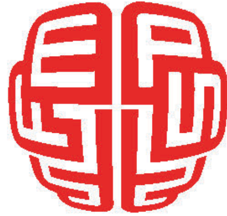

IMBALANCES IN THE EUROPEAN UNION

Policy Brief 1

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The financial crisis in 2008 was the starting point for the most severe economic crisis since the Second World War. Since 2008 the European Union has been in recession twice. Now – six years after the crisis broke out – domestic demand is still subdued and the economies are growing at a slow pace at best. Put differently Europe is still affected by the crisis and recovery prospect is bleak.

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Large potential in reducing European current account and private saving surpluses

The financial crisis in 2008 was the starting point for the most severe economic crisis since the Second World War. Since 2008 the European Union has been in recession twice. Now – six years after the crisis broke out – domestic demand is still subdued and the economies are growing at a slow pace at best. Put differently Europe is still affected by the crisis and recovery prospect is bleak. The debt troubled countries have suffered significantly more than the rest of the member states, especially during austerity programs and the structural reforms that have been necessary in order to meet the convergence criteria in the Stability and Growth Pact.

The Stability and Growth Pact is a fiscal pact between the 28 member countries of the European Union where each country commits to comply with the terms of the agreement. According to the pact each member state cannot have budget deficits exceeding 3 percent of GDP per year. The limit of public debt is 60 percent of GDP and the structural balance deficit cannot be more than half a percent of GDP.

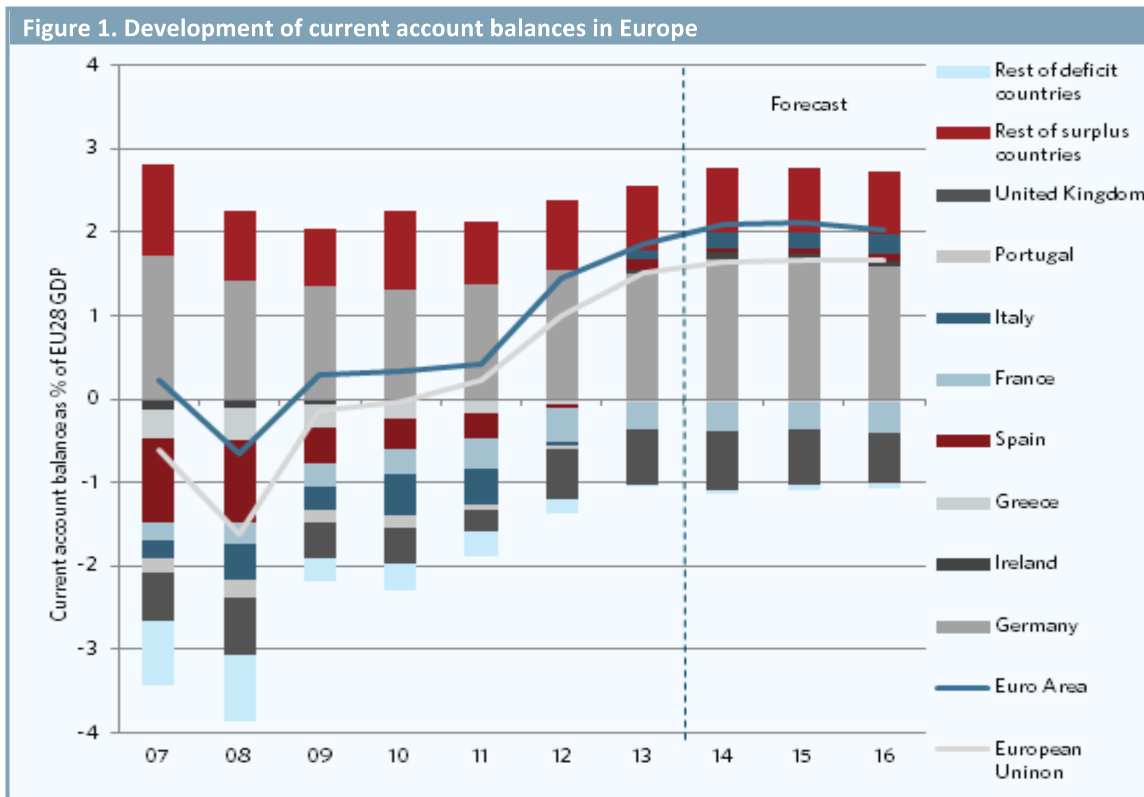
In 2010 the EU Commission recommended that 24 out of the (at that time) 27 member states should tighten fiscal policy. The coordinated consolidation put an end to the moderate economic recovery and sent the region back into recession. Many countries have reduced the public debt and cut government budget deficits at the cost of high unemployment, low growth rates and low domestic demand due to lack of consumer and investor confidence. Fulfillment of the Stability and Growth Pact might very well be one of the most important reasons why Europe took a second dip into recession after the economies started the fiscal consolidations needed to meet the requirements.

