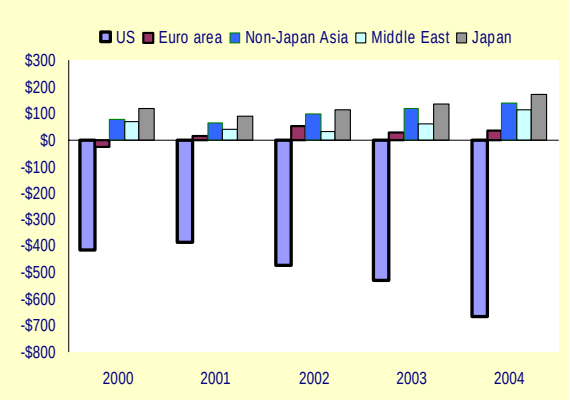
Focus

II. Global current account imbalances and the euro area

Global current account imbalances have dominated discussions among policy-makers already for a number of years. The most important imbalances concern the large and rising current account deficit of the United States and the matching surplus of East Asia and the Middle East, while the current account for the euro area is roughly balanced. Nevertheless, the euro area would likely be substantially impacted by any disorderly unwinding of the global imbalances. Different scenarios show that the euro area could suffer from substantial current account and output losses, if the adjustment involves a sharp depreciation of the dollar and a recession in the United States. On the other hand the impact would be mitigated if East Asia were to increase its imports. The euro area on its own can make only a limited contribution to reducing global imbalances, primarily because its own starting position is balanced. Even a sizable increase in the euro-area's trend output growth would not result in substantial and lasting improvements in the US external balance. However, the euro area can prepare itself to better absorb the shock that any disorderly unwinding would bring by implementing structural reforms that improve the flexibility and resilience of its constituent economies.

Increased global financial integration makes it easier for countries to run large current account imbalances than in the past. Recent years have seen the build-up of large current account deficits in the United States, which are matched by an increasing current account surplus in particular in East Asia and the Middle East. However, the unprecedented scale of these imbalances has led to fears that their eventual correction could give rise to disruptive exchange rate realignments, with significant global implications.

Graph 32: **Current account balances**
(bn US $ – 2000 to 2004)



Source: IMF.

In sharp contrast to the United States and its East Asian and Middle Eastern lenders, the euro area has a roughly balanced current account. Nevertheless it could find itself at the heart of the economic disruption caused by a possible disorderly correction of global imbalances. This focus examines these issues as follows: the first section takes stock of the recent developments in global current account imbalances; the second section discusses possible ways in which the these imbalances could be corrected through adjustments in the United States or Asia; a third section considers what, if anything, the euro area could do to reduce the global imbalances; and a final section concludes, stressing the need for the euro area to implement economic reforms to brace itself for the possibility of a disorderly unwinding of the global imbalances.

1. Global imbalances

US current account deficit

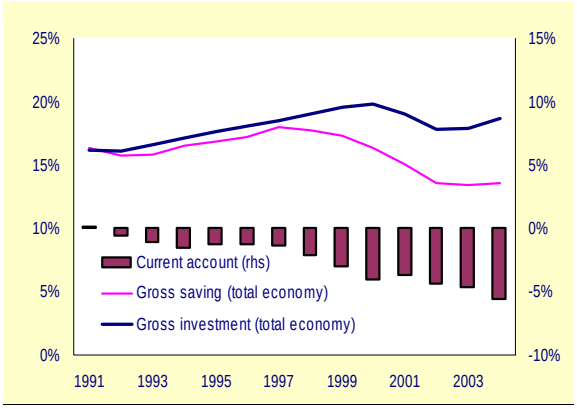
The US current account deficit is the focal point of the concerns about global imbalances. In 2004, the US deficit rose to nearly 670bn US dollars (5.7 percent of GDP – Graph 32).[13] This represents around 1.6 percent of world GDP. This is significantly higher than the US external deficits of the 1980s, which never rose above 3.5 percent of US GDP and 1 percent of world GDP, values which the US has now exceeded for six years in a row. The US current account deficit is unprecedented in its magnitude and duration for an industrialised country. The USA is now absorbing around 70 percent of the net capital outflows of all countries running current account

[13] The IMF's *World Economic Outlook* September 2005 provides an in-depth analysis of global savings and investment trends.

surpluses, despite an already significant fall in the value of the US dollar since 2001.

