higher growth in the near future are dim, due to lack of economic reforms, private and public debt overhang and imposed austerity programs. Moreover, the observed adjustment is strongly asymmetric and leads to more rather than less divergence. Overall, we feel the chosen approach will prove to be unsustainable and infeasible in the near future. To defend the euro and the euro area, a new approach is urgently needed.

Keywords: macroeconomic imbalances, current account, competitiveness, economic integration, optimum currency area

JEL classification: F42, F32, F36.

Acknowledgements
This paper was written on the occasion of the retirement of professor Joan Muysken, University Maastricht.

1. Introduction

Since 2008 the euro area economy has been struggling with the consequences of the global financial crisis, the subsequent eruption of national banking crises and finally the emergence of sovereign debt crises in some of the member states. Together this has resulted in persistently low economic growth and high and rising unemployment. Initially, mainly the Southern euro area countries seemed to be significantly affected. But gradually the impact is being felt in Northern countries as well.

To find appropriate solutions to the crisis and perhaps more importantly to take measures that will significantly reduce the likelihood of similar crises to emerge again, a better understanding of the underlying causes is crucial. Unfortunately, no consensus has appeared so far either in academics or in politics on the ultimate factors to blame. This is partly due to the complex cross-border interactions in today's integrated and complex global economy. The toxic mix of the liberalization and globalization of finance, the emergence of financial innovations traded in opaque financial markets and too easy credit conditions set the stage for high-risk lending, debt buildups in the public and private sector, asset price bubbles and macroeconomic imbalances in many developed countries.

However, for the euro area an extra factor has played a central role. Holinski et al. (2012) argue that the introduction of the common currency without a high degree of economic and political integration has been the main underlying factor that facilitated growing economic divergence within the euro area. In the period 2000-2007 this was reflected in growing cumulative current account imbalances within the euro area. Many of the Southern European members ran sustained current account deficits while the Northern members ran surpluses. The single currency and the integrated financial system, in particular the banking system, accommodated this divergence through private capital flows from North to South. Holinski et al. (2012) show that the divergence is not primarily caused by fiscal profligacy but – apart from Greece – by excessive private sector borrowing in the South. Holinski et al. (2012) conclude that the European crisis – at least initially – was not so much a fiscal crisis as a balance of payments crisis which had its roots in the real economy. Related to this, De Grauwe (2009) points out that differences in wage policies as well as differences in the speed of structural reform processes in labour and goods markets across euro area members have resulted in divergent degrees of competitiveness as reflected in different time paths of effective exchange rates.[1]

For many observers the importance of the balance-of-payments dimension of the current crisis has come as a surprise. During the run-up to the monetary union, broad consensus existed that within the future euro area balance-of-payments problems would be absent almost by definition. This belief was based on the idea that financial markets would be able and willing to fund any creditworthy private household or firm regardless of its national location and that net cross-country flows within the euro area would be comparable to interregional flows within countries and would be just as harmless. Ex post this view is seen to inappropriately neglect the fact that despite the monetary union significant country-specific effects remain. This is due to among others the organization of the banking systems – and corresponding implicit guarantee upon bank defaults – on a national basis as well as the national character of taxation and fiscal transfers in general.

Many policy actions have been taken by the euro area policymakers at both the national and supra-national level since 2007. Emergency support for countries in severe trouble has been set up through various channels. More structurally, on the fiscal side a European Semester has been introduced that

[1] The importance of the balance-of payments divergence as a characteristic of the euro area problems is also recognized by for instance Merler and Pisani-Ferry (2012) and Sturm et al. (2013).

considerably strengthens the ex ante coordination and control of national fiscal policy by the European Commission. Simultaneously, proposals for further integration of the European banking system into a full-fledged banking union are being negotiated.

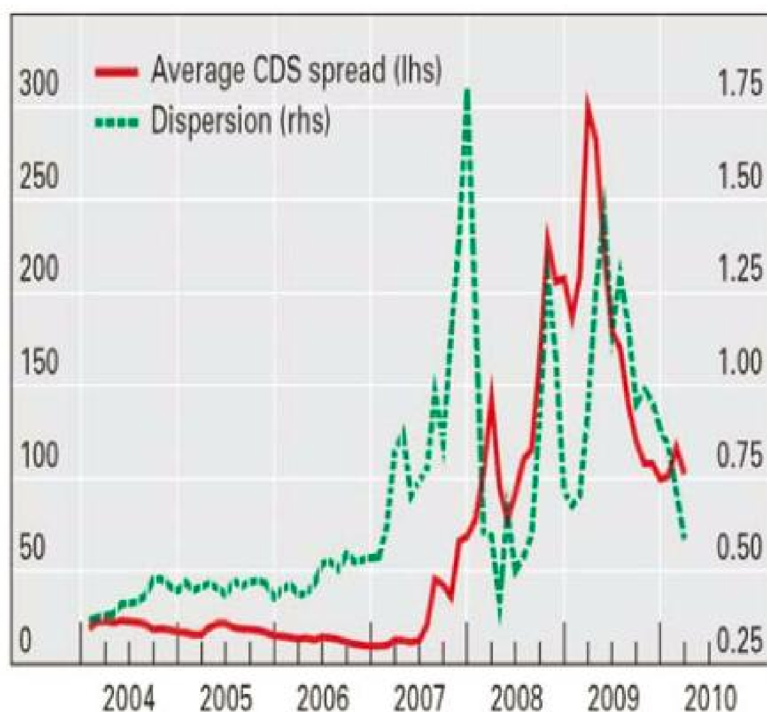
With respect to the balance-of-payments problem, the EC has introduced an excessive imbalances procedure to check and possibly correct unsustainable current account developments. However, the discussion about this latter procedure continues and important questions such as the issue of symmetric versus asymmetric adjustment remain. Currently, political and media attention appears to be focused on the fiscal side – the degree of required austerity – and the banking side – stress tests, and the organization of European regulation, supervision and resolution – rather than on the macro-economic imbalances and underlying structural divergences. In this contribution we intend to follow-up on Holinski et al. (2012) by providing a progress report on adjustment to macroeconomic imbalances in the euro area since 2007 and discussing the degree to which additional measures are necessary.

The paper is set up as follows. In section 2, we provide a broader background to the crisis as it has manifested itself in the euro area. Also, we briefly discuss the various short-run and long-run emergency measures that have been taken to cope with the crisis. In section 3, we extend the balance-of-payments analysis of Holinski et al. (2012) to the period 2007-2012 and discuss the degree to which adjustment has been successful as well as the degree of asymmetry. Section 4 concludes.