A by-product of the low domestic demand has been improvements in the current account balances. Figure 1 shows the development of the current account balance in percent of EU28 GDP since 2007. The low domestic demands during the consolidations, due to lower government spending and private spending, have implied a lower import in the European countries. This has created trade surpluses in the countries which have turned the current account deficits into current account surpluses in many countries.

Before the economic crisis the European Union on average had an overall balanced current account balance. Immediately after the crisis the deficits in some countries began to diminish. In 2011 after the fiscal consolidations began, the deficits were reduced even more while surpluses began to increase. In 2013 UK and France are the only countries with current account deficit to speak of. The deficits of Greece and the rest of the deficit countries are hardly notable.

Italy, Spain and Ireland have turned their current account deficits into current account surpluses. Since the millennium Germany has had a current account surplus. Germany's large current account surplus has remained stable through the crisis as have the rest of the surplus countries.

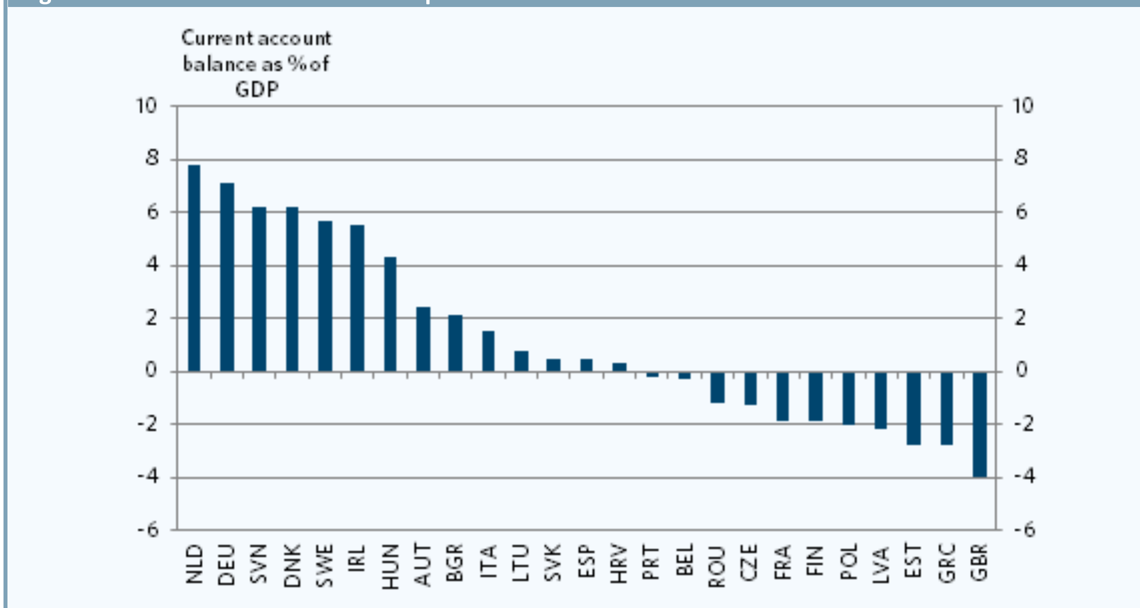
Figure 1. Development of current account balances in Europe



