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Eurozone: How large is the need for external adjustment?

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EUROZONE: HOW LARGE IS THE NEED FOR EXTERNAL ADJUSTMENT?

In addition to the need for government consolidation, the second major challenge facing a number of EMU countries is the reduction of external deficits. Some empirical analyses have reached the conclusion that countries like Spain, Greece and Portugal would have to achieve devaluation of anywhere in the region of between 20% and over 30% to arrive at a sustainable external position[1].

Within a monetary union, however, an individual country does not have the power to adjust the external value of the currency. The only option is internal devaluation. Internal devaluation means nothing other than cutting domestic costs in relation to the costs in partner countries. Essentially, cutting wage costs is likely to be the only way of achieving this, which is why many doubt whether internal devaluation of any more than 10% is feasible[2].

What is striking, however, is that some countries, like Spain for example, have already been able to slash their current account deficits considerably, although only a few percentage points have been knocked off unit labor costs. A balanced current account should normally also pave the way for the medium-term consolidation of net international investment positions. So are the estimates produced by the empirical analyses wrong when they point towards the need for substantial devaluation? In some respects, it would appear so. Most studies interpret current account deficits as being a symptom of poor price competitiveness. This is certainly true in part (though only in part). The real estate bubbles, in particular, have caused soaring domestic demand in some economies, which makes external balances look bad without a lack of competitiveness being at the root of the problem. After these bubbles burst and the contractionary impact of government consolidation policy hit, domestic demand declined, in some cases considerably, taking pressure off the current account.

We believe – at least in the short term – that a country's current account balance is influenced primarily by price competitiveness and domestic demand dynamics. The price and cost competitiveness of an EMU country is determined by real effective exchange rate of the euro and the development in unit labor costs. The "harmonized competitiveness indicators based on unit labor costs indices for the total economy", which is available for all EMU countries, encompasses both components of competitiveness.

[1] Goldman Sachs, European Economic Analyst, Achieving fiscal and external balance (Part 1): The price Adjustments required for external sustainability, March 15, 2012.

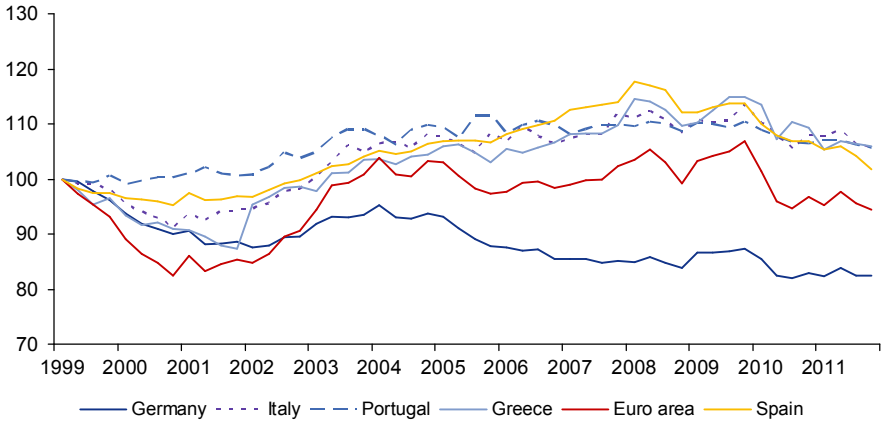
William R. Cline, John Williamson , The Current Currency Situation, Peterson Institute for International Economics, Policy Brief, November 2011.

Virginie Coudert, Cecile Couharde, Valerie Mignon, On currency misalignments within the euro area, CEPII, WP No 2012-07, April 2012.

[2] William R. Cline, John Williamson, November 2011, p.11.

Harmonized competitiveness indicators based on unit labor costs

Index, 1999Q1=100



Sources: ECB, Deutsche Bundesbank.

The euro area as a whole has been largely balanced in external trade terms for years now, with only a marginal current account deficit emerging of late. As a result, it would appear appropriate to look at the development of an EMU country's domestic demand in relation to the average for the euro area as a whole. An above-average expansion in domestic demand compared with the EMU average is likely to fuel external deficits.