2. The Background

We already stressed that the causes of the euro area crisis are deep and diverse and strongly differ across member countries. Nevertheless, in our view the most visible trigger and starting point of the euro area crisis can be identified as Lehman Brothers' bankruptcy in September 2008. It resulted in a world-wide contagious meltdown of the global financial system which could only be prevented from a full collapse by massive interventions of the major national governments and central banks in many different ways. Most prominently, US and European governments had to support many banks and insurance companies by granting large credits and in some cases even nationalizing those companies as in the cases of Fannie Mae, Fannie Mac, AIG in the US and Royal Bank of Scotland, ING, Fortis and Hypo Real Estate just to name a few. As the virus of insecurity about the safety of counterparties spread through the globalized and much interconnected financial system, banks almost stopped lending each other funds. The international money market dried up and CDS spreads of financial institutions skyrocketed to never seen levels (Figure 1) leading to even more problems for banks to fund themselves and to keep enough liquidity to provide the funds that were now withdrawn from anxious customers and counterparties.

Figure 1: CDS market financial institutions



Notes: the CDS market is based on the CDS spreads of 34 large banks and 14 large insurance companies in Europe and North America. Average CDS spread (lhs) is in basis points. Dispersion (rhs) is the standard deviation of the cross section of CDS spreads, divided by the contemporaneous average.
Source: Bank for International Settlements. 2010. *Annual Report*, Basel, June

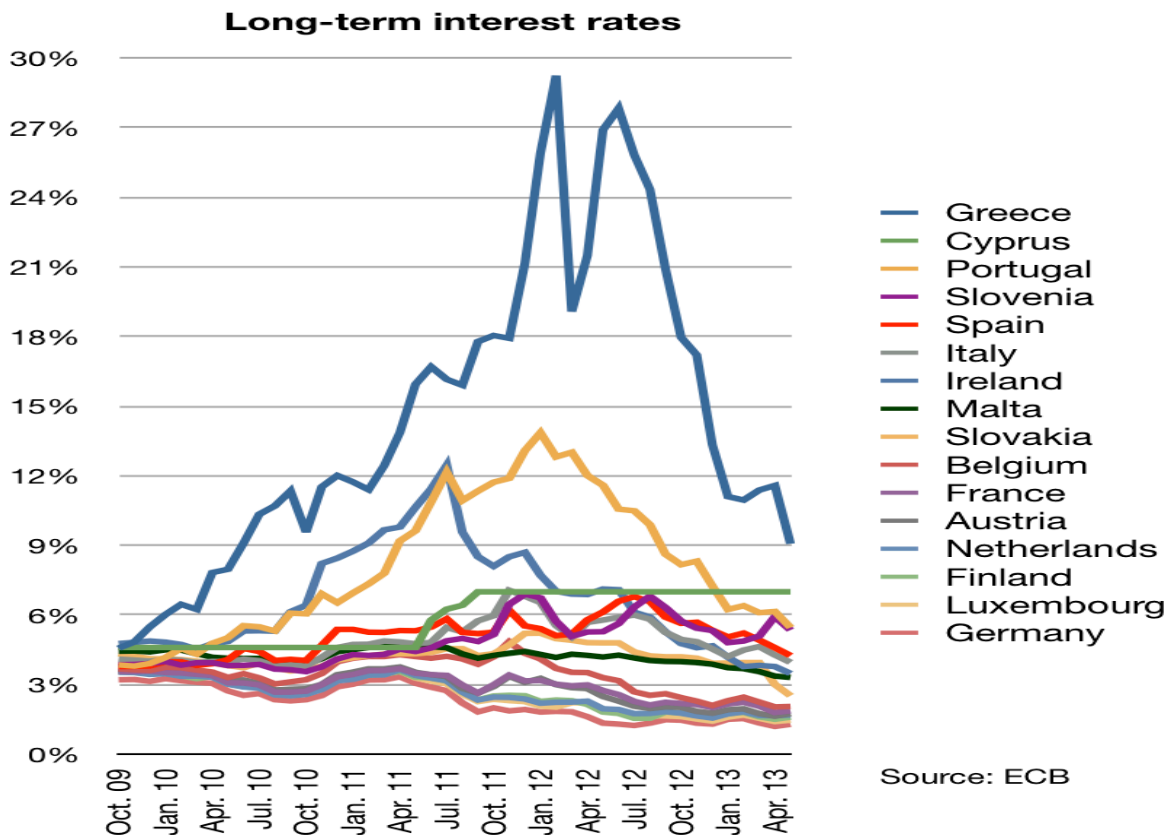
A vicious circle of mistrust started that could only be broken by unprecedented monetary policy measures. Central banks like the FED and ECB virtually flooded the markets with almost unlimited liquidity and drastically decreased interest rates. On top of this, many national governments had to intervene as well and recapitalize national banking systems in order to prevent their collapse like for example in the UK, the Netherlands, Germany, Ireland and Iceland.

Banks reacted by heavily restraining their credit granting, leading to a credit crunch. Together with world-wide fears about the collapse of the financial system and wide-spread uncertainty of consumers and producers it led to the strongest contraction of the global real economy since the great depression in the beginning of 1930s. Many European governments again intervened. This time the main objective was to support their national real economy and prevent wide-spread bankruptcies and unemployment. The interventions took different forms but mostly tried to boost demand for key national industries. Clearly such governmental interventions were credit-funded leading to sky-rocketing public deficits and debt levels. Governments literally took over parts of the crippling banking sector and its bad debts and simultaneously had to support the real economy with extra public spending.

In the beginning of 2010, the world economy seemed to stabilize and to get ready for more positive developments. Particularly in the United States, the clean-up of the banking sector advanced relatively quickly. Moreover, the Federal Reserve implemented an aggressive and sustained expansionary monetary policy. However, in Europe the next phase of the crisis was about to start. Markets got more and more concerned with the national sovereign debt levels – partly due to rescue packages in the

years before – in the peripheral European countries. Interest rates for countries with particularly high debt levels, government and/or current account deficits sky-rocketed. Especially Greece and later Portugal experienced difficulties to finance their budget deficits via financial markets (see Figure 2). Also, the European interbank market remained dead-locked due to the perceived weaknesses of individual European banks and the tight connections between European governments and their national banking system.