Note: Surplus countries include countries with current account surpluses before the economic crisis and deficit countries include the countries with current account deficits before the economic crisis. The surplus countries are Belgium, Luxembourg, the Netherlands, Austria, Finland, Denmark and Sweden and the deficit countries are Estonia, Cypress, Latvia, Lithuania, Malta, Slovenia, Slovakia, Bulgaria, Czech Republic, Croatia, Hungary, Poland and Romania.
Source: EU Commission Forecast autumn 2014 and AMECO database.

If we take a closer look at current account surpluses in percent of national GDP it becomes clear that there are very high surpluses especially in some of the central and the northern European countries. This can be seen in figure 2 that shows the current account balance in percent of GDP in 2014.

Figure 2. Current account balance in percent of GDP in 2014



Source: EU Commission Forecast autumn 2014.

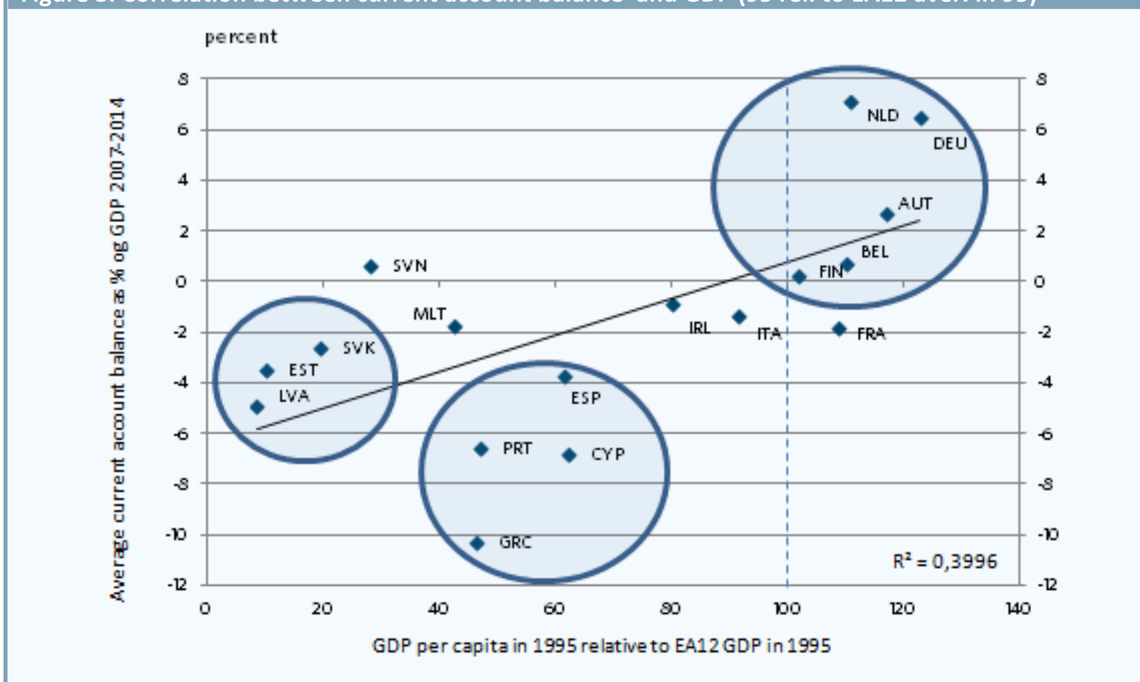
Still a little less than half of the countries have current account deficits. Looking at the Eurozone and plotting the average current account deficit in percent of GDP from 2007-2014 and GDP in 1995 when the Eurozone was established indicates a positive correlation. The imbalances we see today originate from the differences between the countries when the Eurozone was established.

The countries whose GDP level were above the average EA12 GDP are more likely today to have had a current account surplus the last 8 years. Note that France is the only country in the Eurozone that had a higher-than-average GDP in 1995 and now has a current account deficit.

