

Workshop on Global Imbalances
By Desmond Lachman

1. I very much **welcome the paper** by Ahearne, von Hagen and Schmitz in that it draws attention to two basic weaknesses in the Euro area that if soon not corrected could have large systemic effects. Specifically, it highlights (a) the very large **divergences since 1999 in competitiveness** behavior among the euro members and (b) the very different **current account positions** they have.
2. What is disturbing about these divergences are (a) that on present trends there is every reason to **expect that they widen further in the future** given the very different wage and price behavior among members and (b) this was **not supposed to be how the euro operated**. It was hoped that removing the devaluation option as an easy way out for the Mediterranean members, they would be forced to reform and deliver better productivity and inflation performance. Evidently that has not happened.
3. The main contention of the authors is that these very different current account balances are the sign of **a proper functioning of the euro area** rather than a sign of improper macro-economic management. They take the position that EMU has changed the pattern of capital flows in the euro area by increasing the tendency of **capital flows to go from relatively rich to relatively poor countries**. As such these capital flows are promoting convergence.
4. There are **three basic reasons** why I take a very different view of developments in Europe than do the authors. As a result, far from seeing these divergences as a healthy development, I see them as reflecting **something very dysfunctional** in the euro area that could in time lead to its demise in its present form. For that reason, I think that there can be not room for complacency in Europe and that there needs to be an intensification of reform efforts in the euro area's wayward members' policy.
5. **The three main points** that I would like to make about the authors' contention that capital flows are contributing in a good way to the widening of the current account deficits of countries like Greece, Portugal and Spain are as follows:
 - (a) First there is **a basic question of causality**. The fact that there might be a correlation between capital flows and divergent current account behavior does not necessarily mean that it is the capital flows that is driving the divergent current account behavior. As the authors themselves document, there is a very good correlation between developments in the different **countries' competitive positions and their current account balances**. This makes me wonder whether in thinking that healthy capital flows are leading to current account divergences, they are not seeing the **tail wagging the dog** rather than the dog wagging the tail. It would seem far

more plausible to me, that the widening of current account positions due to competitiveness factors is requiring capital flow rather than the other way around. These capital flows are likely to be all the more readily available in a world where (a) the **markets are flush with liquidity** and (b) where the markets are laboring under the illusion that the introduction of the euro has **removed the need to differentiate** very much between the different euro member countries. This is reflected right now in remarkably low spreads between say the debt of the Mediterranean countries and that of Germany despite the very different fundamentals.

- (b) The second point is that the authors themselves note that there is **little academic evidence that capital generally flows in a healthy way from the richer to the poorer countries**. (a) This is certainly not happening with **the United States and Asia**. So why should we think that this is what might be going on in Europe; and (b) if one looks at **the miserable productivity performance in Spain Italy and Portugal** one would find it difficult to believe that capital flows from the rich European countries to the poorer European countries is contributing to convergence.
 - (c) The third point that I wish to make is that the authors do not look at the question of capital flows from **a sustainability or a savings and investment perspective**. Had they done so, I would think that they would have arrived at a very much less sanguine view of what is going on in Europe. They would see that the opening up of current account deficits in individual European countries is **not the counterpart of an increase in productive investment** that would lead to higher growth and the countries' ability to service the debt but rather to either an increase in **residential investment or to the widening in the public sector deficit**.
6. I would like to illustrate this last point with a cursory look at **Spain's savings and investment balance**. As one can see from the chart, since 1999 Spain's external current account deficit has widened by around 6 percentage points of GDP yet its non-residential investment as a percent of GDP has increased by around 1 percent of GDP. The main counterpart to the widening of the current account deficit was **a 5 percentage point of GDP increase in residential investment**. This hardly gives one much comfort that Spain is using its increased foreign borrowing wisely or that it will avoid problems down the road.
 7. One has to wonder **how stable these capital flows will be** when the bubble in **Spanish house prices bursts**. As Chart 4 illustrates over the last seven years, Spanish home prices in real terms have increased by over 5 percent a year or accumulative 50 percent in part reflecting the negative interest rates at which Spanish home owners can finance themselves. This has led to housing in Spain now having risen to something like **9 percent of GDP** or to practically the highest level in Europe. One also has to wonder **how Spain will cope with any bursting of its housing bubble** given that it no longer has a monetary policy of its own.

