PANOECONOMICUS, 2011, 5, Special Issue, pp. 571-592
Received: 3 October 2011; Accepted: 10 November 2011.

UDC 339.923:061.1 EU]:338.124.4
DOI: 10.2298/PAN1105571U
Original scientific paper

Jorge Uxó

University of Castilla – La Mancha, Spain

✉ Jorge.Uxo@uclm.es

Jesús Paúl

CEU San Pablo University, Spain

✉ pagut@ceu.es

Eladio Febrero

University of Castilla – La Mancha, Spain

✉ eladio.febrero@uclm.es

Financial support from University of Castilla – La Mancha (Project HU20112276) is gratefully acknowledged. We would also like to thank anonymous referees for their useful comments and suggestions, although any remaining errors are our own responsibility.

Current Account Imbalances in the Monetary Union and the Great Recession: Causes and Policies

Summary: Current account imbalances within the eurozone are at the roots of its economic crisis. We argue that, though relevant, emphasis should shift from competitiveness to differential rates of growth of domestic demand as its chief explanatory factor. Euro core countries have experienced a shortage of domestic demand, with wage restraint playing a key role. This has led them to experience a current account surplus, which could not be understood independently of a buoyant domestic demand in the peripheral countries, funded with private debt. As a byproduct of that strong demand, the periphery suffered from wage inflation and a loss of competitiveness. This dual growth pattern is unsustainable as indebtedness cannot go on without any limit. Neither wage cuts nor fiscal austerity in the periphery will help to solve this mess: although trade balance would be restored, it would lead to a negative shock in aggregate demand, threatening their ability to settle debts at due dates.

Key words: Euro area, Current account imbalances, Wage policy, Great recession.

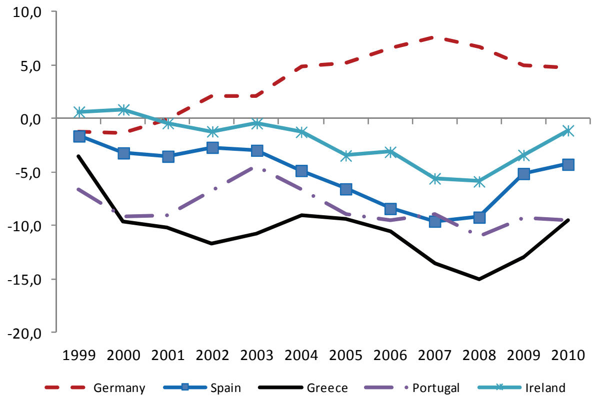
JEL: E6, F4.

Most analysis of the causes of the economic crisis within the European Monetary Union (EMU) focus on current problems of public finances and the sovereign debt crisis, and the proposed solutions usually include as a critical component the tightening of the Stability and Growth Pact and the application of strict measures of fiscal austerity.

In our view, however, the underlying reasons for the European crisis must be sought rather in the imbalances accumulated since the outset of the monetary union, particularly private and external debt, which in turn reflect the current account deficits and surpluses that were taking place between different members of the euro zone. Therefore, the absence of institutional mechanisms to prevent and correct these imbalances is more relevant to explain the crisis that the alleged violation of the fiscal rules.

Although the euro area as a whole has remained relatively close to external balance with the rest of the world since 1999, with an average net lending of 0.3% of GDP, there have been significant and growing external imbalances within the EMU.

On the one hand, Germany and other smaller countries such as Netherlands, Finland, Austria and Belgium have registered large current account surpluses during this period, and exports have played a key role in their growth strategy. On the other hand, Spain, Greece, Portugal and Ireland have characterized precisely by the opposite: large and growing current account deficits. Figure 1 shows the evolution of these imbalances since 1999 for Germany and the four countries with larger deficits.



Source: European Commission (2011).

Figure 1 Current Account, % GDP

Initially, the European authorities denied the importance of these imbalances, associating them to the process of convergence between countries and to optimizing decisions of individual agents, without macroeconomic consequences. Later on, and especially after the crisis, external imbalances have been attributed almost exclusively to economic policy mistakes and "bad behavior" of the deficit countries: excessive fiscal spending, lack of competitiveness and export capacity, poor allocation of financial resources raised in international markets and excessive wage growth. By contrast, the surpluses are seen (for example, European Commission 2010a, 2010b) as a demonstration of economic efficiency and "virtue": prudent fiscal policies, wage moderation and high productivity. Consequently, the proposals to address them, as the recent *Euro Plus Pact*, focus on the application of painful adjustment programs to restore competitiveness in these countries, mainly by means of wage restraint, fiscal austerity and structural reforms to improve their ability to compete (European Council 2011).

In this article we propose an alternative explanation for the causes of current account imbalances within the monetary union and their relationship with the origin of the economic crisis and, consequently, different economic policy proposals. The sources of current account deficit and surpluses are considered together and linked to the unbalanced growth model that has been developed within the EMU. Some countries with weak domestic demand follow an export-led growth strategy, whereas others base their growth on the expansion of the domestic demand financed by debt. At the same time the single monetary policy, with the same nominal interest rate for all countries, reinforces the appearance of these two patterns.

This model is characterized by a global shortage of demand, driven largely by the deterioration of income distribution, which is temporarily corrected by the accumulation of debt in some countries. However, the emergence of major imbalances, especially the accumulation of private debt, makes it very fragile and unsustainable in the medium term.

According for example to Jean Paul Fitoussi and Joseph Stiglitz (2009) this is the true origin of the crisis and, therefore, the measures that have been undertaken in the last year in the European Union are in the wrong direction. The euro area needs different solutions to boost aggregate demand and to promote a balanced growth model, without imposing all the burden of the adjustment on the deficit countries. Gustav Horn, Heike Joebges, and Rudolf Zwiener (2009) and Engelbert Stockhammer (2010), among others, have also analyzed the development of two unsustainable growth patterns in Europe and its relation with the current crisis.

1. An Alternative Explanation of Current Account Imbalances

The central idea of this section is that current account imbalances that have been observed within the EMU are not the result of internal imbalances and domestic economic policy mistakes of countries with large deficits. The deficits of some countries and the surpluses of others stem from the same phenomenon: the existence of an unbalanced growth model in which some countries with very low growth of wages and a weak domestic demand solve the negative effects on growth and employment following a export-led growth strategy, whereas others base their growth on the expansion of the domestic demand financed by increasing debt.

Both strategies are interdependent: the growth of the core is sustained by the demand from the periphery and, at the same time, these countries need that the surplus countries fund their current account deficits.