Below the trend we find the debt troubled countries that had less-than-average GDP in 1995 and through 2007-2014 on average have had a current account deficit.

Latvia, Estonia and Slovakia had a very low GDP level relative to the EA12 average in 1995 and on average these countries have had a current account deficit the last 8 years. Slovenia is the only country with GDP less than average with an average current account surplus.

Figure 3. Correlation between current account balance and GDP (95 rel. to EA12 aver. in 95)

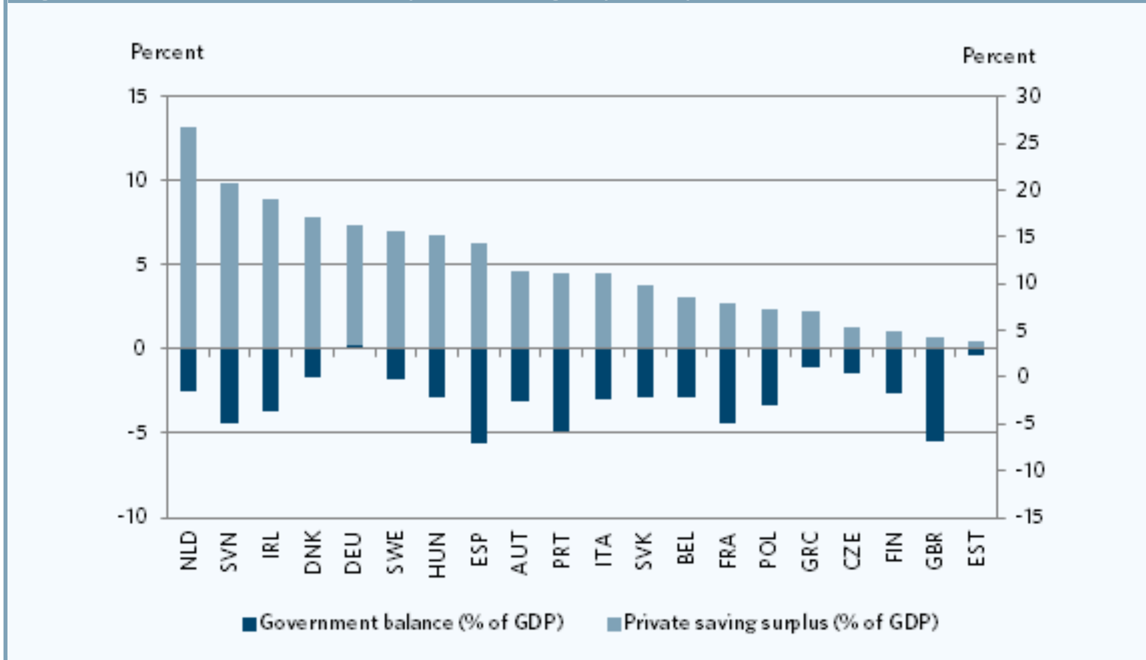


Note: *Current account balance.
Source: EU Commission Forecast autumn 2014 and AMECO database.

The current account surpluses indicate that some countries have room for consumption and investment. This would improve the economic situation in both the short term and the long term. After austerity measures have been introduced in Europe many countries now lie within the limit of government budget deficit. These countries have the option to stimulate the economy. Fiscal stimulus is an unavoidable tool to dodge stagnation and lead the region back on a sustainable growth path.

Low consumer and business confidence have caused high private saving surpluses in the European Union. The propensity to save or repay debt has been high due to uncertainty about the future and companies have postponed investments. The private saving surpluses indicate that liquidity and capital are present in the European countries and are thus a large potential for growth. Figure 4 shows that the majority of the European countries have high private saving surpluses. Even the debt troubled countries Italy, Spain and Greece have a higher private saving surplus than government debt.