Figure 2: Long-term European interest rates 2009-2013

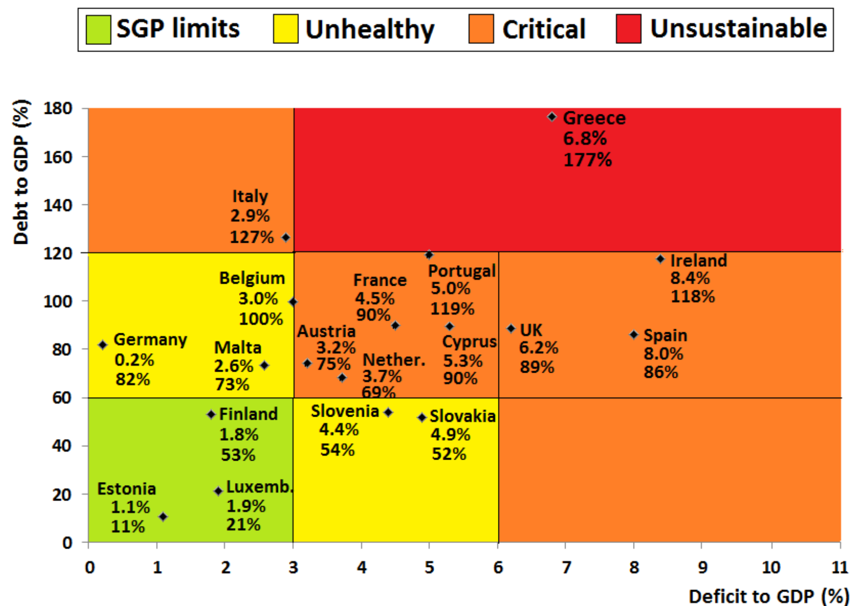


The increasing interest rates for government bonds of Mediterranean euro area countries created the danger of a vicious circle. A higher interest rate burden increased the probability of a sovereign default or even an exit from the euro area. In turn, this fueled further upward pressure on interest rates and widening yield spreads with safe haven countries like Germany, the Netherlands, Austria and Finland. Rolling over expiring government debt at market rates became increasingly infeasible for struggling countries. Moreover, efforts to reduce governmental deficits by i.e. higher taxes and/or lower expenses met with strong social resistance in the weak countries and were seen as insufficiently credible in financial markets. It failed to calm down markets or bring down interest rates and instead fueled further speculation about a possible break-up of the Eurozone. Note that hardly any progress was made on the parallel reform agenda in many countries.

By 2012 national debt levels relative to GDP had increased across the whole euro area compared to 2007, but most significantly so for the peripheral countries. In these countries, the increase was due to

high budget deficits on the one hand and contracting economies on the other. Figure 3 shows that countries like Greece, Portugal, Ireland and Italy in 2012 had national debt levels way above the 100% to GDP level. Also Spain is approaching that level of debt to GDP quickly with a deficit of 8% and a debt level of 86% to GDP in 2012, a very high unemployment rate (around 27.2 % in the first quarter of 2013[2]) and a contracting economy.

Figure 3: European budget deficits and public debt to GDP - 2012

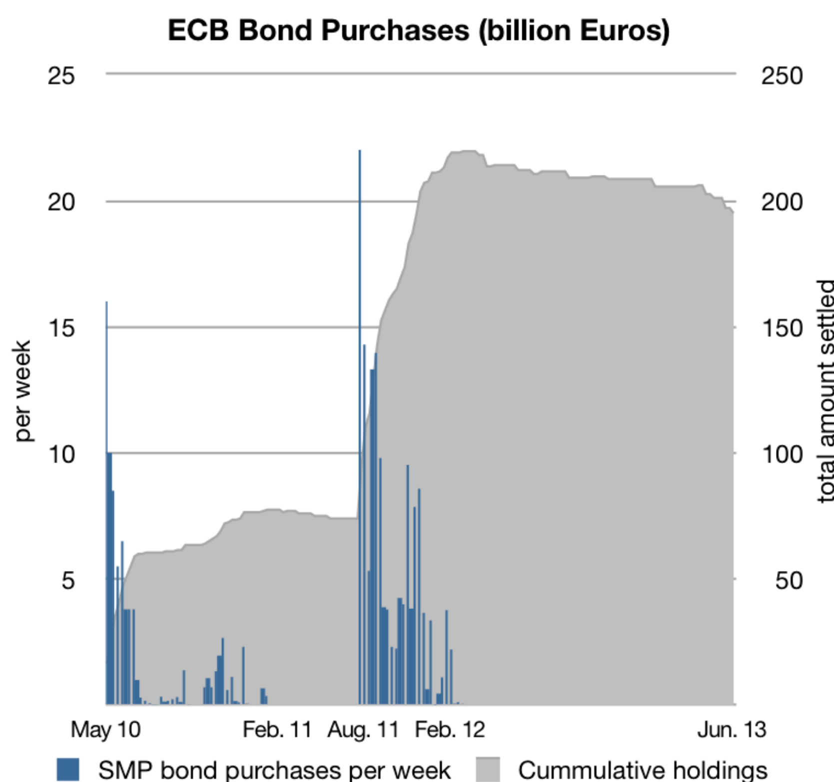


Meanwhile, euro area leaders and the ECB also installed some supra-national arrangements to prevent contagion and endangerment of the euro itself. The most prominent ones are the following:

- In May 2009, the EU member states created the European Financial Stability Facility (EFSF) providing financial assistance to Eurozone countries in difficulty to roll-over their government debts.
- In January 2011, the EU created the European Financial Stability Mechanism (EFSM) an emergency funding program reliant upon funds raised on financial markets guaranteed by the European Commission and the budget of the EU as collateral.
- Both EFSF and EFSM were replaced in September 2012 by the permanent rescue funding program European Stability Mechanism (ESM)
- The ECB has taken several (controversial) measures to bring down interest rates on some countries government debt. Like the FED the ECB also lowered dramatically its interest rates. Most prominent though and also most effective was Chairman Mario Draghi’s announcement on 26 July 2012 to purchase short-term government debt of struggling Euro countries without any limits. The extent to which the ECB intervened in the governmental debt market can best be seen in Figure 4 where the ECB’s bond purchases and holdings are recorded. Here the massive purchases in 2010, 2011 and 2012 are shown with an almost quadrupling of the holding during the second half 2011 and the first half 2012.