8. Even stronger arguments can be made about **the stability of capital flows to Italy** where the loss in Italian competitiveness over the past five years has already contributed to a marked slowdown in output growth and where the public debt is already on the rise. Given the restraints imposed on Italian monetary and exchange rate policies by euro membership, it is difficult to see how Italy can effectively address its public finance problem without inducing a prolonged recession
9. It would be easier for Greece, Italy, Portugal, and Spain to address their imbalances in the context where **Germany took measures to stimulate domestic demand** rather than to rely on export growth. This imperative for Germany to adopt more expansive policies is supported by the authors' finding that German trade is the most sensitive in Europe to any strengthening in the euro. It is for this reason that one has to be particularly concerned that Germany is now engaging on a program of fiscal tightening at precisely the time that the Euro continues to strengthen.

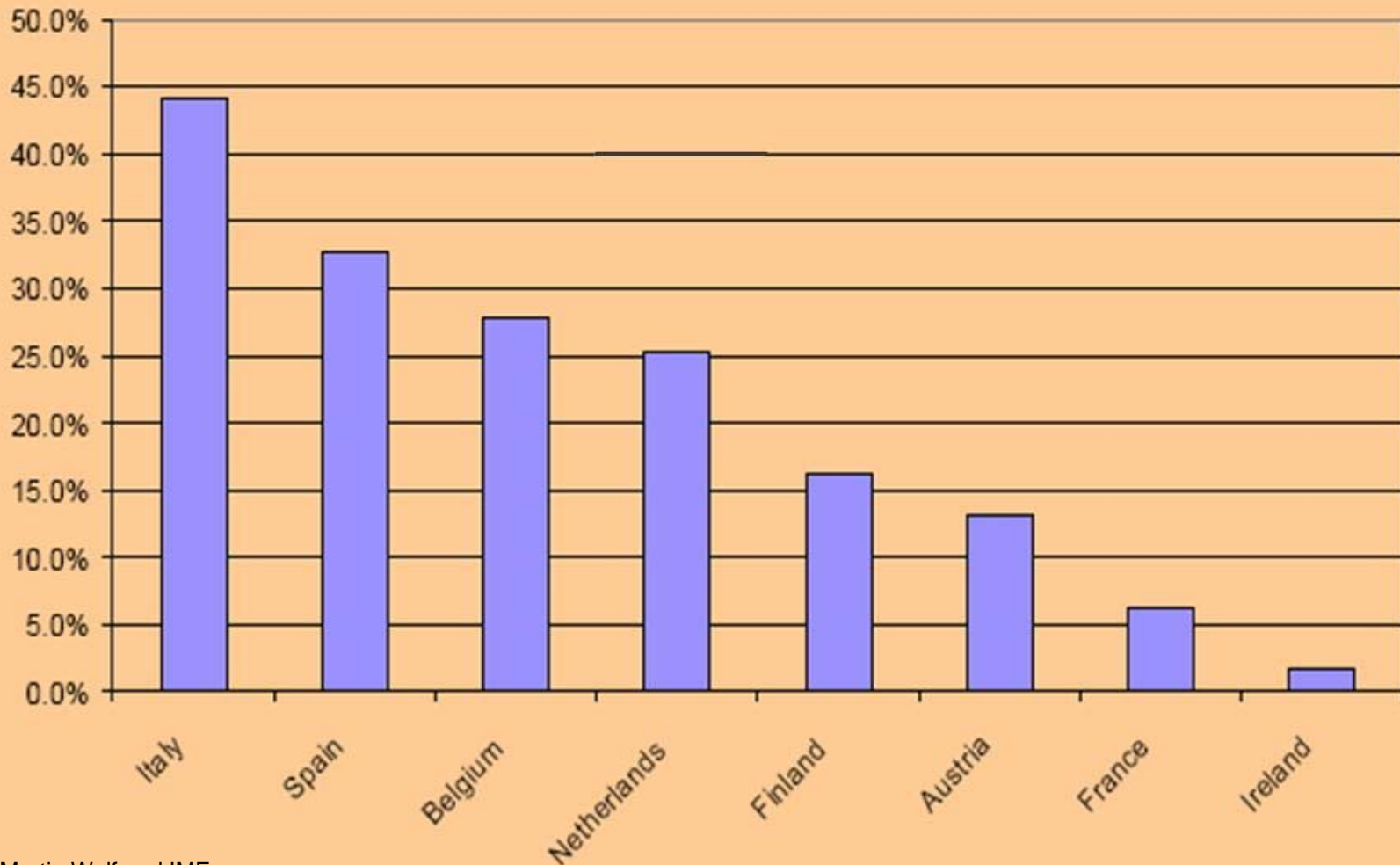
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Chart 1: Divergence in European Competitiveness