Figure 4. Government balance and private saving surplus as percent of GDP in 2014



Source: EU Commission Forecast autumn 2014

Reducing current account surplus in Germany will increase growth and employment all over Europe

As described above several European countries still have a good starting point with relatively healthy public finances and a large private savings surplus. Countries like Germany, Austria, Netherlands, Sweden and Denmark all have public finances that leave room to maneuver, meaning that they have the option to stimulate the economy. Current account surplus combined with the large private savings surpluses shows that liquidity and capital are present, but the sluggish growth rates in domestic demand confirm that confidence and consumer and investors willingness to consume and invest are low.

Germany is having the largest surplus in the EU (in percent of EU's GDP). In the following we will look at Germany as an example, and see what potential there is for growth and jobs all over Europe, if German demand increases corresponding to the current account surplus being reduced to half its level in percent of GDP over a 5 year period. The macroeconomic model HEIMDAL is used to calculate the effect of the alternative scenario. In the scenario it is assumed that a relatively small fiscal stimulus will generate positive confidence and boost domestic demand in Germany. The alternative scenario is described into more details in box 1.

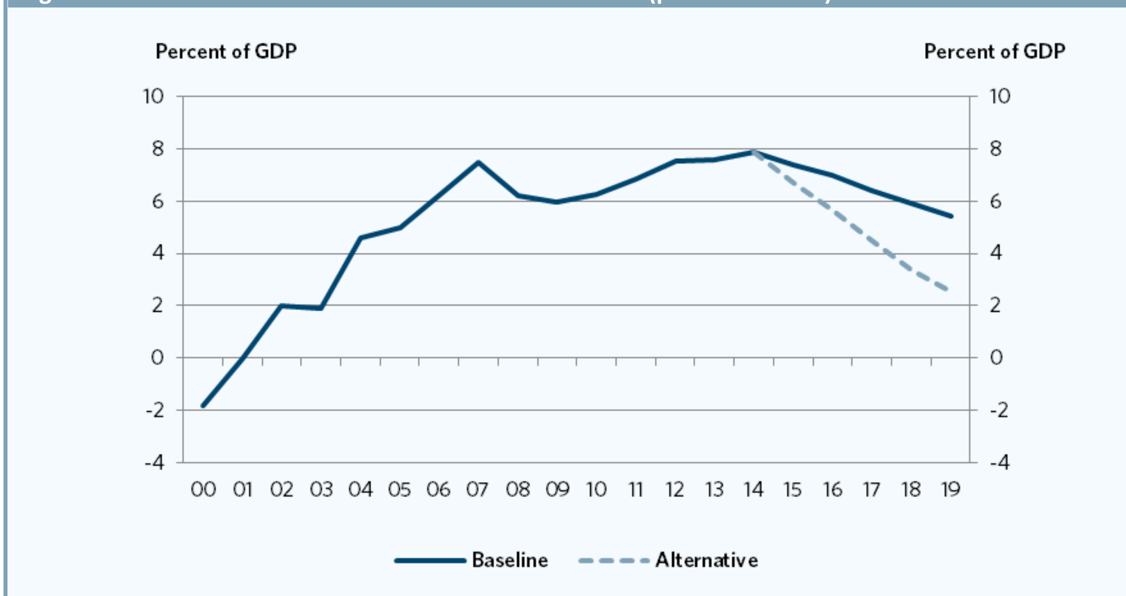
Box 1 Fiscal stimulus and increased domestic demand in Germany

In the scenario it is assumed that Germany stimulates the economy by ½ percent of GDP in 2015 and an additional ½ percent of GDP in 2016 and an additional ½ percent of GDP in 2017, resulting in an increased public investment level of 1½ percent of GDP in 2017, keeping that level in 2018 and 2019. Germany is considered to have room for fiscal maneuvering, because they have neither very large public sector deficits nor large public debt, but a large private savings surpluses.

It is assumed that the fiscal stimulus generates positive confidence and an increase in domestic demand in Germany, resulting in increased consumption and investment ratios. The rest of the European countries will also experience higher growth and prosperity through trade effects that are created when demand increases in Germany. Confidence effects for these countries are not included. Inclusion would result in greater effects.