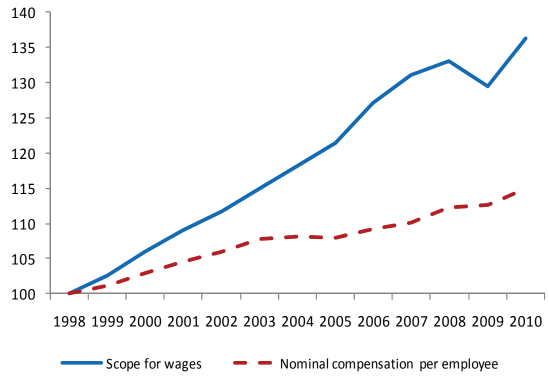
But this “solution” can only be provisional, because the accumulation of imbalances (mainly, rising indebtedness and losses of competitiveness) makes it unsustainable.

The single monetary policy plays an important role in the development and maintenance of this unbalanced growth model, by applying the same nominal interest rate to countries with different behavior in their domestic demand and rates of inflation. This results in a destabilizing effect and in turn gives rise to further increases in current account imbalances.

In order to analyze how this model has developed and why is unsustainable, we will take the case of Germany and Spain as an example, given its importance in explaining the total amount of current account imbalances in the whole of the euro zone. Their external balances have registered an opposite behaviour, and in 2007 amounted, respectively, to 71% of the sum of the surpluses of all lending countries of the EMU and 45% of the total deficit of all borrowing countries. In our opinion, the most relevant factors explaining the surplus in Germany and the deficit in Spain are the following:

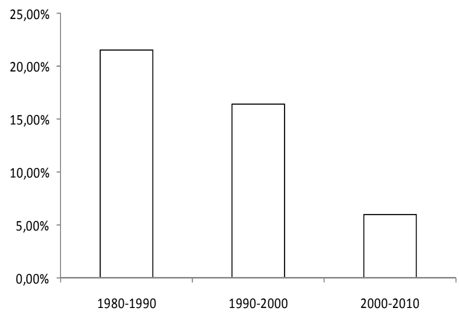
(1) The policy of wage restraint in Germany and its effects on domestic demand and competitiveness. To determine whether the wage policy is too restrictive in a country, we use as a benchmark the sum of growth in productivity per employee and the inflation target, as in Eckhard Hein and Achim Truger (2009). This amount represents the scope available for nominal wage increases, without changing the rela-

tive share of income or exceeding the inflation target ("Scope for Wages"). Normally, for a Member State of EMU this target should be that established for the whole of the Euro zone (2%). Given that between 1999 and 2007 (from the start of EMU until the onset of the crisis) the average productivity per worker in Germany grew annually by 1.1%, the scope for wage growth was 3.1% per year. However, in this period the compensation per employee (in nominal terms) grew up in Germany at an annual rate of 1%. This means that in those years, wages in Germany grew by 16% less than that allowed by increased productivity without compromising the inflation target (Figure 2a). And Figure 2b shows that the increase in nominal unit labor cost in Germany during the last decade have been much lower than in previous periods.



Source: AMECO (2011).

Figure 2a Nominal Wages in Germany



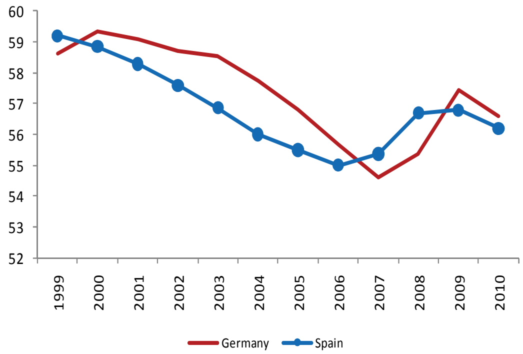
Source: AMECO (2011).

Figure 2b Nominal Unit Labor Cost Growth in Germany

This had two important consequences. The first is that the share of wages in income brought down (Figure 3a), which had a negative impact on domestic demand growth (between 1999 and 2007, its average annual growth rate reached only 0.7% versus the 1.4% that had been achieved between 1995 and 1998, Figure 3b).

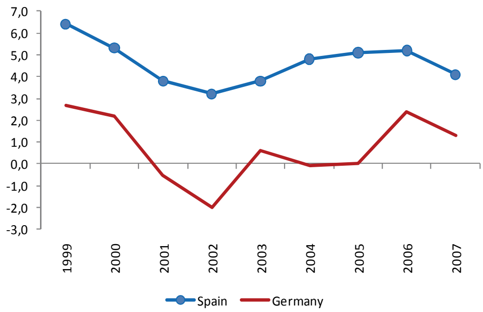
Horn et al. (2009, p. 25) present a complete analysis of the changes in income distribution in Germany during the last years and its consequences on aggregate demand. They conclude that "the majority of the population has reacted to declining real wages and social spending cuts (especially in the state pension system) in recent years by reduced consumer spending. As statistical analyses show a large part of the increase of the household savings ratio is due to changes in the distribution of income and increased old-age provisions in connection with the recent pension reforms. Almost half of the increase of the savings ratio between 2001 and 2008 can be attributed to the shift in the income distribution from wage to profit incomes. The other half seems to be due to the effects of the pension reform."

Then, the low growth in wages was reflected in a reduced growth of private consumption, but the increase in the share of profits in income was not reflected in a more dynamic investment, which even declined, but in a higher net saving of non-financial corporations and of the total economy (Figure 3c). In this context, the foreign sector is the main source of economic growth, well above the historical experience of Germany in the decades before (Figure 3d).



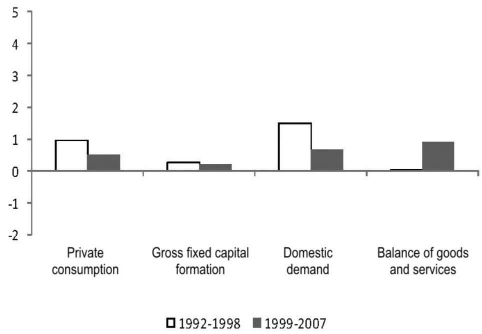
Source: AMECO (2011).

Figure 3a Labor Income Share



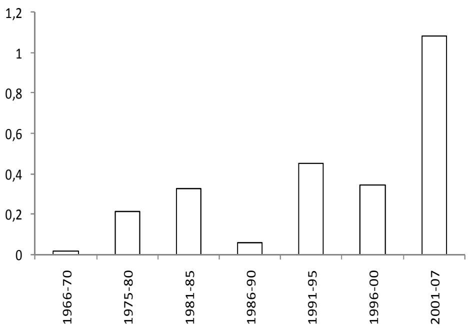
Source: AMECO (2011).

Figure 3b Domestic Demand, Rate of Growth



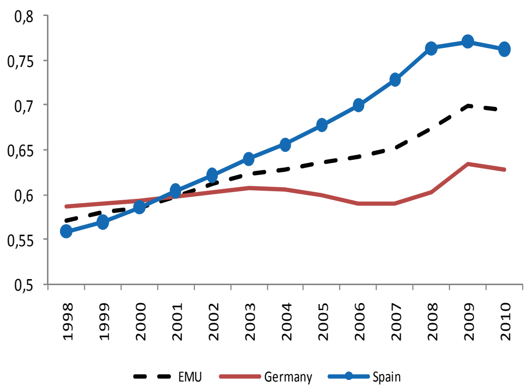
Source: AMECO (2011).