The external imbalances reflect domestic imbalances in the US economy (Graph 33). While investment rates have not changed much over the last ten years, the savings rate has declined sharply since the late 1990s. US households have reduced their personal saving as a percentage of disposable income, from 7% at the beginning of the 1990s to a mere 1% in 2004. Over the last five years there has also been an important deterioration in public finances, which went from a surplus of 1.3% of GDP in 2000 to a deficit of 4.3% of GDP in 2004. The resulting savings–investment gap was filled by a substantial capital inflow into the USA. The late 1990s witnessed a surge of private equity inflows connected with the ICT boom. After the ICT bubble burst, private capital flows diminished substantially. Instead foreign central banks started to buy ever-increasing volumes of dollar-denominated bonds, thus financing both the US current account and the US budget deficit.

Graph 33: **United States internal and external balance**
(% of GDP – 1991 to 2004)



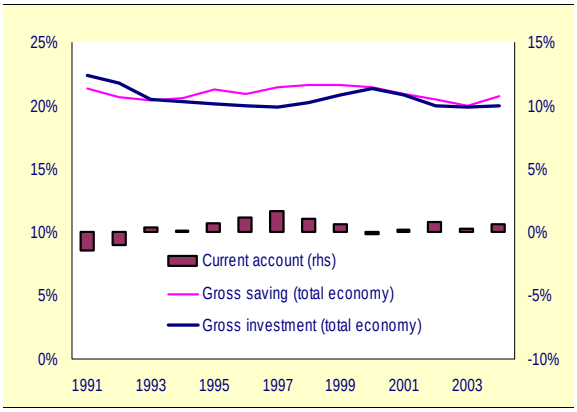
Source: Commission services.

Surplus in East Asia and the Middle East

The counterbalancing improvement in the current accounts accrued mostly in East Asia and the Middle East. Other countries, such as Japan, retained a positive but relatively unchanged current account balance. The Middle Eastern current account surplus is explained mostly by windfalls from high oil prices. The dominating factor in East Asia is the central banks which have accumulated huge dollar reserves in recent years through interventions aimed at stabilising their exchange rate vis-à-vis the dollar, thus supporting their exports. At the current rate, the build-up of foreign reserves by East Asian central banks (some 530 billion US dollars in 2004) finances about three-quarters of the US deficit.

The dilemma of the Asian central banks is that an appreciation of their currencies would not only reduce their countries' external competitiveness but would also imply a devaluation of their huge dollar reserves in terms of national currencies. Although the current situation becomes more difficult the longer it lasts, it is likely that most Asian central banks will continue to accumulate foreign exchange reserves at a high pace in the near future. The decision of China in July 2005 to suspend the dollar peg and to move instead into a managed floating regime based on a basket of currencies will have only a moderate impact.

Graph 34: **Euro-area internal and external balance**
(% of GDP – 1991 to 2004)



Source: Commission services.

External balance in the euro area

Unlike the United States and the surplus regions, the euro-area current account is very close to balance (Graph 34). In 2004, the euro area current account registered a small surplus of 48 billion euro, 0.6% of GDP. It had been mildly positive for most of the past ten years. The achievement of this balanced position is also remarkable in the light of the substantial

appreciation of the euro vis-à-vis the US dollar since 2001 – but this appears to have been more than compensated by a high global import demand, while domestic demand in the euro area was weak.

Intra-euro-area current account balances

However, the aggregate current account position of the euro area hides some substantial differences among euro-area Member States. Germany alone runs a large current account surplus of 80 billion euro (3.7%) of GDP. Without this, the euro area would have had a negative current account. Other countries, such as Belgium, the Netherlands, Austria and Finland, also have positive balances, but only in Finland are the surpluses as high as those of Germany in relative terms.