Figure 5 shows the effect on the German current account of fiscal stimulus and increased domestic demand in Germany. It is seen how the current account balance, within a 5 year period, is reduced to less than half the level (in percent of GDP) compared to what it would have been without increased domestic demand.

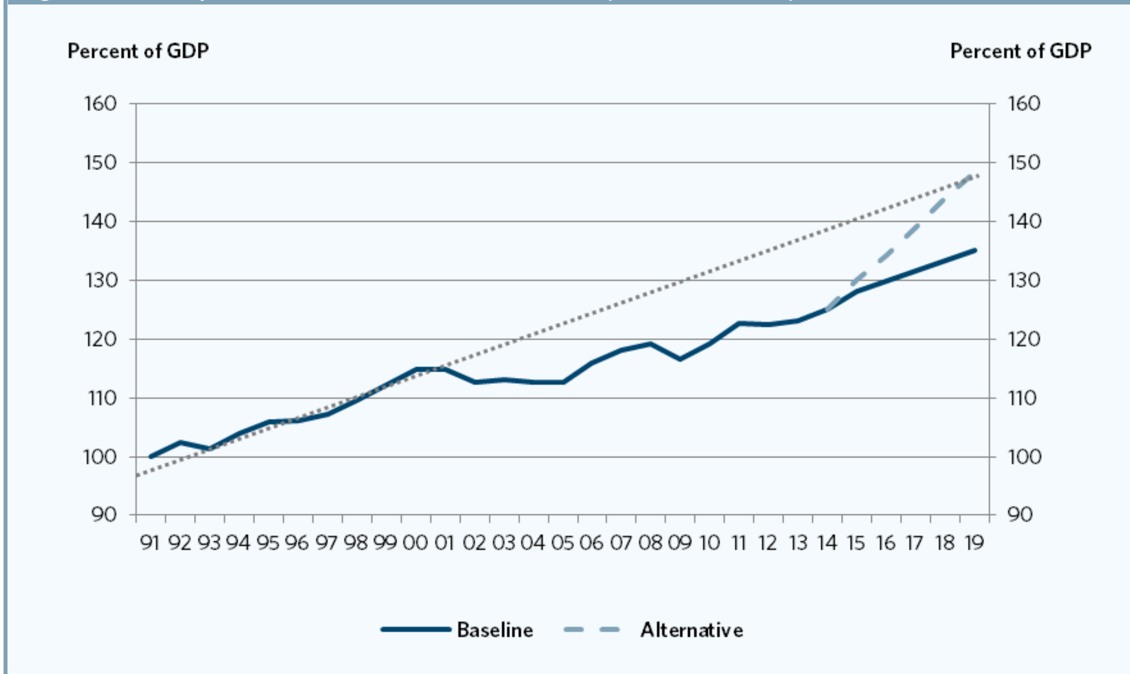
Figure 5. Effects on the German current account balance (percent of GDP)



Source: ECLM based on the international macroeconomic model HEIMDAL.

Figure 6 shows the development in German domestic demand in the baseline scenario, and in the alternative scenario it is seen how the modest fiscal stimulus is improving domestic demand to such an extent that the level in domestic demand in 2019 in the alternative scenario will reach the growth pad it had in the 1990´s.

Figure 6. Development in German domestic demand (index 1991=100)



Source: ECLM based on the international macroeconomic model HEIMDAL.

The modest stimulus and the increase in domestic demand will also boost the German GDP growth and employment. As seen in table 1, GDP will be lifted by nearly 5 percent and 1.7 million jobs will be created in Germany, when the current account balance is reduced by half over a 5 year period compared to the baseline scenario. It is seen how domestic demand will increase and export decrease compared to the baseline scenario, meaning that German wealth creation will, all things being equal, switch from (to a large extent) being export driven, to (to a larger extend) being domestic demand driven where wage increases are boosting consumption.

Table 1. Effects on the German economy

	Accumulated effect 2015-2019
GDP (percent)	4.7
Domestic demand (percent)	9.8
Export (percent)	-1
Employment (mio. jobs)	1.7
Government balance	1.0
Current account balance (change in percentage points)	-2.9

Source: ECLM based on the international macroeconomic model HEIMDAL.