[2] Source: Spanish national institute of statistics

Figure 4: ECB Bond Purchases and Holdings in Billion Euros



Since the 2nd half of 2012, interest rates have started to come down somewhat (Figure 2). The most important factor behind this reduction definitely is the ECB's announcement to buy an unlimited amount of short-run government bonds of weak countries. Also, markets appear to be willing to take a wait-and-see approach with respect to fiscal consolidation and structural reforms in the different countries. Despite these positive signs, the situation is still very uncertain. Low growth remains a threat to fiscal consolidation both because of its negative effect on the debt/GDP ratio and the eroding effect on public support for further cutbacks. Political unrest is another potential cause for new financial market turbulence, as witnessed by the recent rise in interest rates when two Portuguese ministers stepped down. The big clean-up of the banking systems across Europe is still to come and the European banking union which is supposed to break the detrimental link between individual governments and their national banking system is still on the drawing table. Finally, it is unclear to what extent and at what speed promised reforms of product and labour markets will be implemented.

In the next section we turn to an overview of the factual developments in macroeconomic adjustment in the euro area as indicated by a number of balance-of-payments statistics.

3. Development of macro imbalances since 2007

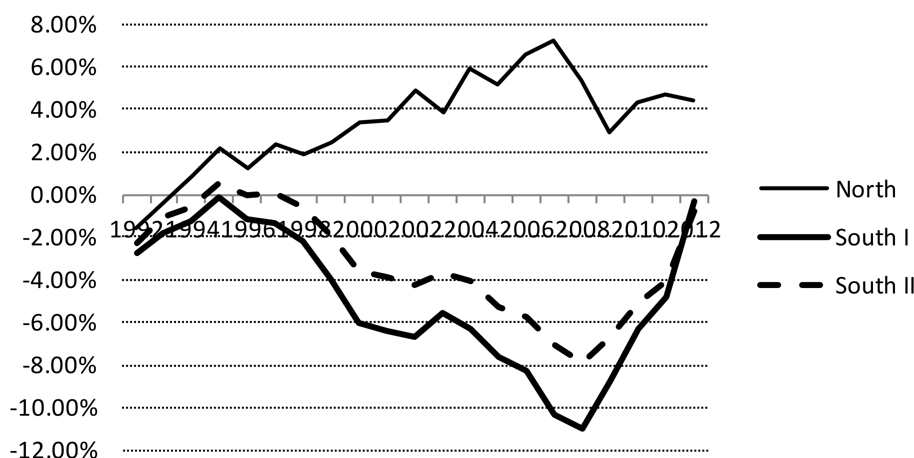
Holinski et al. (2012) analyze the external positions of two groups of euro area member countries over the time period 1992-2007. They distinguish the run-up period to the euro area 1992-1998 and the infant stage of the actual euro area 1999-2007, till the start of the global financial and economic crisis in 2008. With hindsight, the first years of the euro area are easily described as a time period with a stable political and economic environment which was ideally suited to initiate and steer the convergence processes that the introduction of a common currency called for. Unfortunately, this time was wasted. Instead a remarkable divergence process was embarked on that led to the emergence of a

group of countries as distinct net foreign debtors and another group of countries as distinct net foreign creditors. The former group includes Greece, Ireland, Portugal and Spain (henceforth referred to here as *South I*), while the latter group includes Austria, Finland, Germany and the Netherlands (referred to as *North*).

Now we extend the analysis with the period 2008-2012. This sheds light on the development of external imbalance patterns in the euro area during the more recent crisis years. We intend to investigate whether the current economic crisis has set into motion equilibrating forces to obtain convergence within the euro area. In the public debate, Italy and France are often associated with the weak Mediterranean countries. Therefore, we explicitly include them in the analysis by creating a group *South II* that includes the *South I* countries plus Italy and France. In the subsequent analysis, we take un-weighted averages across the members of one group for a number of macroeconomic variables to keep the analysis manageable. Obviously, considerable heterogeneity also exists within groups. Where appropriate, we will explicitly account for this heterogeneity.

Figure 5 provides suggestive evidence that both the start of the euro in 1999 and the start of the financial and economic crisis in 2008 constitute a sort of turning points. Already in the 1990s, during the run-up to the euro the Northern countries have current account surpluses on average while the Southern ones have deficits. The size of the gap remains limited though. From the late 1990s onward, the current account balances of *North* and *South I* start to diverge to a gap of about 16 percent of GDP in 2008, leaving *North* as sizeable surplus countries and *South I* as sizeable deficit countries. Since 2008 current account development displays a different pattern for the two regions. While we observe largely stable current account surpluses of around 4 percent of GDP for *North*[3], we see that current account balances in *South I* bounce back from the low of about minus 11 percent of GDP in 2007 and 2008 to almost reach equilibrium in 2012. All four countries in *South I* experience a considerable improvement in the current account. However, only Ireland has managed to generate a sizable surplus, where the other three countries in 2012 still registered deficits. Taking into account Italy and France in *South II* leads to a somewhat less pronounced development of the current account imbalances, but leaves the qualitative picture roughly unchanged. In fact, both Italy and France have relatively stable small current account deficits over the third sub period.

Figure 5: Current Account (1992-2012)



[3] Finland is the exception. Its current account surplus gradually moved from a large surplus in 2007 to a small deficit in 2012.

The first column of Table 1 confirms that the variation in overall net savings as well as in net public versus net private savings was quite limited for *North* across the three sub periods. In the crisis period the private sector starts saving a bit more while the public sector saves less. Given the fundamentally different economic environment before and after 2007, the observed stability in *North* is in itself an interesting finding. For *South I* and *South II* , a completely different pictures emerges. In the third sub period a complete reversal of the second takes place: private savings increase to a level close of that in the 1990s, whereas public savings substantially decrease. On average, total net savings of *South I* and *South II* respectively are roughly constant across the second and third sub period, but the composition is vastly different. In addition, Figure 5 shows that these averages – while approximately similar across the two periods – hide the fact that in the second period the average concerns a downward trending current account, while in the third period it relates to an upward trending current account. The bottom line is that on the macroeconomic level, adjustment is decidedly asymmetric with the burden falling completely on the Southern group of countries.