Figure 3c Contributions to the Increase of GDP, Germany



Source: Eurostat (2011).

Figure 3d Contribution of the Net Exports to the Increase of GDP, Germany



Source: AMECO (2011).

Figure 4 Unit Labor Cost (Nominal, €)

The second consequence is that unit labor costs remained almost constant throughout this period, while in the rest of EMU grew 14%, and 30% in Spain (Figure 4). This improvement in the competitive position of Germany is clearly reflected in their exports of goods and services to the rest of the euro area, which worth was 80% higher in 2007 than in 1999. In the same period, imports had grown only 51%, due also to the weakness of its domestic demand. In terms of GDP, the trade surplus with the rest of the EMU countries rose from 0.5% of GDP in 1999 to 3.8% in 2007.

Despite these positive contributions to the growth of external demand, between 2000 and 2007 the German economy recorded a growth rate of 1.5% which is low compared with other Euro zone countries (2.1%), with its own previous experience (1.9% between 1994 and 1999), and with the growth rate required to prevent a rise in unemployment, which rose from 8.2% in 1999 to 11.2% in 2005. No doubt, therefore, that the growth of domestic demand in Germany was weak.

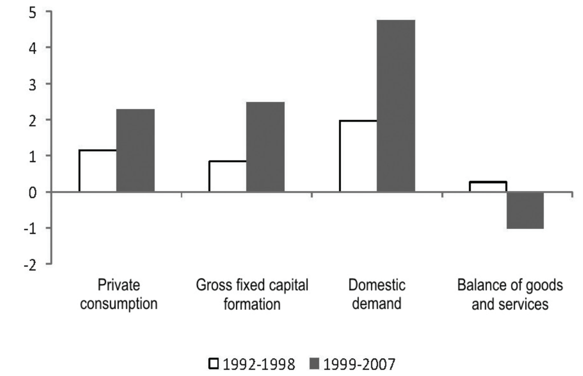
(2) The increase of domestic demand and debt in Spain. If the German economy grew at an average annual rate of 1.5% between 2000 and 2007, Spain was growing at 3.6%**.** This high rate was mainly driven by domestic demand, specifically by private sector construction spending, and gave rise to a large increase in private debt and indebtedness with the rest of the world. Between 1997 and 2007, construction work started for more than 6 million dwellings were started to be built and one out of five new jobs was created by the construction industry. Private and public consumption remained high, like productive investment. However, the latter meant a lower contribution to GDP growth because a great portion of this demand was covered with imports (48% in 1995, and nearly 60% in 2005) (Figures 5a and 5b).

The strong growth in residential investment was driven by several factors, among which we should underline at least three: some demographic and social changes that increased the demand for housing, very low real interest rates and the reduction of the requirements for granting mortgage loans to families. For further discussion see Oscar Dejuán and Eladio Febrero (2010).

Population increased nearly 7 million people, with immigration shifting from 2.9% of total population in 1997 to 13.8% in 2009 (more than 5 million new immigrants). The rate of unemployment fell from almost 25% in mid 1994 to roughly 8% in 2007. Baby-boomers were in their 30s in the mid 1990s, the average age of first-home buyers in Spain. Finally, it should be noted that the rate of ownership is very high in Spain and also it grew reaching 85% in 2007 (this percentage represents the rate of households living in a house of their own).

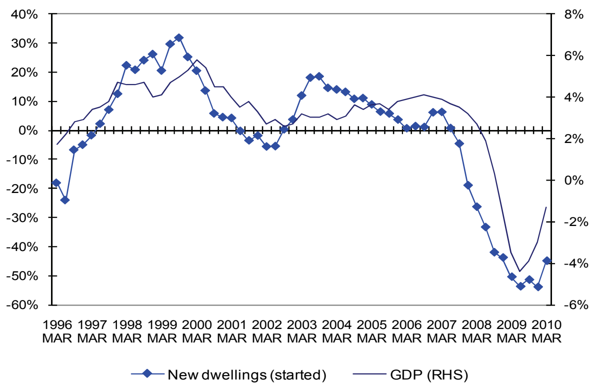
However, as housing prices rose to a much higher rate than real wages (they remained almost constant in Spain during these years, and the labor share declined, as it is shown in Figure 3a) this potential increase in housing demand could materialize in a more effective spending only thanks to mass access of families to credit. This was made possible by the coincidence of a strong decrease in interest rates and the change in the financial institutions' credit policy.

Regarding interest rates, Figures 6a, 6b, 6c and 6d, show the reduction experienced in both long term and short term rates in Spain, with the latter in negative figures between 2002 and 2006. This is due to the fall of nominal interest rate in Spain in the years before the start of EMU (more than 6 points between 1995 and 1999) due to the convergence of all the official rates and the disappearance of risk premium associated for example to exchange rates variations, and the existence of higher inflation than the average. In 2000 the rate of inflation in the Spanish economy was 3.4% versus 2.3% in the euro area and 1.5% in Germany. The average inflation rate since then has remained in Spain at 2.8% compared to 2% of the whole monetary union and 1.5% in Germany.



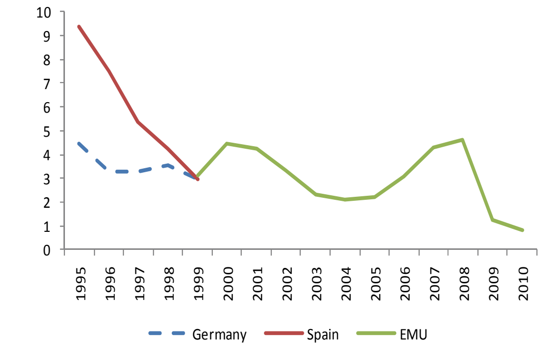
Source: AMECO (2011).

Figure 5a Contributions to the Increase of GDP, Spain



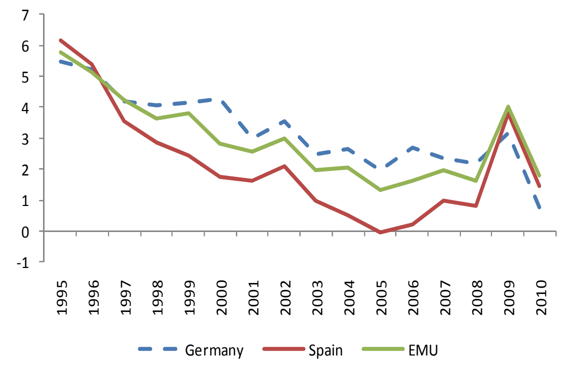
Source: Banco de España (2010).