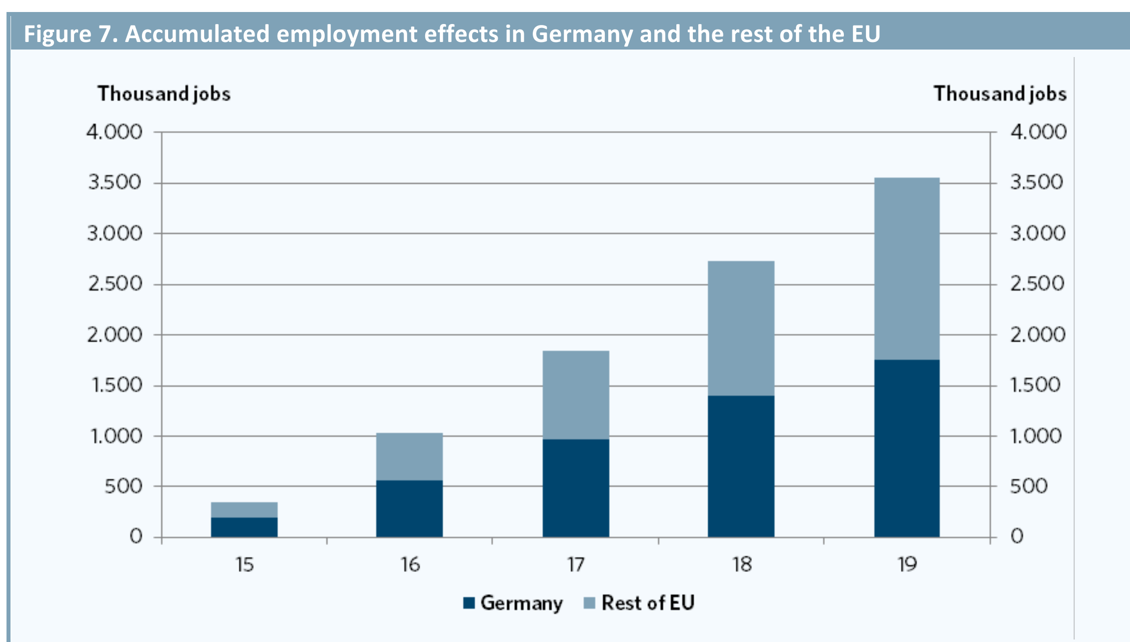
Spillover effects to the rest of EU

By stimulating the German economy and increasing confidence and domestic demand, the rest of the European countries will also experience higher growth and prosperity through the trade effects that are created when demand increases in Germany. In the scenario it is only

assumed that confidence is increased in Germany, in practice it is very likely that the positive confidence will spread to the rest of Europe. If the current situation is reversed and more optimism and positivity are spread throughout Europe, it can create a chain reaction of positive confidence. If this is the case then the positive spill-over effects will be even greater than outlined below.

Figure 7 shows the employment effects in the EU decomposed into job creation in Germany and job creation in the rest of EU. Even though domestic demand is only increased in Germany, the increased demand for imports in Germany will through trade effect create jobs all over the EU. All in all 3.5 million jobs are created in Europe, where 1.7 million, corresponding to half the jobs, are created in Germany, and the same amount in the rest of the EU.