Table 1: Current Account versus Public and Private Savings

	Net savings			Net public savings			Net private savings		
Region	**1992-1998**	**1999-2007**	**2008-2012**	**1992-1998**	**1999-2007**	**2008-2012**	**1992-1998**	**1999-2007**	**2008-2012**
North	0.9%	4.8%	4.3%	-2.4%	0.6%	-1.2%	3.3%	4.2%	5.6%
South I	-1.5%	-6.8%	-6.3%	-4.9%	-1.9%	-8.7%	3.1%	-4.9%	2.5%
South II	-0.6%	-4.4%	-4.9%	-4.9%	-2.0%	-7.2%	4.3%	-2.4%	2.3%

Figure 6: Net Public Savings (1992-2012)

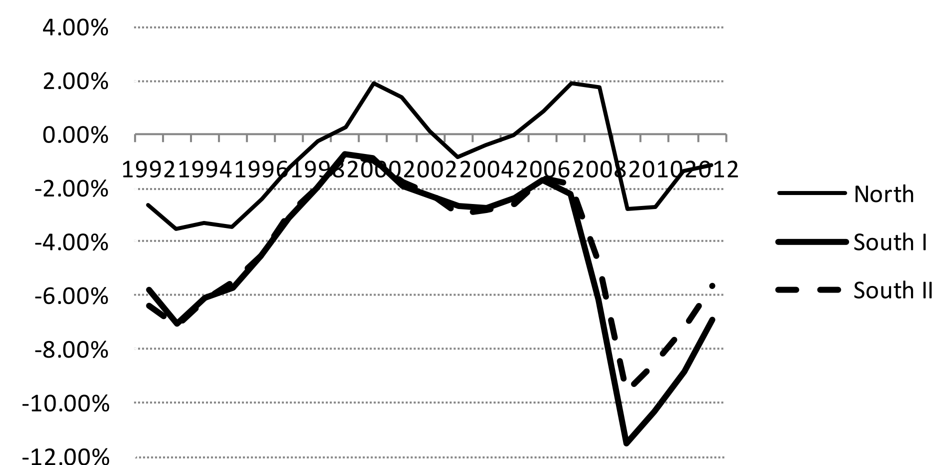


Figure 6 provides a more detailed picture of the dynamics of net public savings in the third sub period. During the second sub period Southern governments ran deficits around 2 percent of GDP, while Northern countries on average experienced balanced budgets. The limited cycles around these averages correspond to the business cycle, with some deterioration during recessions and improvements during booms. The close correspondence between *North* and *South* in these cycles is tentative evidence for the high degree of economic integration of the euro area as a whole.

The financial crisis, followed by the euro sovereign debt crisis, causes a structural break in this pattern with a decline for *North* to deficits around 2 percent, with Finland and the Netherlands doing much worse than Austria and Germany. Both *South I* and *South II* see an impact decline of net public

savings to -11 and -9 percent of GDP in 2009 respectively. This holds especially true for all countries in *South I*. Since 2010, the austerity measures imposed by the troika of EU, ECB and IMF have led to a partial rebound. The change in public finances in France and Italy is marginal.

Figure 7 exemplifies the development of net private savings. The small rise in North is almost exclusively due to the Netherlands. The reversal of private savings in *South* as displayed in Table 1 actually is an underestimation, due to its average character. Net private savings in *South I* and *South II* climb from an all-time low of minus 8 and minus 5.5 percent of GDP in 2007 respectively to new heights of about 5 to 6 percent of GDP in 2012. Again, the effects in France and Italy are small. Such tremendous changes in the decisions of households and firms to save indicate the enormous extent of the shocks that the private sector is experiencing in these countries and the degree to which it is reacting to the severe financial and economic crisis since 2008. This becomes even more visible when we consider gross private savings and private investment separately in Figure 8, Figure 9 and Table 2. These underline the adjustment taking place in the Southern countries as opposed to the relative stability in *North*.

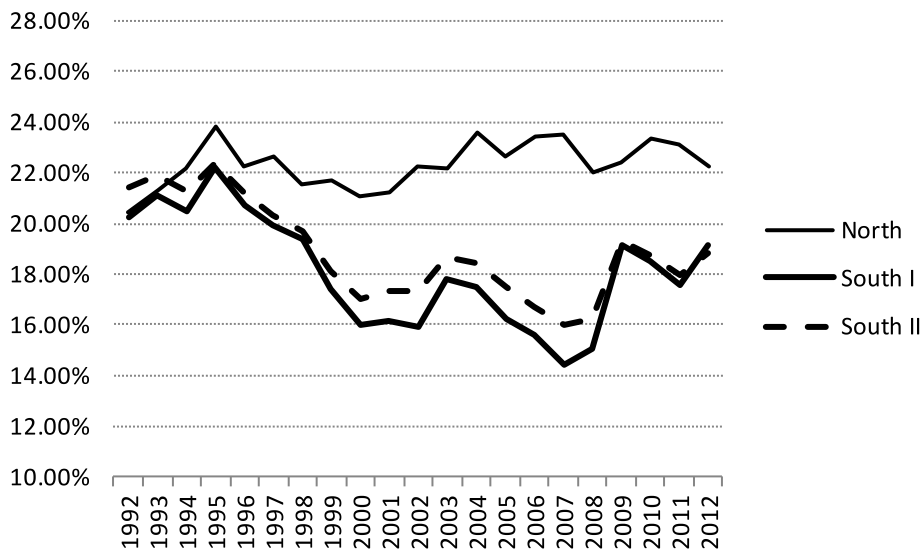
In *North*, neither private gross savings nor investments show a particular upward or downward trend over the past two decades. Gross private savings fluctuate within a narrow band of 1 or 2 percentage points around 22 percent of GDP, while the investment level with an average of 17.1 percent of GDP over the third – crisis – period is only marginally lower than the 18.2 percent of GDP that could be observed in the first half of the euro area period. Moreover, this relatively modest average decline in investment since 2007 is primarily due to the Netherlands and to a lesser extent Finland. Overall, these countries seem to have reached a steady state of some sort. This is an interesting observation from a behavioral and institutional point of view and deserves to be analyzed further.

Figure 7: Net Private Savings (1992-2012)

Table 2: Average Savings and Investment as a Percent of GDP

	Net private savings			Gross private savings			Private investment		
Region	**1992-1998**	**1999-2007**	**2008-2012**	**1992-1998**	**1999-2007**	**2008-2012**	**1992-1998**	**1999-2007**	**2008-2012**
North	3.3%	4.2%	5.6%	22.0%	22.4%	22.6%	18.7%	18.2%	17.1%
South I	3.1%	-4.9%	2.5%	20.6%	16.3%	17.9%	17.5%	21.2%	15.4%
South II	4.3%	-2.4%	2.3%	21.2%	17.5%	18.2%	16.9%	19.9%	16.0%

Figure 8: Gross Private Savings (1992-2012)



The lack of crisis impact in *North* is even more remarkable when compared with the corresponding developments in *South I*, respectively *South II*. The tremendous improvement of the net private savings position by more than 14 percent of GDP in *South I,* respectively more than 9 percent of GDP in South II, can only be marginally attributed to the gross savings part of the equation. In particular, over the time period of the euro area gross savings remained surprisingly stable with an average of about 16.3 and 17.5 percent of GDP for *South I* and *South II*, respectively, in the first half of the euro area period (1999 to 2007) and with an only marginally higher average of about 17.9 and 18.2 percent of GDP in more recent years of the euro area. Thus, gross savings have on average only contributed about 1 percentage point to the improvement of the net private savings positions of *South I* and *South II* in recent years. Most of this improvement comes from Ireland and Spain. It leaves the dynamics of investment in these countries as the main source as explanation.