Table 4: **Current account in the euro area**

	In billion €					
	1994	1996	1998	2000	2002	2004
BE	11	11	12	9	14	9
DE	-28	-12	-13	-27	48	82
EL	0	-1	-1	-7	-9	-9
ES	-5	6	1	-20	-18	-34
FR	1	14	32	17	12	-10
IE	2	3	1	1	-1	-2
IT	11	32	23	1	-4	-4
NL	16	15	10	18	11	13
AT	-4	-4	-2	-2	5	5
PT	-1	-1	-5	-10	-7	-8
FI	1	4	7	10	10	6
Euro Area	4	65	65	-10	61	48
	As % of GDP					
	1994	1996	1998	2000	2002	2004
BE	5.5	5.1	5.3	3.8	5.2	3.1
DE	-1.6	-0.7	-0.7	-1.3	2.2	3.7
EL	-0.7	-1.0	-1.4	-5.5	-6.3	-5.4
ES	-1.2	1.2	0.2	-3.2	-2.5	-4.1
FR	0.1	1.1	2.4	1.2	0.8	-0.6
IE	3.6	4.4	1.9	0.8	-0.9	-1.1
IT	1.3	3.2	2.1	0.1	-0.3	-0.3
NL	5.6	4.9	2.8	4.6	2.6	2.7
AT	-2.7	-2.3	-0.9	-1.1	2.3	2.1
PT	-1.6	-1.3	-4.5	-9.0	-5.8	-6.0
FI	1.6	4.1	5.8	7.3	7.4	4.3
Euro Area	0.1	1.1	1.1	-0.1	0.8	0.6

Source: Commission services.

Other euro-area countries run significant deficits. In the cases of Portugal, Greece and Spain, the deficits are of a similar order of magnitude to that of the United States. However, such current account deficits are to be expected as a part of a normal income catching-up process and therefore are likely to be relatively unproblematic. Furthermore, in the absence of intra-euro-area nominal exchange rate fluctuations, current account adjustments in these countries can only take place via slow changes in prices and factor cost.

Net foreign asset position

The evidence suggests that the United States economy is extremely vulnerable to a fall in international investor confidence. However, the current account deficit is only one factor determining the evolution of the net-foreign-asset-to-GDP ratio, which is the best indicator for assessing the sustainability of the external position.[14] Current account deficits in past decades explain why both the euro area and the US show negative net foreign asset positions of some 15 and 23% of GDP respectively.[15] Another factor is obviously GDP growth. With nominally constant net assets, higher GDP lowers the net-asset-to-GDP ratio.

The ratio can also be significantly affected by net external asset revaluations. The magnitude of these revaluations again depends on a number of parameters. One aspect is whether the nominal rate of return on external assets and liabilities differs. For instance it appears that American investments abroad, which are concentrated in equities, yield a substantially higher return than foreign investments in the USA, which mostly consist of bonds. The higher the internationally held assets and liabilities are, the higher is the impact of differentials in the rates of return.

Finally, and very significantly, the evolution of the asset position depends on the exchange rate. Just like the nominal rate of return, the impact of the exchange rate depends on the composition of the international asset holdings. For advanced economies like the United States and the euro area, foreign assets are usually denominated in

[14] See, Lane, P. and G. Milesi-Ferretti, "A Global Perspective on External Positions" in R. Clara, ed. (2005 forthcoming): *G7 Current Account Imbalances: Sustainability and Adjustment*; Chicago University Press, accessible at: http://www.nber.org/books/curracct/lane-milesiferretti8-19-05.pdf

[15] Unlike flow parameters, data on asset stocks are subject to substantial uncertainties.

foreign currencies; liabilities are denominated in the home currency. Consequently, an unexpected depreciation (not reflected in ex-ante interest differentials) will increase the domestic currency rate of return on external assets and hence improve the net foreign asset position.[16] This puts a country in the advantageous position that depreciation leads to an immediate improvement in its net asset position, notably when cross-country holdings are dominated by fixed interest bonds. Investors from the appreciating currency would consequently see their assets lose value.