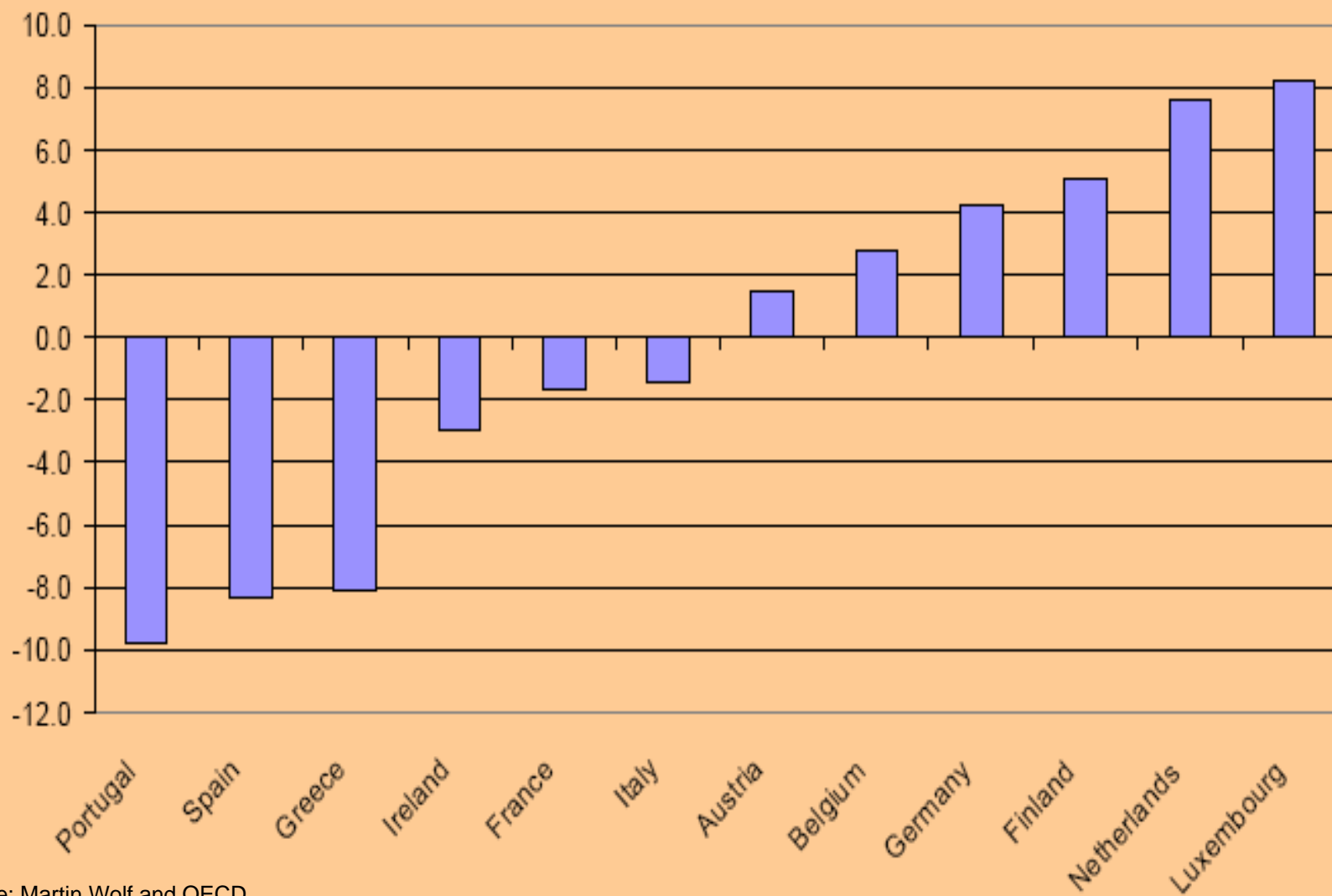
**Appreciation of Real Exchange Rate Relative to Germany's
Between Q1 1999 and Q3 2006
(based on relative unit labor costs)**