Figure 9: Private Investment (1992-2012)

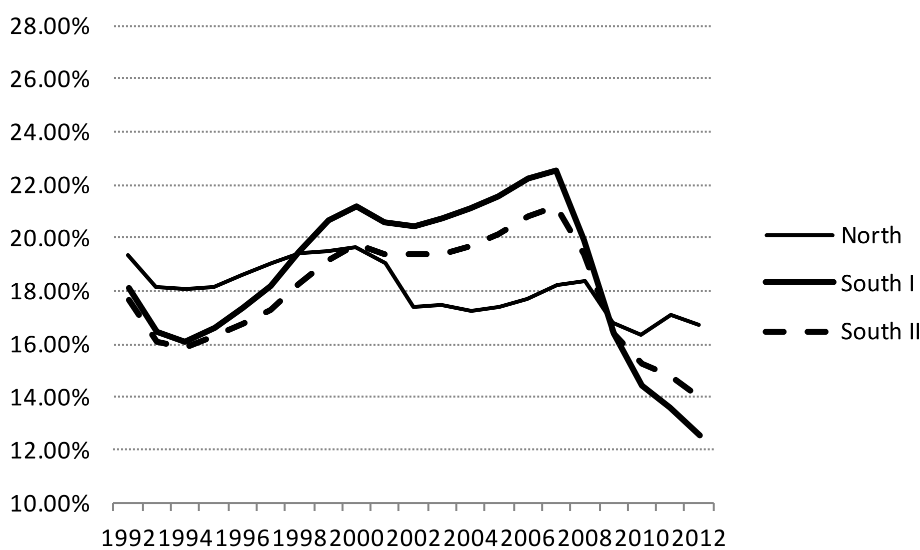


Figure 9 clearly shows that the improvement of the net private savings positions in *South I* and *South II* can be largely explained by the sharp fall in investment levels observed in these countries. In *South*

I investment has declined by about 10 percent of GDP over the years 2007 to 2012 and by more than 7 percent of GDP in the same period of time in *South II*. These figures are another testimony for the immense uncertainty about future business prospects paired with financial constraints that are prevailing for households and firms in southern European countries.

Overall, the picture that is emerging is that of strong and asymmetric adjustment in the euro area. The effects of the crisis in *North* appear to be relatively limited. The same holds true for France and Italy, the two countries that would like to belong to the group of strong countries (*North*) but are nevertheless often associated with the weaker ones (*South I*). Particularly in *South I*, painful internal adjustment is under way. On the private side, investment demand is on a strong downward trend. On the public side, strict consolidation programs are in operation in these countries. As a result, government deficits gradually decrease from their peak levels in 2009.

External deficits as measured by the current account are declining as well due to the combined effect of low public and private domestic demand. To shed more light on the external part of the adjustment process, we now turn to a decomposition of the current account in its various components. In particular, we pay attention to the development of the trade balance and the (net factor) income account.[4] Table 3 and Figure 10 and Figure 11 provide an overview.

Table 3: Current Account Decomposition as a Percent of GDP

	Trade balance			**Net factor income**			**Transfers**		
	1992-1998	**1999-2007**	**2008-2012**	**1992-1998**	**1999-2007**	**2008-2012**	**1992-1998**	**1999-2007**	**2008-2012**
North	2.7%	5.3%	4.8%	-1.2%	0.0%	0.4%	-0.8%	-1.1%	-1.2%
South I	-1.3%	-2.8%	0.1%	-2.2%	-4.5%	-6.0%	2.1%	0.2%	-0.5%
South II	-0.1%	-1.7%	-0.4%	-1.7%	-2.9%	-3.8%	1.2%	-0.2%	-0.8%

Table 3 shows that in *North* hardly anything changes from the pre-crisis euro period to the crisis period. In *South I* the average improvement of the trade balance in the period 2008-2012 of 2.9% is partly undone by the deterioration of the income account by 1.5%. For *South II* the same but more moderate pattern is visible, as France and Italy contribute little to the overall dynamics. Figures 10 through 15 provide more detail and show that the averages in Table 3 hide strongly divergent trends.

First, we focus on the trade balance in Figure 10. The trade balance in *South I* strongly improves after 2007. This is the case for all countries in *South I*, but particularly so for Ireland which on its own accounts for the overall positive average of 4 percent in 2012. In that year, Spain and Portugal have approximately reached a balanced trade account while Greece is lagging with a trade deficit of 5 percent.

[4] Net transfers only account for a small part of the current account and are relatively stable in the euro period. Therefore, we will not discuss them here.

Figure 10: Trade Balance (1992-2012)

Figure 11 and Figure 12 display the contribution of exports and imports respectively to the improvement of the trade balance in *South I* after 2007. The picture is clear. After years of stagnation, exports (as a percentage of GDP) show a rising trend again from 2009 onward in *South I*. To some extent this is exaggerated, as nominal GDP in these countries is actually falling and thereby substantially contributes to the positive trend. For imports, on the other hand, the positive trend in the pre-crisis period disappears and imports – as a percentage of falling GDP – stabilize. In *North* both exports and imports experience a strong dip in 2008-09 when the financial crisis hit the world economy but both resume their upward trend when the world economy picks up again after 2009.