Table 5 shows that these factors can be extremely important at least in the short run. Over the last four years, the net-asset-to-GDP ratio in the United States and the euro area deteriorated at practically the same rate of 5.6 and 5.8 pp, respectively, in spite of large differences in their current account position.

Table 5: **Evolution of net asset ratio in the euro area and the United States** (2000-2004)

	Euro area	United States
Initial net foreign asset-position (1)	-9.8	-16.7
Change in net foreign assets (1) of which	-5.6	-5.8
• Cumulative current account GDP growth	1.6	-18.8
• GDP growth	1.4	3.9
• Capital gains	-9.0	10.1
• Errors, omissions	0.4	-0.9
Selected parameters (2)		
Change in REER	31.5	-14.8
Stock prices (foreign minus domestic)	4.4	11.6
Avg. real return on assets	-2.7	4.8
Avg. real return on liabilities	-0.5	-0.4

(1) Percentage of GDP.

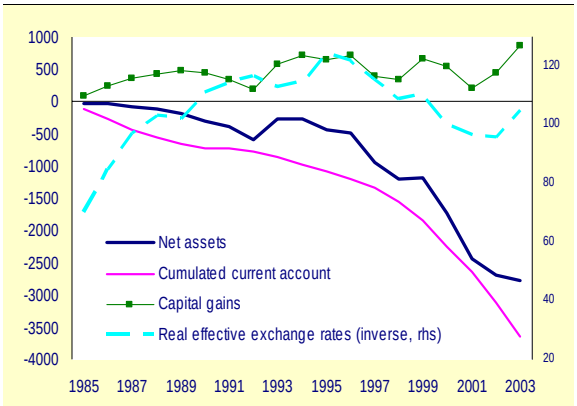
(2) Percent.

Source: Lane and Milesi-Ferretti.

The United States' cumulative current account deficit of 18.8% of GDP was to a significant extent neutralised by the fact that capital gains of US-held foreign assets exceeded those of the foreign-held US assets by 10% of GDP. This was helped significantly by an effective depreciation of the dollar by 15% in real terms. In addition, US investors enjoyed a markedly higher rate of return for their foreign assets than foreigners yield in the USA.

The euro area, by contrast, suffered relative capital losses far in excess of the cumulative current account surplus. Most of the loss is explained by a considerable (30%) revaluation of the euro over the period in question. Even without this, European investments abroad yield lower returns than those of their American counterparts. Furthermore, low growth reduced the euro area's net foreign asset-to-GDP ratio only by 1.4 pp, while the US net asset ratio was reduced by nearly 4 pp between 2000 and 2004.

Graph 35: **Change in US net foreign asset position since 1985** (bn US $ – 1985 to 2003)



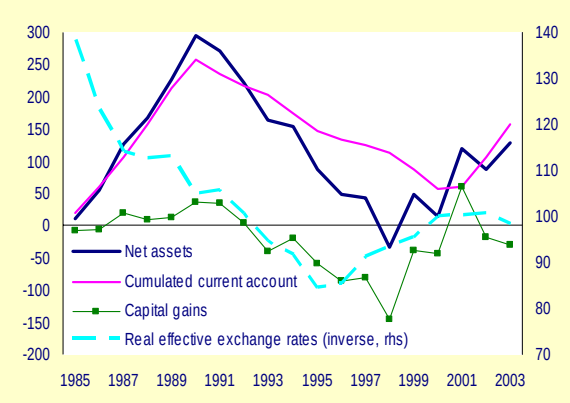
Source: IMF.

Like the current account balances, the net asset positions in the euro area are far from homogenous. While some countries, such as Belgium, France and Germany, enjoy positive net asset positions, in others such as Spain, Portugal, Greece, Ireland and Finland, the net asset position is highly negative with values of between 20 and 70% of GDP. It is, however, difficult to draw direct conclusions from these figures about the sustainability of the external balances for individual Member States.[17]

[16] Developing economies which are net debtors and whose liabilities are primarily denominated in foreign currency increase their debt ratio when their currency depreciates.