Figure 5b Dwellings and GDP (% Growth), Spain



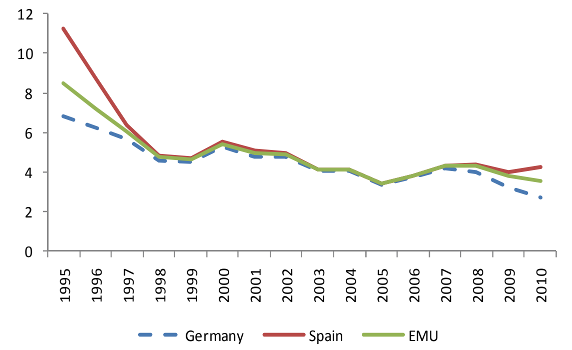
Source: AMECO (2011).

Figure 6a Nominal Long Term Interest Rate



Source: AMECO (2011).

Figure 6b Nominal Short Term Interest Rate



Source: AMECO (2011).

Figure 6c Real Long Term Interest Rate

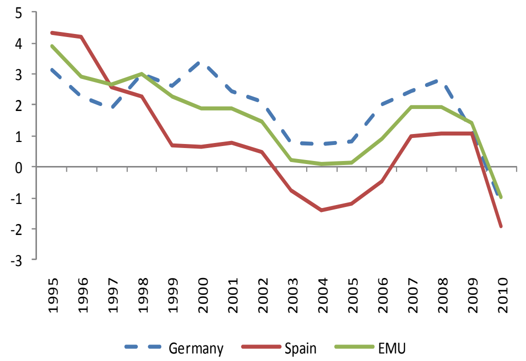


Figure 6d Real Short Term Interest Rate

On the other hand, the strong growth of banking credit was also partly due to the policy of banks to offset the effect on benefits of narrowing interest margins derived from the fall of interest rates. The average duration of a mortgage grew from 19 to 28 years, there was a significant increase in the value of credit with respect to housing and the effort of the debt - percentage of income that a representative household has to devote to debt service - rose by more than 12 points.

All these factors led to a rapid growth in housing demand which was largely matched, though not fully, by the supply, so there was a rise in prices. In turn, this resulted in expectations of further price increases and the real estate bubble began.

Therefore, the creation of EMU meant an expansionary shock to the Spanish economy, and the consequence of this surge in demand financed by debt and accompanied by a higher inflation rate than the average was obviously a rise in imports and the external deficit.

(3) The difference in "neutral" interest rates in Germany and Spain and the difficulties for the functioning of monetary union. As outlined in the previous points, two economies with very different stances of their respective domestic demand coexist in the monetary union: restrictive in Germany and expansive in Spain. In this situation, the single monetary policy had a destabilizing effect, exacerbating current accounts imbalances instead of bringing them down.

The European Central Bank aims to stabilize the inflation rate and uses as instrument the interest rate, which should be set in its "neutral" value: that which ensures that the pressure of demand is not excessive and not overcome the "inflationary barrier". However, this rate is not a natural constant, but depends on various factors which may change, especially the different components of demand. For example, the policy of moderate wage growth leads to lower growth in consumer demand in Germany, and consequently the neutral interest rate is reduced in this country. But as the European Central Bank can only apply a monetary policy and its objective is price stability in the euro area as a whole, the decline in the rate of interest that occurs is too moderate for Germany, while for other countries where autonomous factors of demand have a more dynamic behavior, as in Spain, is excessive. As a result, inflation falls below the average in the former and rises above the average in the second, leading to the differences in real interest rates we have shown above. Although there is also a stabilizing mechanism through changes in real exchange rates (real appreciation tends to reduce net exports and aggregate demand in Spain and increase them in Germany) it seems to act more slowly.

(4) The origin of imbalances lies in the private sector. It is important to note, for its strong implications for adequate economic policy proposals, that changes in net lending and borrowing recorded in Germany and Spain are explained mainly by the private sector behavior, and not by the public sector. Moreover, while in Spain these figures reflect the expansion of investment spending rather than the fall in the weight of savings to GDP, in Germany the increase in savings is largely responsible for changes in net lending, although there is also a significant drop in investment spending.

Table 1 Gross Saving and Gross Capital Formation in Germany and Spain, % GDP

Concept		Germany				Spain			
		2000	2004	2007	Change 2007-2000	2000	2004	2007	Change 2007-2000
Gross saving	Total economy	20.2	22.0	26.0	5.8	22.3	22.4	21.1	-1.2
	Households and NPISH	10.5	11.3	11.5	1.0	7.5	7.4	6.9	-0.6
	Non-financial corporations	6.9	10.3	11.4	4.5	10.3	9.5	5.2	-5.1
	Non-financial private sector	17.4	21.6	22.9	5.5	17.8	16.9	12.1	-5.7
	Financial corporations	1.2	1.6	0.7	-0.5	1.5	1.5	2.1	0.6
	General government	1.6	-1.3	2.4	0.8	3.0	4.0	6.9	3.9
Gross capital formation	Total economy	21.8	17.1	18.3	-3.5	26.3	28.2	31.0	4.7
	Households and NPISH	7.5	6.0	6.2	-1.3	7.4	9.1	9.7	2.3
	Non-financial corporations	12.0	9.4	10.5	-1.5	15.3	15.2	17.2	1.9
	Non-financial private sector	19.5	15.4	16.7	-2.8	22.7	24.3	26.9	4.2
	Financial corporations	0.5	0.3	0.1	-0.4	0.4	0.5	0.1	-0.3
	General government	1.8	1.4	1.4	-0.4	3.2	3.4	4.0	0.8
Net lending/ borrowing	Total economy	-1.3	4.8	7.7	9.0	-3.2	-4.8	-9.6	-6.4
	Households and NPISH	3.7	6.0	5.6	1.9	1.4	-0.7	-2.4	-3.8
	Non-financial corporations	-6.6	1.5	1.3	7.9	-4.1	-4.5	-11.0	-6.9
	Non-financial private sector	-2.9	7.5	6.9	9.8	-2.7	-5.2	-13.4	-10.7
	Financial corporations	0.4	1.1	0.5	0.1	0.5	0.6	1.9	1.4
	General government	1.3	-3.8	0.3	-1.1	-1.0	-0.4	1.9	2.9

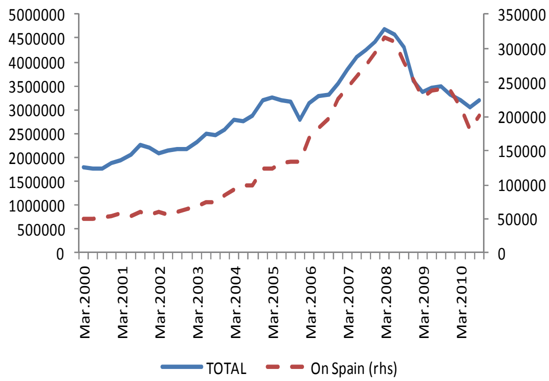
Note: Net lending/borrowing do not equal the difference between gross saving and gross capital formation, because of capital transfers and net acquisitions of non-produced, non-financial assets.