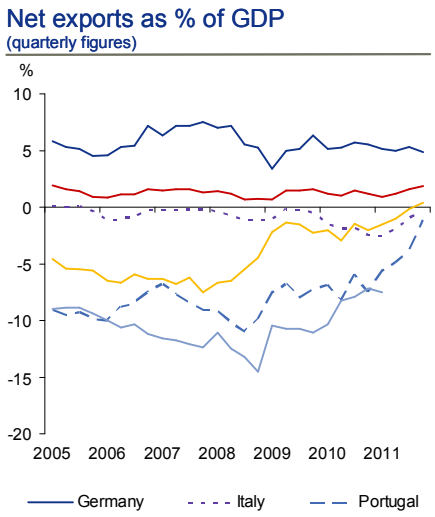
We can now use a regression analysis to see how elastic a country's external balance (expressed as a percentage of GDP) is depending on price competitiveness and domestic demand trends. In the period from 1999 to 2011, we used quarterly data to test the following two explanatory approaches for a number of EMU countries:

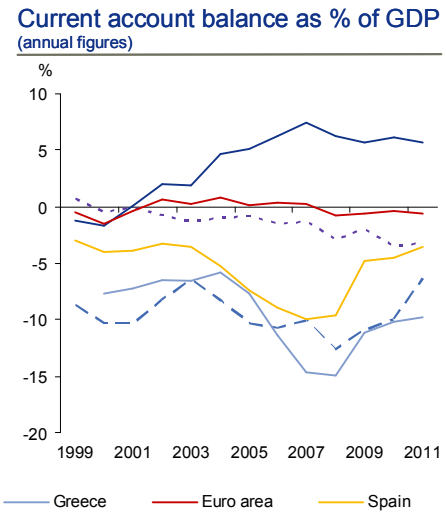
(1) $NEX_i = a_{1i} + a_{2i} RDD_i + a_{3i} ULC_i + a_{4i} REER_i + \varepsilon_i$

(2) $NEX_i = b_{1i} + b_{2i} RDD_i + b_{3i} IPC_i + \varepsilon_i$

i: Germany, Italy, Spain, Portugal, Greece
NEX: net exports as % of GDP (seasonally adjusted)
RDD: real domestic demand of a country in relation to the EMU average (seasonally adjusted, Q1 1999=100)
IPC: Indicator of price competitiveness based on unit labor costs
ULC: unit labor costs of a country in relation to the EMU average (seasonally adjusted, Q1 1999=100)
REER: real effective euro exchange rate.

We have used the net exports of goods and services as the parameter to be explained as opposed to the current account balance, as it is only for net exports that Eurostat has seasonally adjusted quarterly values available for the individual countries. (In the current account, net exports are supplemented to include the income account and current transfers).





Sources: EcoWin, Eurostat.

In addition to the countries with current account deficits, we have also included Germany in the analysis, because it is also interesting to see the extent to which Germany's external surplus reacts to changes in price competitiveness and domestic demand.

We prefer the results of the first explanatory approach, which analyzes the impact of the external value of the euro and unit labor costs separately as price competitiveness factors, because only unit labor costs can be influenced by national economic policy. What is clear, however, is that, the more determining factors there are, the higher the risk of multicollinearity in the statistical approach. This is why the approach of using an overall indicator of price competitiveness can be considered as an alternative in principle. The determining factors are included in the estimate in logarithmic form, which means that their coefficients immediately show the percentage change in the current account balance (in relation to GDP) triggered by a one-percent change in the variable in question.

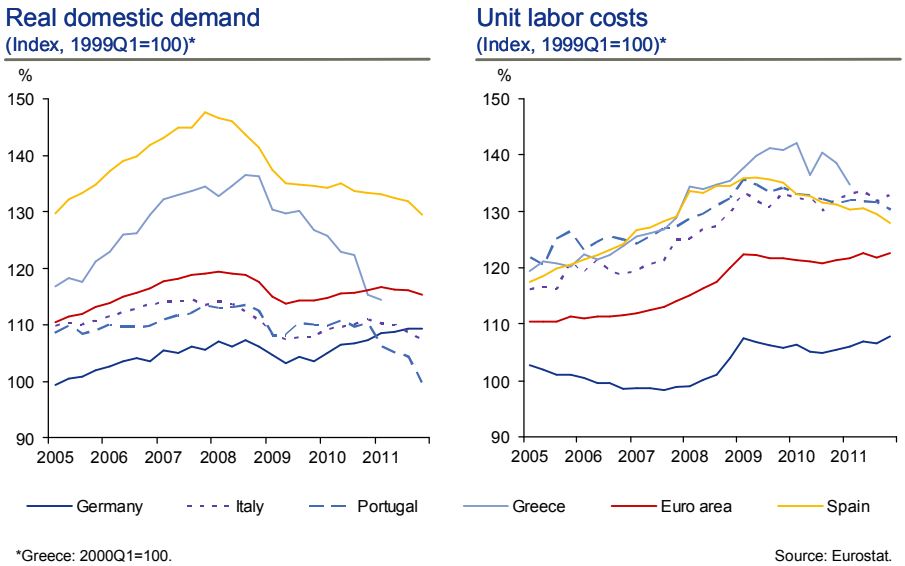
Significant elasticity with the expected algebraic signs (approach 1)