[17] For instance, a Finnish net asset position of minus 150% in 2000 was a sign more of economic strength than weakness at the time, as it mostly reflected the stock market valuation of Nokia.

Graph 36: **Change in German net foreign asset position since 1985** (bn US $ – 1985 to 2003)



Source: IMF.

In spite of these recent trends and having a net asset imbalance two thirds that of the United States, the euro area's external sustainability is not at risk. This is because, in the long term, net assets are clearly dominated by current account balances. Even an impressive 900 billion dollar in capital gains for the US over the last twenty years does not change the long-term picture, in particular as these gains depend also on short-run exchange rate movements (Graph 35). In other countries, the situation is comparable (Graph 36). Also, unlike the United States, the euro area does not need to attract huge sums of foreign capital each year. The recent deterioration of the net asset position is almost exclusively due to a euro appreciation. Even a stabilisation, let alone a depreciation of the euro would substantially improve the euro area's net asset position.

2. Correcting the global imbalances

While the analysis of the evolution of net assets modifies the estimation of the necessary current account improvement, the United States external balance is clearly unsustainable. The current account does not need to be zero to stabilise the debt ratio. This could already be achieved at a deficit of 1% of GDP[18], but depends on US growth, as well as the degree to which it can maintain the unequal exchange of high-yielding foreign assets against low-yielding US assets. Even in the best of cases, there needs to be a substantial improvement in the current account. It would certainly make matters more difficult if foreign buyers of US assets achieved higher returns on their investments. If investors demanded a higher risk premium, making the US foreign position less tenable, a disorderly unwinding could ensue.

It is not easy to determine exactly what impact an adjustment of external imbalances on the euro area would have, because it hinges on the underlying shifts in economic parameters as well as the size and speed of adjustments in the exchange rate. It is unlikely that the current account gap now prevailing in the United States could be corrected by exchange-rate adjustments alone, even if the dollar devaluation were very large. An important part of the rebalancing must come from changes in economic fundamentals, i.e. changes in savings rates and productivity.

Adjustment channels

Before discussing possible scenarios to correct the imbalances it is useful to review briefly the various channels by which adjustment, and notably a rising euro exchange rate, would affect the euro area economy.

Trade channel: An appreciation of the euro increases the price of exports and lowers the price of imports. Over the medium term, this relative loss in European price competitiveness will have a negative impact on the trade balance, the magnitude of which is influenced by a number of parameters. These are the extent of the pass-through of the exchange rate to import prices; the degree to which exporters reduce their profit margins and cut their prices to maintain market shares; the relative elasticities of export and import substitution; and the starting position. In addition, the reaction of the trade balance to exchange rate changes depends on the lag times between placing international orders and receiving the products. Because exports tend to be denominated in domestic currency (i.e. euros) and imports in foreign currencies, the immediate impact might even be a widening of the trade balance.

Purchasing power channel: While a euro appreciation leads to a loss of competitiveness for producers of tradable goods and services,

[18] Roubini, N. and B. Sester: The US as a Net Debtor: The Sustainability of US External Imbalances, mimeo Nov. 2004. http://www.stern.nyu.edu/globalmacro/Roubini-Setser-US-External-Imbalances.pdf.

consumers might actually benefit. A rising euro means lower import prices and, hence, an increase in purchasing power.

Asset price channel: As seen from the euro area, liabilities are usually denominated in euros, while assets are denominated in dollars. Mechanically, a dollar devaluation leads to a proportional reduction in the value of dollar-denominated assets. This in turn reduces the value of euro area companies with US assets, insofar as they are not hedged, and might limit their capacity to borrow and invest. On the other hand, these companies might benefit from the increased competitiveness of their foreign subsidiaries.

Interest rate channel: A fall in the dollar triggered by reduced demand or an increased risk premium for US-held assets would lead to higher interest rates in the US and lower interest rates in Europe through increased demand for euro-denominated bonds. This effect would be reinforced, if investors expected further euro appreciations in the future. This channel would benefit Europe unless the demand for a higher risk premium also spilled over into the euro area, which would have the effect of reducing investment.