Figure 11: Exports (1992-2012)

Figure 12: Imports (1992-2012)

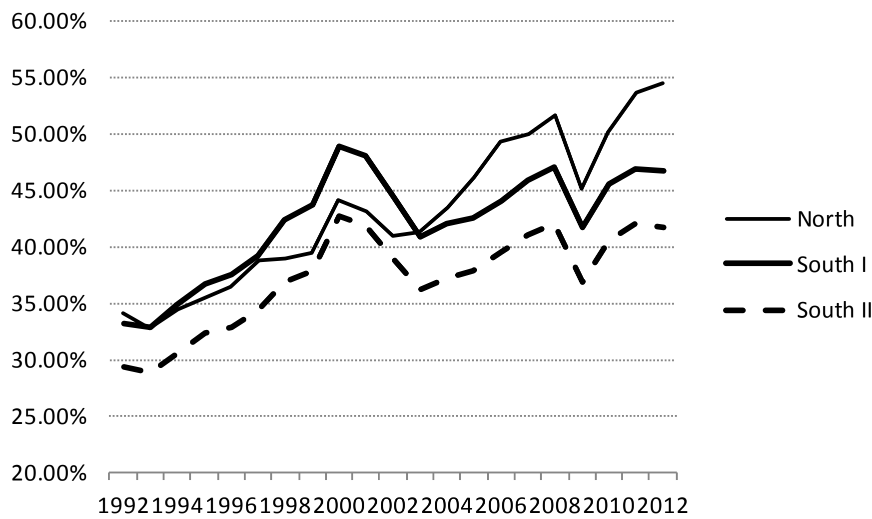


Figure 13: Real effective exchange rates (BIS, 1993=100)

Figure 13 provides some sobering information on the determinants of the improved trade balance of *South I*. It shows the significant loss of competitiveness in the Southern economies in the period 2001-2007 as well as the modest improvement since 2007. This improvement is roughly in line with the general real depreciation of the euro in the global economy in recent years and with the gain in competitiveness in *North*. The gap between *North* and *South* has not decreased, however, implying that structural divergence within the euro area remains a significant problem for the future.[5] Overall the evidence suggests that the improvement of the trade balance in *South* is due to a mix of three factors: a modest recovery of the world economy leading to more euro area exports, a modest real euro area depreciation which is also helpful in stimulating exports and a strong contraction of imports due to the deep recession in *South*. Signs of more structural adjustments in the South that lead to convergence with North are not clearly visible in these data.

[5] Within *South II*, only France has a competitiveness level similar to that of *North* in 2012. On the other hand, competitiveness in the Netherlands is closer to some of the Southern countries than to its Northern neighbors in 2012.

Now, we turn to the income account. In Table 3, we already noticed an average deterioration of net factor income for the South in the period 2008-2012 compared to the preceding period. It directly illustrates how cumulative current account deficits from the past keep burdening the Southern economies today. Due to these deficits, the countries in *South I* (and *South II*) have increasingly become net foreign debtors over the past two decades. As a result, an increasing percentage of GDP needs to be used to pay foreign creditors. Figure 14 shows a strong negative trend indicating rising interest payments for *South I* from the late 1990s onward. At some point, *South I* not only had to attract foreign capital to finance its trade deficits, but also to pay interest on its outstanding debt. From 2009 onward, net factor payments as a percentage of GDP appear to have bottomed out. The improvement of the trade balance has definitely contributed to this stabilization. However, rising interest rates have partly offset this gain. Moreover, net foreign liabilities as a percentage of GDP are still rising as is demonstrated in Figure 15. All countries in *South I* now have foreign liabilities close to a 100 percent of their GDP, implying substantial future repayments and a high vulnerability to future interest rate rises and sudden stops of capital inflows. Reversing the negative trend in the net foreign liabilities to GDP ratio requires either substantially higher trade balance surpluses or higher nominal GDP growth or both. The longer the current trend continues the less sustainable the external position will get.

Figure 14: Net Factor Income (1992-2012)

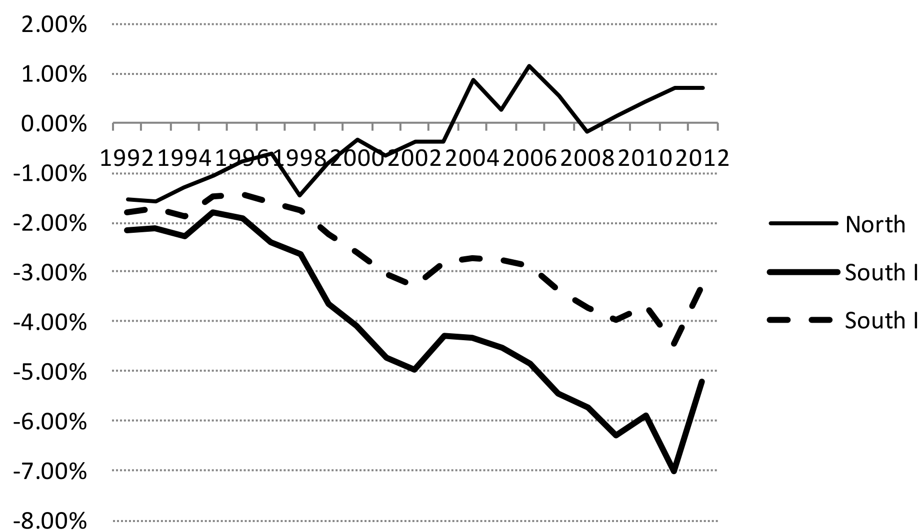
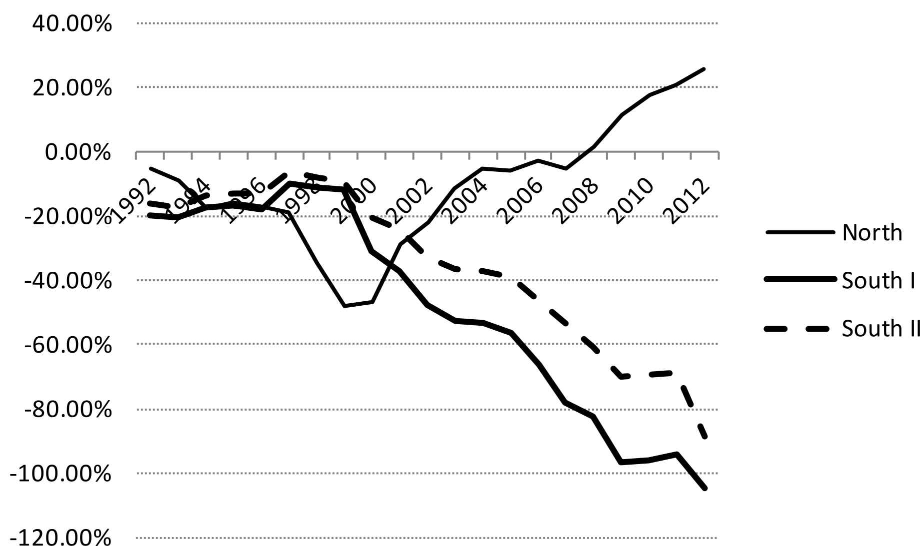


Figure 15: Net Foreign Assets (1992-2012)



4. Conclusions

On the surface, the analysis in the preceding section suggests that macroeconomic adjustment in the Southern countries of the euro area is well under way. External imbalances as measured by the current account deficit have almost disappeared and both net private savings and net public savings move upward.