Source: Martin Wolf and IMF

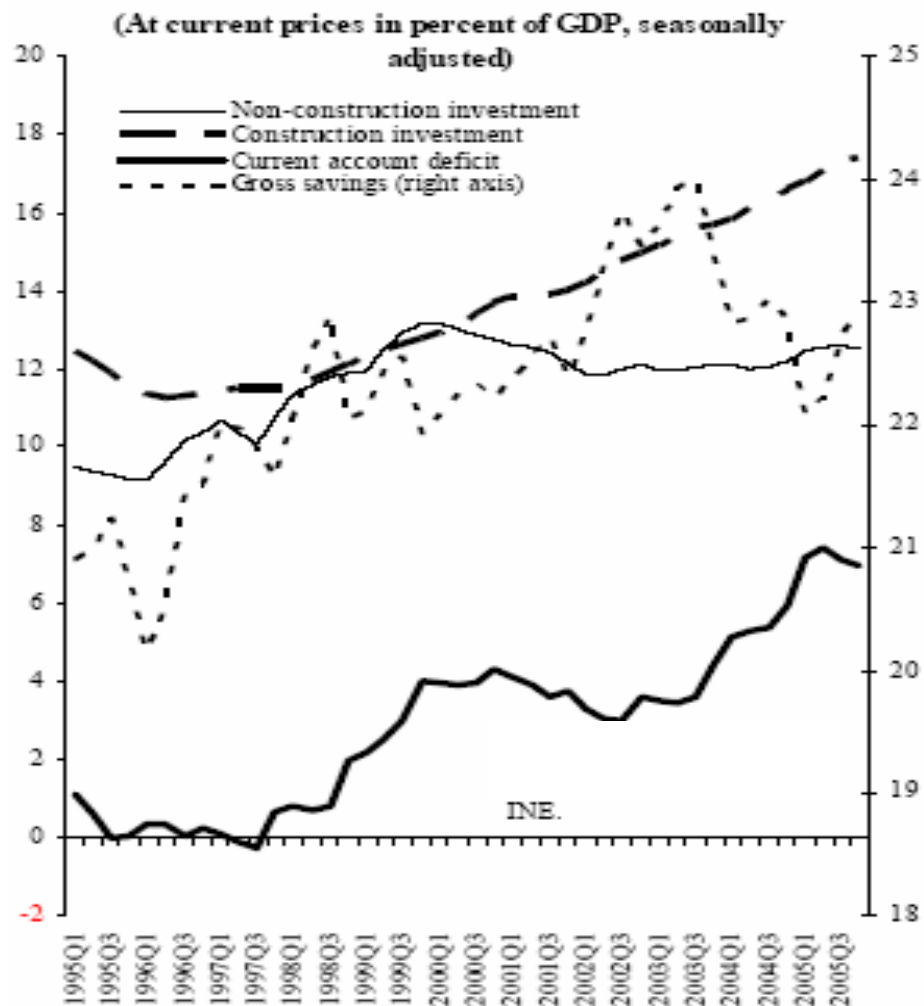
Chart 2: Divergence in European Current Account Performance

Current Account Balances 2006
(as percent of GDP)