Source: Eurostat (2011).

Table 1 shows that the increase of net lending in Germany is mainly due to deleveraging of the non-financial private sector in the period 2000-2004. More specifically, 80% of this increase took place in non-financial corporations, because the gross saving increases considerably and capital spending suffers an important reduction. Households also contributed to increasing the net lending of private sector, but to a much lesser extent. In relation to the public sector behavior, we can distinguish two periods. Between 2000 and 2004 there was an increase in the public deficit which partially offset the weakness in private demand, but since then the budget consolidation also contributed to the increase in overall net saving.

Regarding Spain, according also with Table 1 the increase in net borrowing (6.4 points of GDP between 2000 and 2007) is mostly explained by an increase in gross capital formation (4.7 points of GDP) and its origin lies also in the behavior of the private sector, mainly in non-financial corporations. Between 2000 and 2007, the financial balance of corporations deteriorated by 6.9 percent of GDP and households by 3.8 points, while the net lending of general government increased by 2.9 percentage points of GDP.

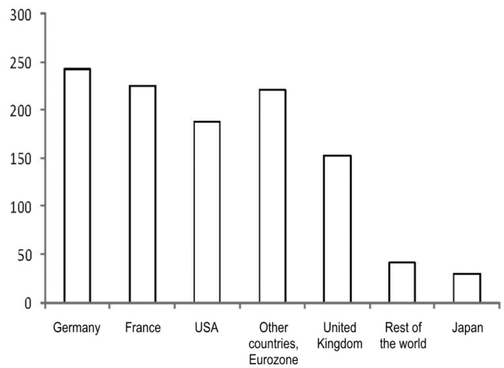
(5) What is the relationship between the expansion of credit in Spain and the increase in net lending of Germany? The net borrowing in Spain has been covered to a significant extent with the increasing net lending of Germany. In 1998, the volume of foreign claims held by German banks did not reach the 400 billion dollars (about 20% of German GDP). A decade later, before the onset of the international financial crisis, these assets were close to $ 5 trillion (180% of German GDP). In the same period, foreign assets of German banks against Spanish borrowers multiplied by more than 6 and it represented more than 6% of total foreign claims of German banks (Figure 7a). As a result of this process, the external exposure of Spain against German banks reached 242,000 millions of US dollars in the third quarter of 2010, equivalent to approximately 17% of Spanish GDP, or 22% of cross-border debt of Spanish banks (Figure 7b).



Note: Immediate borrower basis.

Source: BIS (2011).

Figure 7a Foreign Claims of German Banks (Millions $)



Note: 3Q-2010. Ultimate risk basis, except for German banks that are on an immediate borrower basis.

Source: BIS (2011).

Figure 7b Foreign Exposures of Spain against International Banking (Billions $)

The creation of the monetary union, the elimination of the risk premium and the increased financial integration made possible for these resources to be channeled more easily and at historically low cost to Spanish households and corporations, and this probably raised the threshold that can reach the current account deficit without problems for financing.

However, this relationship between credit expansion in Spain and the financial resources available in Germany does not mean that the origin of the expansion of domestic demand is in the excess of German saving, as has been defended by, for example, Hans-Werner Sinn, Teresa Buchen, and Timo Wollmershäuser (2011). Under this scenario, German saving would has been channeled to the Spanish banks, that have increased the credit to households and nonfinancial corporations. This would have boosted the investment spending, leading the expansion of demand and the housing bubble. At the same time, the outflow of this saving would be the cause that would explain the sluggish investment in Germany and the slow growth of its domestic demand.

In fact, the divergent growth of demand in Germany and Spain has its own causes, which we noted above, and the behavior observed in financial flows is rather a consequence. The strength of demand in Spain explains the expansion of credit to the private sector, which is created endogenously by the banking sector. As part of the demand generated by these funds goes to deposits abroad through imports, the Spanish banks must raise funds by borrowing from those German banks where the deposits that have been created from its credit operations have materialized. Mostly, this is done by selling assets backed by mortgages to Spanish families.

2. The Crisis in the Euro Zone as a Consequence of the Accumulation of Imbalances in "Peripheral" European Countries

The growth pattern driven by domestic demand, which is characterized by high current account deficits, leads to the accumulation of a series of imbalances that prevent its continuity. But on the other hand, if these countries cannot keep on borrowing, the export-led growth model also collapses, unless countries such as Germany can find other markets in which to place their exports. Therefore, the true cause of the European economic crisis lies in the development of a growth model doomed to failure. The international financial crisis is the factor that precipitated it and the subsequent worsening of public finances hinder the solution of the crisis, but they are not its origin.[1]

The first of these imbalances is the high level of debt, mainly from households and non-financial corporations, as Table 2 shows. For example, in Spain the total debt of non-financial private sector rose from 132% of GDP in 2001 to 214% in 2007. This table also confirms that the Spanish debt problem appeared first in the private sector imbalances and not in the public sector. It also rose the accumulated debt held by residents of the rest of the world rose (in Spain, from 45% to 110% of GDP). Finally, the existence of a continued and growing deficit in the current ac-

[1] Eckhard Hein, Achim Truger, and Till van Treeck (2011) present a similar analysis of the causes of the crisis.

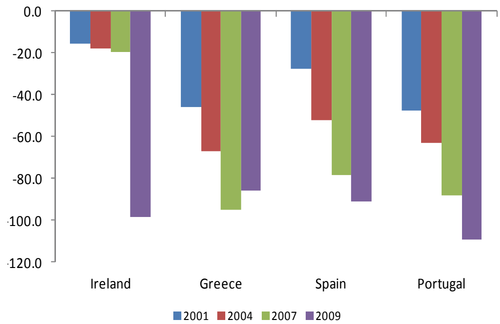
count of these countries has given rise to a progressive deterioration in its international investment position (Figure 8).

Table 2 Private and Public Debt in Deficit Countries (% GDP)

Sector	Year	Ireland	Greece	Spain	Portugal
Debt of housenholds and non-financial corporations (1)	2001	150.9	63.0	132.4	187.4
	2004	170.5	77.3	159.9	198.9
	2007	211.4	106.5	213.7	229.9
	2009	317.2	123.0	225.1	259.6
Public debt (2)	2001	35.5	102.9	55.5	52.9
	2004	29.4	98.6	46.2	58.3
	2007	25.0	105.0	36.1	62.7
	2009	65.5	126.8	53.2	76.1

Notes: (1) Total loans and securities other than shares; (2) Definition of the excessive deficit procedure.

Source: Eurostat (2011).



Source: Eurostat (2011).