Below the surface, a more complex and worrisome picture emerges. First, the improvement of the trade balance in the South seems only to a limited extent due to internal structural adjustment. Most important determinants are the recovery of the world economy and the sharp decline in imports and investment as a consequence of the deep and prolonged recession. Some gain in competitiveness has been realized but the gap with the Northern euro members has not decreased, predicting new problems ahead.

Second, the foreign debt burden is still increasing for the Southern countries and has reached a level of about 100 percent of GDP for each of them. This inheritance from the past is likely to become unsustainable in the future and may lead to further – bank – defaults and the need for new emergency rescue packages either by national governments or EU institutions like the ESM. In any case, it is very likely to act as a sustained drag on future growth.

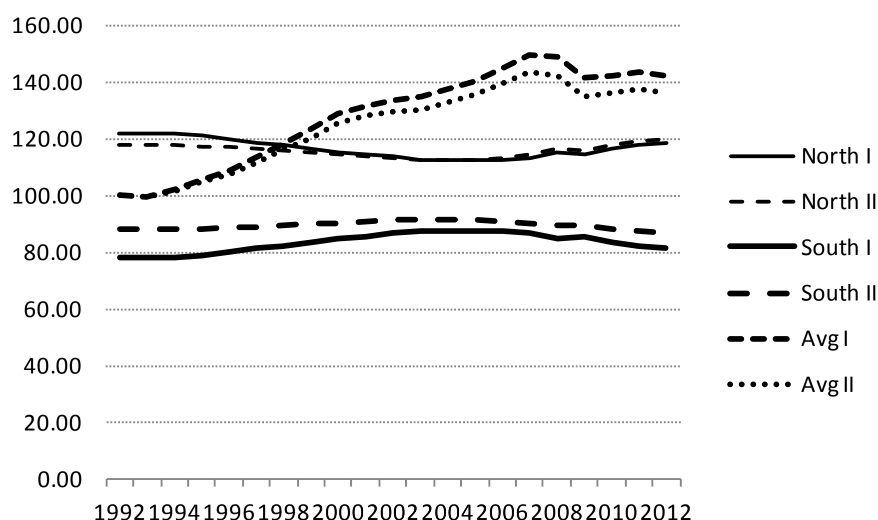
Third, a similar debt problem is re-emerging for the Southern sovereigns. While the – projected – deficits are slowly declining, they are and will remain substantial for the next few years. As a result, sovereign debt levels are likely to increase further from the already high levels observed today (Figure 3).

Fourth, the adjustment process so far has been strongly asymmetric. Our evidence shows that the Northern euro area members have been relatively unaffected from the financial crisis and subsequent euro crisis. Overall, their global competitiveness is higher, and their savings and investment patterns are more stable. The same holds true for France and Italy, though especially for Italy it is questionable

how long the country will be able to continue on this path. In the North, the Netherlands takes a peripheral position with relatively low competitiveness and a relatively high decline in investment since 2007.

Some argue the asymmetric adjustment in the euro area is justified as those who have gone off balance need to take their own responsibility. The standard counter argument is that also the Northern countries have become unbalanced as every borrower needs a lender. However, even more important is the fact that due to the asymmetric adjustment, divergence within the euro area is growing further as exemplified by Figure 16.

Figure 16: Absolute and Relative GDP per Capita (1992=100)



In this figure the lines with index I refer to the analysis without France and Italy, while index II lines includes these two countries. The lines *Avg I* and *Avg II* give the development of real per capita income across all countries in the respective samples with base year 1992. Untill 2007 the trend is upward. The crisis interrupts this trend and causes a 10 percent drop. From 2009 onward the average real per capita income is roughly stable at the lower level. The lines labeled *North* and *South* indicate the relative income of each group, benchmarked against the overall average. For instance, in 1992 the income in *North I* was about 20 percent higher than the average income in that year, while the income in *South I* was 20 percent lower than the average. Untill 2005-2006 there is – marginal – convergence between the two groups. However, since then divergence has reappeared and the income gap between *North* and *South* is growing again. Another way to present the same message is that untill the crisis real income per capita in the Southern countries was on average growing a bit faster than in the Northern ones, 2.4 percent per year versus 1.9 percent. Since 2007, real income is about stable in *North* while it is falling in *South.*

In section 2, we concluded that due to a combination of new institutional arrangements, emergency measures and power play by the ECB, financial markets have become quieter in the last year. At the same time, we concluded that the tranquilitiy could be temporary as uncertainty and fragility are still high. Our analysis in section 3 supports this latter point. Despite superficial progress in addressing the existing imbalances, problems loom large. Both sovereign debt and external debt are approaching

sustainability thresholds and indications of substantial structural reform are not visible yet in the macro data for the Southern countries. Prospects for higher growth in the near future are dim, due to lack of economic reforms, private and public debt overhang and imposed austerity programs. Moreover, the asymmetric adjustment leads to more rather than less divergence. Overall, we feel the chosen approach will prove to be unsustainable and infeasible in the near future. To defend the euro and the euro area, a new approach is urgently needed.

References

Blanchard, O., F. Giavazzi, and F. Sa (2005), International Investors, the U.S. Current Account, and the Dollar, *Brookings Papers on Economic Activity I,* pp. 1-66.

Grauwe, P. de (2009), The Fragility of the Eurozone's Institutions, *Open Economies Review*, 21, pp. 167-174.

Holinski N., C. Kool and J. Muysken (2009), *International Portfolio Balance: Modeling he External Adjustment Process,* METEOR Research memorandum RM/09/033.

Holinski N., C. Kool and J. Muysken (2012), Persistent Macroeconomic Imbalances in the Euro Area: Causes and Consequences, *Federal Reserve Bank of St. Louis Review*, January/February, 94, pp. 1-20.

Merler, S. and J. Pisani-Ferry (2012), Sudden Stops in the Euro Area, *Brueghel Policy Contribution* 2012/06, pp. 1-16.

Sturm, J.-E., G. Bertola, J. Driffill, H. James, A. Valentinyi and H.W. Sinn (2013), Rebalancing Europe, *The EEAG Report on the European Economy 2013*, CESifo, Munich..