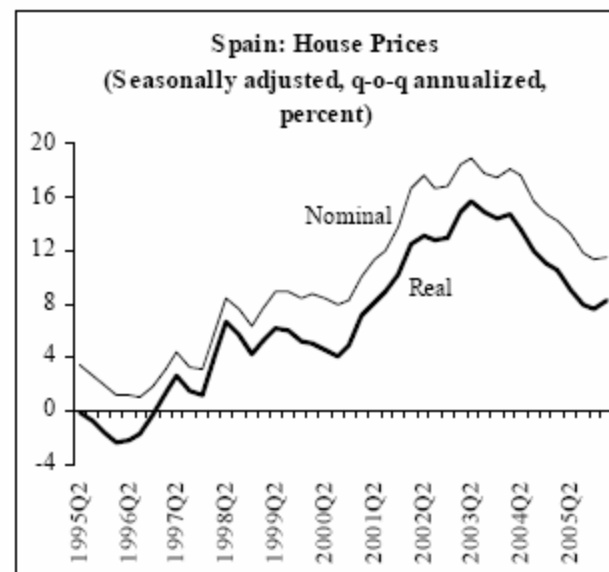
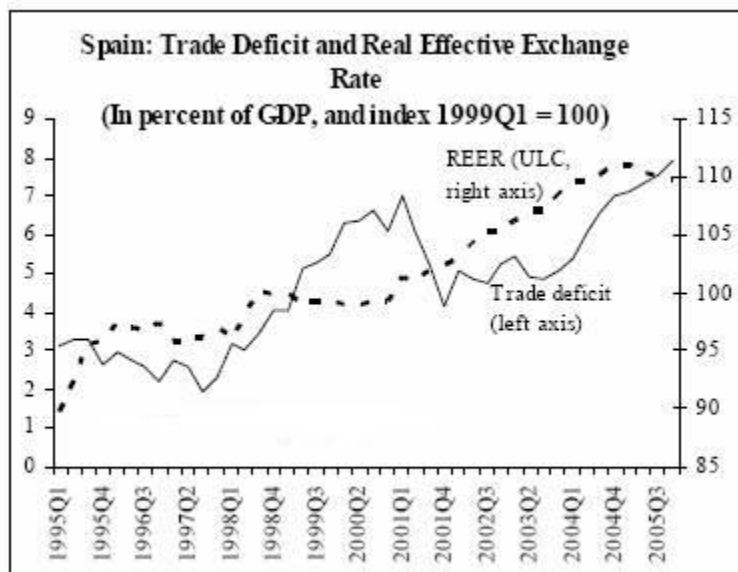
Source: Martin Wolf and OECD

Chart 3: Spain Current Account Deficit, Savings, and Investment



Sources: Bank of Spain and INE

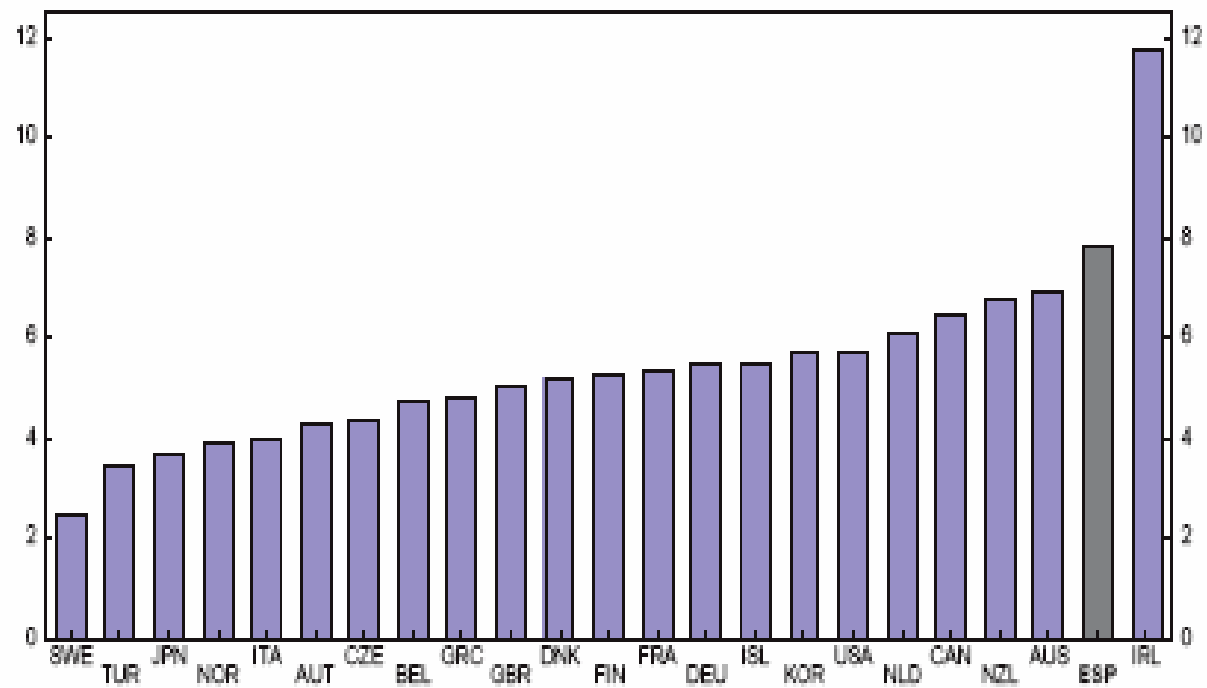
Chart 4: Spanish Trade Deficit and Housing Prices