Figure 7. Accumulated employment effects in Germany and the rest of the EU

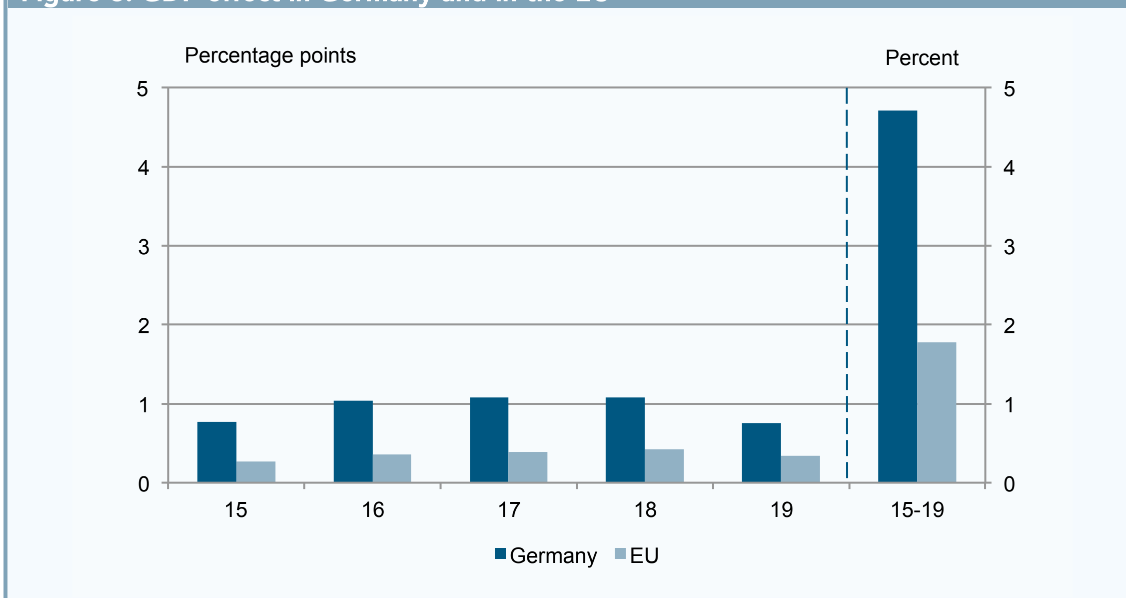


Source: ECLM based on the international macroeconomic model HEIMDAL.

The same picture is seen when looking at the GDP-effects. As a consequence of the stimulus and the increased demand in Germany, the German GDP will on average grow by nearly 1 percentage point more each year in the period from 2015-2019, resulting in an increase in the GDP-level of 4,7 percent in 2019 compared to the baseline scenario. Due to the trade effects the EU GDP growth rate will be increased by close to 0.4 percentage points each year, summing up to an increase in the European GDP level of 1.8 percent in 2019.

The figures show how the German stimulus and increased demand will spread to other European countries - also to some of the debt troubled countries in southern Europe. The calculations above only include confidence effects for Germany. The effects seen in the rest of the countries are therefore the pure trade effects. The effects would be larger if the confidence effects were also included.

Figure 8. GDP effect in Germany and in the EU



Source: ECLM based on the international macroeconomic model HEIMDAL.

German demand can help Europe

The model calculations have shown that it is not optimal for the European economy, when the largest country, and the growth engine of Europe, is running large current account and private savings surpluses. There is a large potential not only for Germany but, through spillover effect, for the whole EU, if Germany manages to reduce its current account surplus through increased domestic demand. If Europeans restore confidence in the future and greater willingness to consume and invest the future may look brighter.

The scenario clearly shows how a small stimulus can boost German demand, which potentially can be a catalyst for growth and job creation all over Europe. Because of the integration of the European economies, the increased German demand will have spillover effects to countries whose economies are hardly hit by consolidation.

In the calculations above we look at Germany as an example. But other countries such as Austria, the Netherlands, Denmark and Sweden are also in a situation where they have room for fiscal maneuvering, as they have neither very large public sector deficits nor large public debt. At the same time they also, like Germany, have a large potential for increasing domestic demand as they have larger current account and private savings surpluses. Ideally these countries would coordinate a European boost to domestic demand.

With the potential hidden in the current account and the private saving surpluses this could jumpstart the economy if the countries are able to turn around consumer and investor confidence. Achieving this goal could lead Europe back on a sustainable growth path, bring unemployment rates down and improve unemployment and living standard both today and in the future. Coordinated investment strategies throughout the European Union will benefit all. Working together is more powerful than working alone.