Figure 8 Net International Investment Position (% GDP)

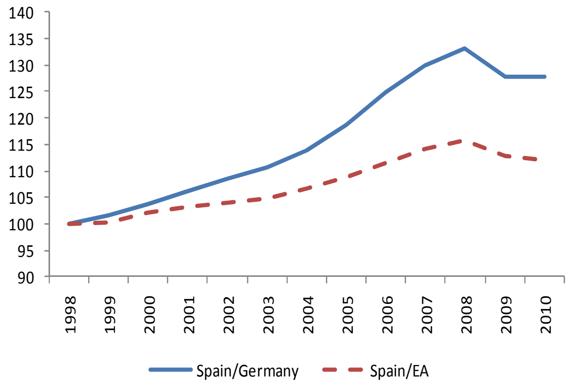
Another characteristic of the growth pattern of some peripheral countries (Spain and Ireland) is the overweight of the real estate sector. At the end of the previous expansive period, the weight of building industry in the generation of value added was much larger in Spain than the average for other countries in EMU, and its growth had been offset by a similar fall in the manufacturing sector (Table 3). This overweight of real estate sector and the bubble in housing prices also had a significant impact on the financial sector, because the high percentage of bank assets related to real estate (either in the form of mortgage loans to households or to real estate transactions).

Finally, the differences in the growth rates of unit labor costs that have taken place in the euro area over a long period of time have had a cumulative impact on competitiveness, as reflected in Figure 9a. Relative unit labor costs between Spain and Germany in 2007 were 30% higher than in 1998, and if the comparison is with the euro area the loss of competitiveness was 14%. In Figure 9b we see, finally, that the growth of nominal wages in Spain has been higher than the scope coming from the increase of productivity and the inflation target (just the contrary than in Germany).

Table 3 Supply Structure (% Gross Value Added, PPS)

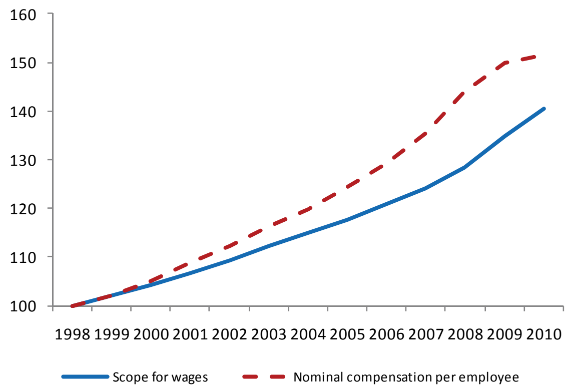
Economic sector	Spain		Rest of Euro Area-12	
	1997	2007	1997	2007
Primary sector	5.0%	2.7%	2.9%	2.1%
Industry (exc. construction)	22.2%	17.3%	26.0%	24.7%
Manufactures	19.0%	15.0%	22.2%	21.7%
Construction	7.1%	11.8%	6.3%	6.5%
Services	65.7%	68.1%	78.7%	85.4%
Trade, restaurants and hotels, transport	26.4%	24.5%	23.1%	23.8%
Financial Intermediation	18.3%	22.5%	29.8%	34.7%
Public and social services	21.0%	21.0%	25.8%	26.9%

Source: Eurostat (2011).



Source: Ameco (2011).

Figure 9a Relative ULC in Spain versus Germany and the Euro Zone (1998=100)



Source: Ameco (2011).

Figure 9b Nominal Wages in Spain

A possible interpretation of these data is that workers are too expensive, given their productivity. However, growth in nominal unit labor costs in Spain has been accompanied by a declining labor share of wages in income (an increase of profit margins). In other words, the increase in nominal wages is not the result of a change in the distribution of income in favor of wages, but of a higher inflation rate and the attempts to compensate -without full success- its effects on the real wage (relative to productivity). As noted by Jesús Felipe and Utsav Kumar (2011), to reduce the problems of the external sector to a measure of competitiveness centered on unit labor costs puts the burden of adjustment on workers, and ignores that the unit capital costs (ratio of the nominal profit rate to capital productivity) has also grown in the peripheral countries, and faster than labor costs.

To see the relationship between the accumulation of imbalances, the origins of the crisis and the difficulties to overcome it, we can use the example of Spain again (Dejuán and Febrero 2011) explain these arguments more deeply).

The growth of the previous period had been closely linked to residential investment, but in 2007 it had exhausted for several reasons. First, the household debt had reached very high levels and housing prices had tripled in ten years. Although initially the debt has an expansionary effect, insofar as it is intended to finance higher spending, the burden of debt service has detrimental effects in the long-term. Thus, at the same time that residential investment falls, the debt service resulting from previous years rises, provoking an increase in "forced savings". And this contraction in spending has been even greater because agents want to reduce the percentage of total debt to disposable income. Besides this, the ECB had begun to raise interest rates in late 2005 fearing a rebound in the inflation rate caused by the increase of raw material prices. Finally, the housing market was already saturated: nearly 7 million dwellings had been built in the last decade and, in 2007, 700,000 units more were started, when it was estimated that the number of unsold dwellings was 500,000.

The economic recovery cannot be grounded again on the construction industry and in fact it is unlikely that the housing market will recover in the short term. In 2009, the stock of unsold dwellings amounts to 688.044 units, 2.7% of the total stock of existing dwellings. And the previous expansion coincided with several social and demographic factors that are not maintained today.

Once the construction has halted its momentum, no other productive sector has taken over as the locomotive of the economy, resulting in a raise in unemployment that has worsened the problem of households' indebtedness.

An expansionary fiscal policy was carried out in 2008 and 2009 to offset the fall in private demand. However, the increase in public deficit and debt and sovereign debt crisis led the Spanish government to implement fiscal austerity measures, which causes an additional restrictive effect. And although the external sector has moved to make a positive contribution to growth, the cumulative loss of competitiveness highlighted above also limits its expansive effect.

Finally, the access to international financial markets to finance domestic spending also cut off. This shows that external debt has a limit, regardless of whether it originates in the public sector or the private sector. Membership of monetary union facilitated the financing of current account deficit before the current crisis began, but also exacerbates the difficulties that these countries now face, which makes international investors wary of lending to Spanish borrowers. As pointed out by Paul De Grauwe (2011), a massive sale of securities of the peripheral countries would lead to a depreciation of its currency if this existed, favoring the correction of current account deficit. However, the nominal depreciation cannot take place within the euro zone, so the situation is equivalent to having issued debt in a foreign currency.