Sources: Bank of Spain, IMF

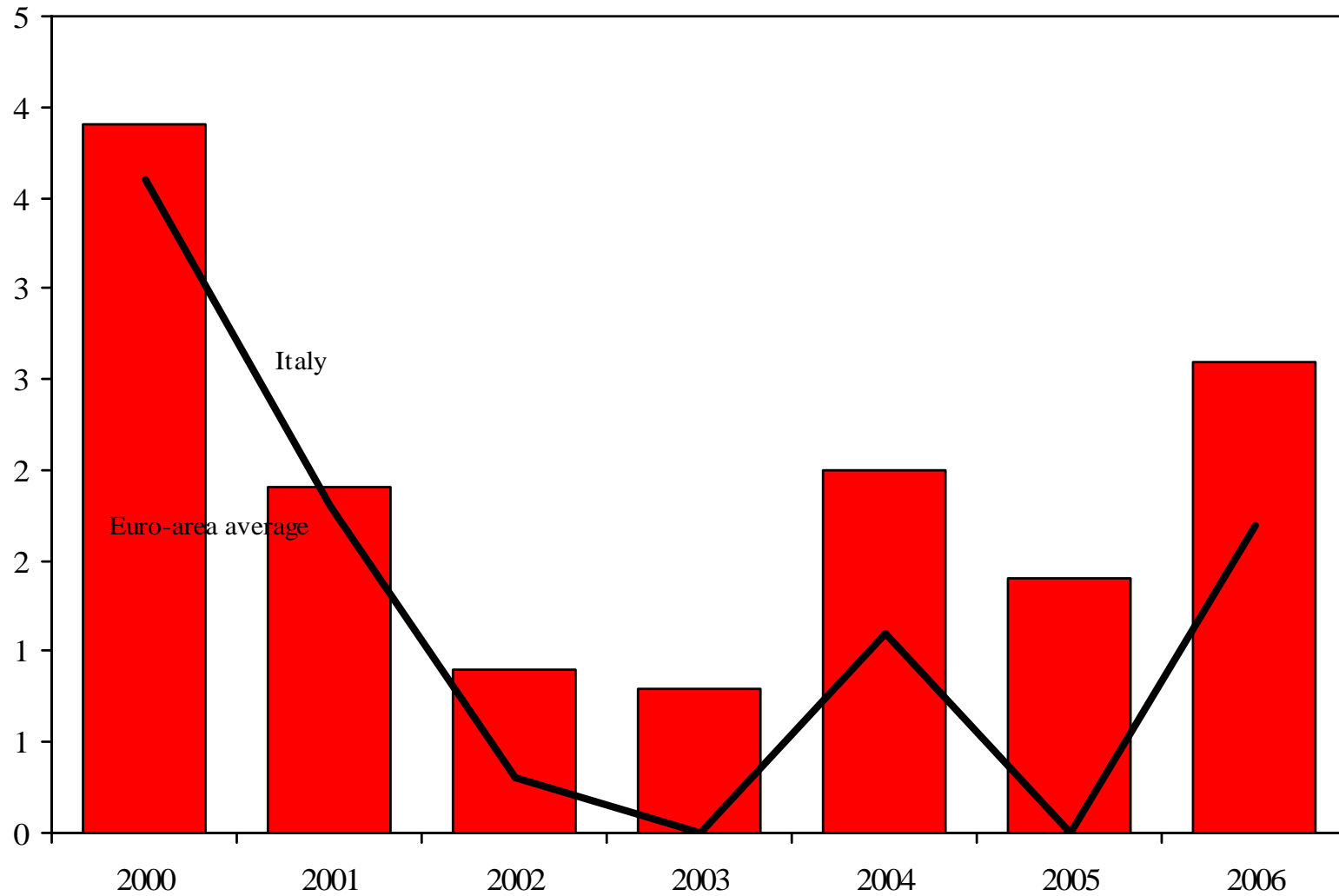
Chart 5: Housing Investment Share

2004, per cent of GDP



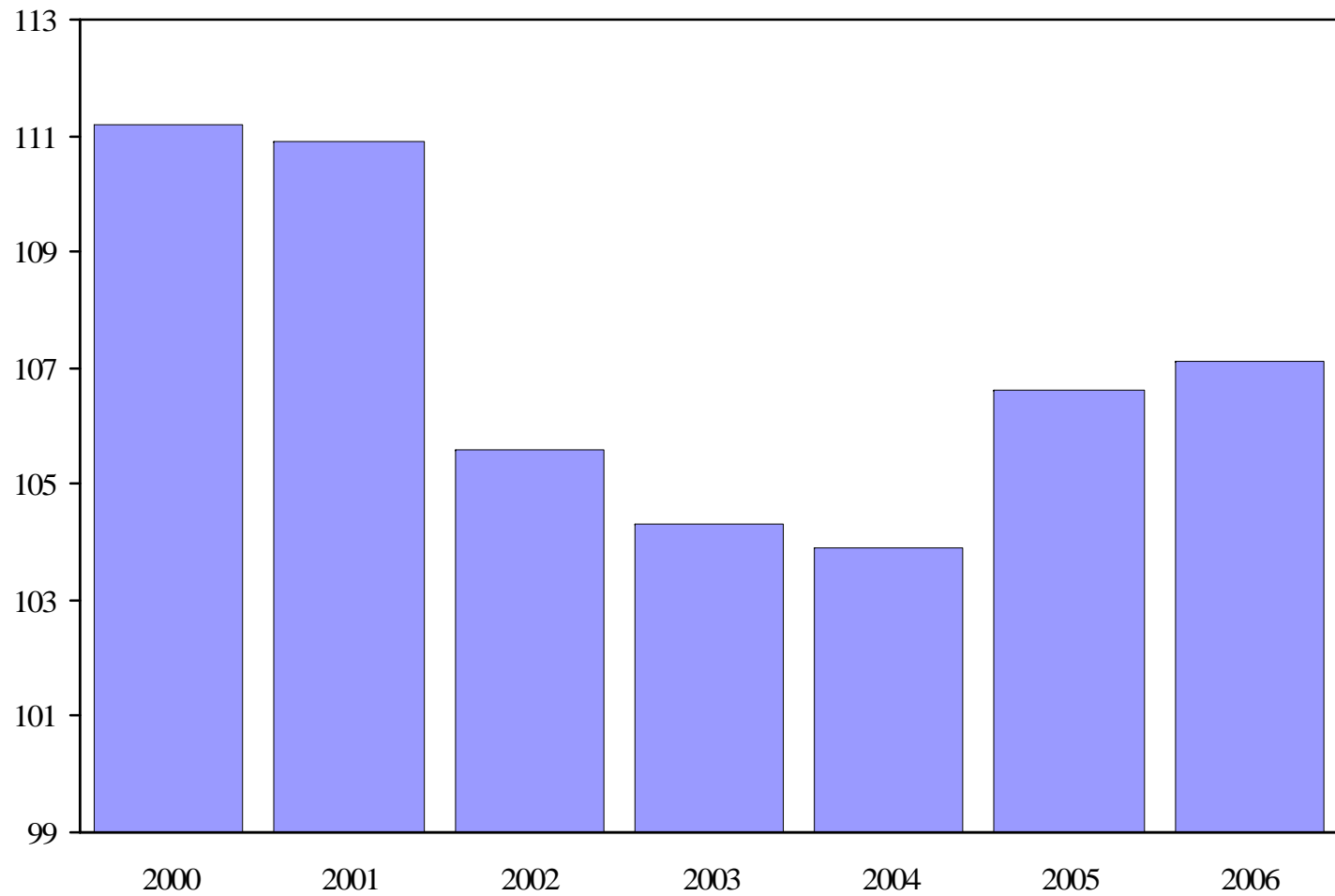
Source: OECD, National Accounts and Economic Outlook 79 database.

Chart 6: Italy Real GDP Growth



Source: IMF

Chart 7: Italy Gross Debt to GDP Ratio



Source: IMF