	RDD	ULC	REER
Germany	-0.38	-0.17	-0.07
Italy		-0.39	
Spain	-0.26		
Portugal	-0.63	-0.12	-0.12
Greece	-0.37		

At the end of 2011, Italy's negative net exports stood at only 0.5% in seasonally adjusted terms, with Portugal's coming in at 1.2% of GDP. Spain actually achieved a surplus to the tune of 0.4% of GDP. In terms of their net exports, this means that these countries are almost balanced in external trade terms. This does not yet, however, apply to the current account. Looking at 2011 on average, Italy's current account balance (2011: -3.5% of BIP) was 1.7 percentage points worse than its net exports. In Portugal and Spain, the corresponding figure was as large as 2.5 percentage points and 2.9 percentage points

respectively. Based on the assumption – which should be realistic – that this difference between net exports and the current account will remain roughly the same in 2012/2013, Spain will have to improve its net exports by 2.5 percentage points, Italy by 2.2 and Portugal by 3.7 in order to achieve a balanced current account.

Based on our elasticity forecasts, this brings us to the following conclusions: Italy's price competitiveness would be boosted by a development in unit labor costs that is 5.5 percentage points more favorable than the EU average in line with the elasticity forecast that Italy would be able to achieve a 2.5 percentage point improvement in its net exports and, as a result, a balanced current account. In Portugal, a unit labor cost trend that is 5% more favorable than the EMU average and domestic demand that is 5% weaker in relative terms would be sufficient to eliminate the country's current account deficit. Spain's current account would be balanced if the country could achieve domestic demand development of around 9.5% below-average development by EMU standards. In terms of the growth seen since the start of monetary union, Spanish domestic demand has still been sitting around 12 percentage points higher than the average for the euro area as a whole of late. If a current account deficit of 2% and less is enough to be considered sustainable in the longer term – for which there is some evidence – the adjustment requirement in Spanish domestic demand is reduced to only around 2%.



Although our empirical analysis shows that the need for internal devaluation/ adjustment in domestic demand is certainly significant in Italy, Spain and Portugal, the dimensions that are being mentioned in the current discussion, with calls for adjustments in the double-digit percentage range, would appear to be vastly exaggerated.

The external adjustment process in Greece, however, has not made as much progress as in Spain or Portugal. At the end of 2011, the net exports deficit still came in at around 7% in seasonally adjusted terms, with the current account deficit totaling some 9% of GDP. Although, in purely arithmetic terms, a 24% weaker development in domestic demand compared with the EMU average could be enough to balance the current account, this is not a realistic goal if we consider that domestic demand has already fallen by around 20%. Our estimate method fails to identify any significant impact of cost/price competitiveness on Greece's net exports. This is probably not due to the fact that there is no lack of price competitiveness, but rather to the fact that Greece's export base (few exportable goods) has been so weak to date that fluctuations in price competitiveness

have had hardly any effect on the country's net exports. In order to achieve an external balance, Greece needs to expand and improve its range of exportable products.

Last but not least: What conclusions can be drawn from the results of our estimates for Germany's external surplus? The estimates on elasticity confirm what was to be expected. Germany's net exports hinge largely on price and cost competitiveness, as well as on the development of domestic demand. Germany's current account balance (2011: 5.7% of GDP) would be cut in half if the country's domestic demand growth were to outperform the EMU average by 5% and the development in cost competitiveness were to be 5% less favorable than the EMU average.

In 2011, the current account for the euro area as a whole was more or less balanced (-0.3% of GDP). There are growing signs, however, that the eurozone is on course for a current account surplus. While the deficits of the countries on Europe's periphery are on the decline, Germany's surplus remains high. In 2012, the euro area could already achieve a small surplus in its current account. This means that the austerity policies being pursued in the peripheral EMU countries look set to have a significant macroeconomic impact that has been virtually ignored to date.

These assessments are, as always, subject to the disclaimer provided below.

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