3. Economic Policy Proposals

Since the outset of the Greek crisis (May 2010) the European authorities (national governments, European Commission and ECB) are applying an economic policy strategy whose main elements are the following (see European Commission 2011a):

(i) The establishment of fiscal consolidation as the top priority of economic policy, considering it a necessary prerequisite to normalize financial markets and ensuring the stability of the euro area. The deficit reduction measures are concentrated in health care costs, pensions, salaries of civil servants and other social benefits as well as increases in indirect taxation. See Sotiria Theodoropoulou and Andrew Watt (2011) for an analysis of the austerity plans passed in the UE;

(ii) A proposal for the reform of European governance with three essential elements: the adoption of the European Semester, the strengthening of the budgetary discipline rules of the Stability and Growth Pact and its translation into national legislation and the adoption of a new mechanism to monitor macroeconomic imbalances, explicitly including current account imbalances. For a critical assessment of these proposals, see Jorge Uxó and Jesús Paúl (2011);

(iii) The adoption in the deficit countries of measures to correct the imbalances in competitiveness as reflected in the evolution of unit labor costs (Euro Plus Pact);

(iv) Implementation of structural reforms in both labor and product markets in order to reduce unemployment and raise the long-term growth. In the Commission's view, these reforms are necessary due to the negative impact that the crisis has had on the potential growth of European economies (for example, European Commission 2011b);

(v) Providing financial support to those economies more vulnerable to sovereign debt crises, which include the European Financial Stabilisation Mechanism, the European Financial Stability Facility and, from 2013, the European Stability Mechanism (ESM);

(vi) Reform of financial supervision and regulation, which would include stress tests and the need for recapitalization of banks more vulnerable, the introduction of new regulations (hedge funds, rating agencies) or the reform of the regulators (European Systemic Risk Supervisory Board and the European Authorities).

We believe that these economic policies not only do not solve the fundamental problems related to the functioning of the monetary union, and specifically current account imbalances, but they worsen them.

Firstly, the general approach of these proposals is clearly focused on the supply side, when the main constraint facing the European economies is the shortage of demand. To solve the growing unemployment, the only measure proposed is the labor market reform, when the origin of this problem is essentially macroeconomic. Surprise, especially, some measures that pursue an impact on labor supply ("make work pay"), when what is recorded in this market is in any case, a situation of excess of supply. Or, to drive growth, they insist on the same structural reforms included in the failed Lisbon Strategy that have, in any case, a long-term effect. The European Commission argues that the crisis has had a negative effect on potential growth, but does not take into account that these effects are produced precisely because of the prolonged shortage of demand and growth (long-term unemployment, discouraged workers leaving the labor force and low investment and therefore less productive capacity). It cannot be argued that demand will eventually adapt passively to the aggregate supply conditions on which it is intended to act, when the source of the imbalances that have led to the current crisis lies precisely in the weak demand growth in core countries.

Secondly, European governments have ended up placing the crisis of sovereign debt and public deficit problems in the center of all its proposals, ahead of the recovery in demand at a rate sufficient to reduce unemployment. They consider it a "prerequisite" to accelerate growth. However, the fiscal crisis is the result of the economic crisis, not its origin. A typical case is that of Spain, where both the deficit and public debt was reduced throughout the prosperity years, amply fulfilling the criteria of the Stability Pact. Current imbalances are not due to failure of the fiscal rules, and it does not make sense to further harden them. It is also obvious that fiscal austerity policies (implemented simultaneously in all European countries) will have a restrictive effect on demand, aggravating the recession.

Thirdly and directly related to the specific issue of current account imbalances, the policies that are currently being implemented to correct them only focus on the adjustment of the competitiveness of the deficit countries, mainly through policies of wage restraint. But the interpretation of the imbalances that have been proposed in this paper shows that the solution to this problem cannot be reached only with deflationary policies in the “peripheral” countries.

A closer look at the Spanish economy will illustrate these conclusions. The economic crisis has led to a sharp increase in unemployment; to reduce it within a reasonable period of time would require a high economic growth in the coming years, probably more than the European average. While to achieve this it would be necessary to stimulate the aggregate demand, the Spanish economy seems trapped in two vicious circles that prevent it to reach this aim in isolation:

(a) The high level of indebtedness of households and corporations limits the possibilities of a strong pull in private consumption and investment, which is also weakened by the current low level of utilization of productive capacity, the deterioration of business expectations and financial system problems. But in the current institutional framework of the euro zone the ability to use expansionary fiscal policy is clearly limited by the problems in debt markets. In this sense, Phillip Arestis and Malcom Sawyer (2011) criticize some characteristics of this institutional framework that restrict the operation of economic policies and propose some alternatives.

(b) If the growth rate returns to be above the average for other euro zone countries to eliminate unemployment, the balance of payments constraint will surely reappear in the form of external current account deficit, but under present conditions it would be difficult to finance it. Therefore, Spain needs to adjust its competitiveness, which also would allow an expansion of its exports, and the way it intends to do this is through internal devaluation achieved with lower wage growth. But this strategy is very risky for several reasons. The first is that it has restrictive effects on demand, not only due to the negative impact on the propensity to consume, but by the increased burden of servicing debt (a nominal contract) on disposable income and the probable loss of tax revenues, which would force further cuts in public spending. The second is that, to be successful, the strategy of wage restraint should lead to lower inflation than the average of other countries in the EMU: what matters is the relative position. However, if all countries intend to engage in competitive reductions of wages (even surplus countries such as Germany could defend its current position of advantage), it is not sure that this "race to the bottom" could be an improvement in competitiveness. Moreover, if policies to reduce wages provoke a generalized reduction in growth rates, it would actually aggravate the structural problem of shortage of demand which the European economy has been facing.

The most important implication that emerges from our analysis, therefore, is that the economic recovery and the resolution of current imbalances cannot come only from the side of the deficit countries, trying to regain competitiveness through wage restraint, but also from the side of the surplus countries. If these countries maintain a policy of low wages and slow growth in domestic demand, it will be impossible to solve this imbalance for deficit countries, except at the expense of a deep recession and deflation, which would actually end up endangering the repayment of past debts.

On the contrary, it seems necessary to address the root causes that have resulted in the lack of demand in the whole system, and to implement a more balanced pattern of growth within EMU, in which the countries do not base their growth on stimulating exports by means of wage competence. This alternative economic policy should include measures like these:[2]

(1) To eliminate the pressure that the risk of a debt crisis implies for the fiscal policy choices of national governments, the ECB should be clearly committed to purchasing as much public debt as necessary. This would avoid speculation against any country;

(2) It should be set a European fiscal authority, with the ability to issue debt on behalf of European countries, at least up to a particular level. This would also require real cooperation on fiscal policy making sure that, the full effect on aggregate demand would be the appropriate one;

(3) Falling taxes -and not increasing spending- has led to fiscal deficits in most European countries. These policies are regressive and put the Welfare State at risk. So, national fiscal authorities should harmonize taxes instead of practising “fiscal competence”;

(4) A widespread policy of wage restraint and cuts in public spending is not the right way to improve competitiveness, particularly if this goal is reached at the

[2] See Febrero and Uxó (2011) for a more detailed analysis of the economic policy alternatives in Spain. Horn et al. (2010) and Stockhammer (2011) also offer some specific economic policy proposals.

expense of higher unemployment. A better way of realign competitiveness between EMU countries would be: (i) to increase the inflation target set by the ECB for the monetary union; (ii) to set a lower than average inflation target in the deficit countries for some time; (iii) to implement a coordinated wage policy, targeting wage increases in accordance with productivity gains plus the national inflation target. Once losses accumulated in competitiveness were eliminated, this wage policy would be neutral for competitiveness inside the Euro Zone, thus avoiding the recurrence of current problems.

4. Conclusions

A way of analyzing the current account imbalances in the euro area, which is basically shared by the European authorities, is to interpret them as the result of problems of competitiveness, lack of efficiency and economic policy mistakes made by the deficit countries. The central idea of this article, however, is that the genesis of these imbalances is in the growth pattern that has characterized the European economies since the creation of the euro. We have used the cases of Spain and Germany to support this assertion.

For several reasons, but mainly as a result of changes in the distribution of income and wage restraint policy, there has been a structural shortage of demand in core countries (e.g. Germany). But these countries have partially offset the negative consequences of this fact on their growth rates thanks to the strong growth in the domestic demand of the "peripheral" countries. In turn, this growth in demand was driven to a significant extent by lower interest rates experienced by these countries to join the monetary union and the ECB setting of a single rate for the entire Euro zone.

However, this solution to the problem of the shortage of demand could only be provisional, because it was financed by increasing borrowing. Current account imbalances are the manifestation of this phenomenon, but also the accumulation of increasing amounts of debt (mostly private), the accumulated losses of competitiveness, the real estate sector hypertrophy and the excessive risk taken by financial institutions.

The creation of the monetary union and the resulting financial integration played also a key role in explaining the rising current account deficit to levels historically unknown: the risk premium disappeared and easier access to funding was ensured.

The Great Recession occurs when this demand growth financed with debt becomes unsustainable (not only in the "peripheral" European countries but also in other countries like the U.S.) and there is no other agent taking over demand generation. Initially it was expected that the public sector would generate such demand, but the debt crisis forced European governments to implement fiscal austerity plans. In any case, the structural problem of lack of demand goes beyond just a cyclical shortage that could be corrected only with transitory fiscal policies. To solve it, it is necessary for domestic demand to grow faster in countries that have developed in the past a growth model based almost exclusively on exports. And to make this possible, it is necessary to change the pattern of income distribution and the wage restraint policy applied in countries like Germany, which is usually seen as an example of moderation and virtue in the official European documents.

References

Arestis, Philip, and Malcom Sawyer. 2011. "The Design Faults of the Economic and Monetary Union." *Journal of Contemporar*y *European Studies*, 19(1): 21-32.

De Grauwe, Paul. 2011. "The Governance of a Fragile Eurozone." The Centre for European Policy Studies Working Document 346.

Dejuán, Oscar, and Eladio Febrero. 2010. "The Failure of a Path of Growth Driven by Household Indebtedness (Spain, 1997-2009)." *Économie Appliquée*, 63(1): 63-78.

Dejuán, Oscar, and Eladio Febrero. 2011. "The Aftermath of a Long Decade of Nil Real Interest Rates (Spain, 1996-2008)." In *The First Great Recession of the 21st Century. Competing Explanations*, ed. Oscar Dejuán, Eladio Febrero, and Cristina Marcuzzo, 222-245. Cheltenham: Edward Elgar.

European Commission. 2010a. "Surveillance of Intra-Euro-Area Competitiveness and Imbalances." *European Economy*, 2010(1): 1-155.

European Commission. 2010b. "Special Issue: The Impact of the Global Crisis on Competitiveness and Current Account Divergences in the Euro Area." *Quarterly Report on the Euro Area*, 9(1): 1-42.

European Commission. 2011a. "The EU's Comprehensive Policy Response to the Crisis." *Quarterly Report on the Euro Area*, 10(1): 7-14.

European Commission. 2011b. *Annual Growth Survey: Advancing the EU's Comprehensive Response to the Crisis*. Brussels: European Commission.

European Council. 2011. "Conclusions of the Presidency." http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/120296.pdf (accessed March 24-25, 2011).

Febrero, Eladio, and Jorge Uxó. 2011. "Constraints and Alternatives for Employment and Output Growth. Spain during the Great Recession." *Journal of Contemporar*y *European Studies*, 19(1): 63-81.

Felipe, Jesús, and Utsav Kumar. 2011. "Unit Labor Costs in the Euro Zone: The Competitiveness Debate Again." Levy Economics Institute Working Paper 651.

Fitoussi, Jean Paul, and Joseph Stiglitz. 2009. "The Ways Out of the Crisis and the Building of a More Cohesive World." Document de travail OFCE 2009-17.

Hein, Eckhard, and Achim Truger. 2009. "How to Fight (or Not to Fight) a Slowdown." *Challenge*, 52(3): 52-75.

Hein, Eckhard, Achim Truger, and Till van Treeck. 2011. "The European Financial and Economic Crisis: Alternative Solutions from a (Post-)Keynesian Perspective." Macroeconomic Policy Institute Working Paper 9/2011.

Horn, Gustav, Katharina Dröge, Simon Sturn, Till van Treeck, and Rudolf Zwiener. 2009. "From the Financial Crisis to the World Economic Crisis. The Role of Inequality." Macroeconomic Policy Institute Report 41.

Horn, Gustav, Heike Joebges, and Rudolf Zwiener. 2009. *Global Imbalances: Cause of the Crisis and Solution Strategies for Germany*. Düsseldorf: Macroeconomic Policy Institute.

Horn, Gustav, Torsten Niechoj, Silke Tober, Till van Treeck, and Achim Truger. 2010. "Reforming the European Stability and Growth Pact: Public Debt is Not the Only Factor, Private Debt Counts as Well." Düsseldorf: Macroeconomic Policy Institute.

Sinn, Hans-Werner, Teresa Buchen, and Timo Wollmershäuser. 2011. "Trade Imbalances – Causes, Consequences and Policy Measures: IFO's Statement for the Camdessus Commission." *CESIfo Forum*, 2011(1): 47-58.

Stockhammer, Engelbert. 2010. "Neoliberalism, Income Distribution and the Causes of the Crisis." School of Oriental and African Studies, Department of Economics, Research on Money and Finance Discussion Paper 19.

Stockhammer, Engelbert. 2011. "Peripheral Europe's Debt and German Wages. The Role of Wage Policy in the Euro Area." School of Oriental and African Studies, Department of Economics, Research on Money and Finance Discussion Paper 29.

Theodoropoulou, Sotiria, and Andrew Watt. 2011. "Withdrawal Symptoms: An Assessment of the Austerity Packages in Europe." European Trade Union Institute Working Paper 2011.02.

Uxó, Jorge, and Jesús Paúl. 2011. "The Reform of the Economic Governance of the Eurozone: Macroeconomic Supervision and Coordination." *International Journal of Public Policy*, 7(4,5,6): 205-225.