Relative price channel: A change in exchange rates will not affect all sectors equally. Prices of tradable goods and services are likely to fall noticeably, while prices for non-tradable goods will remain practically unchanged. Even within the tradable sectors, the impacts can vary depending on market structure, import and export ratios, relative exposure to the dollar, and price elasticity. In the wake of the euro appreciation, substantial shifts of consumption and production could take place between the tradable and non-tradable sectors.

Confidence channel: A euro appreciation is also likely to affect consumer and producer confidence. Much depends on whether the appreciation is the result of an improved outlook and hence capital inflows for the euro area or the result of a deterioration in the USA. In the latter case, private sector confidence is likely to fall, in the light of strong linkages between US and European financial markets. If falling confidence leads to lower spending, and hence lower imports, the contractionary effect of lower exports to the USA might be aggravated. A countervailing effect would be a rise in consumer confidence as a result of lower import prices.

Adjustment scenarios

Three core scenarios can be identified that reduce global imbalances without involving the euro area as a policy actor. A first scenario involves the reduction of US internal imbalances through an increase in the household savings rate. Table 6 shows the result of such a scenario using the DG ECFIN's QUEST model. This scenario (like the following two) is normalised to achieve a 0.5% of GDP reduction in the US current account deficit in the third year after the policy change. The scenario requires a substantial 6% reduction in private consumption. In the first year US GDP falls by 3.8%. This drop is dampened in the following years as a result of lower real interest rates. The improvement in the trade balance takes place mostly through lower imports amidst lower domestic demand. Clearly, the scenario is costly in terms of GDP loss. It also has sizeable spill-overs into the euro area, which suffers from a loss of its GDP by 0.5 % after three years, as its trade balance deteriorates in the in the order of 0.65% of GDP. The costs of this scenario become even more substantial if one keeps in mind that the required current account adjustment for the United States needs to be significantly larger than the values assumed in the scenario.

Table 6: **US savings rate increase** (1)(2)

	Year	1	2	3
Euro area	GDP	-0.83	-1.01	-0.51
	Trade balance	-0.35	-0.66	-0.65
USA	GDP	-3.84	-2.57	-2.58
	Trade balance	0.59	0.50	0.50
Exchange rate (€/$)		-3.71	-2.19	-0.06

(1) Percentage deviation from baseline.
(2) 6 percent reduction in private consumption.

A second scenario that is based on correcting US internal imbalances is a fiscal contraction. To achieve an improvement in the current account by 0.5% of GDP, the United States needs to increase its taxes by 6.5% of GDP in the QUEST simulation (Table 7). Like the previous scenario, the current account improvement stems

from a strong reduction in domestic demand. While the output reduction in the United States is similar to that of the higher savings rate scenario, negative spill-overs of US budget consolidation into the euro area are relatively smaller, because the Euro area benefits from lower interest rates and import prices.

Table 7: **US fiscal contraction** (1)

	Year	1	2	3
Euro area	GDP	-0.23	-0.21	-0.11
	Trade balance	-0.19	-0.45	-0.47
USA	GDP	-1.74	-1.98	-2.63
	Trade balance	0.31	0.42	0.50
Exchange rate (€/$)		-2.81	-2.16	-0.98

(1) Fiscal contraction of 6.5% of GDP modelled as increase in labour income tax and corporate taxes (by 3.25% of GDP each).

A third scenario considers the possibility of a reduction of global imbalances as a result of lower savings in Asia. This is modelled as an increase in Asian imports by 10% (Table 8). In this case GDP and exports rise in both the United States and the euro area compared to the baseline. Due to the higher export share, the euro area benefits more than the USA from this situation. In addition, the United States is more affected than the euro area by the dampening effect of rising interest rates.

Table 8: **Reduction in Asian savings rate** (1)

	Year	1	2	3
Euro area	GDP	0.64	0.34	0.38
	Trade balance	0.64	0.64	0.68
USA	GDP	0.34	0.16	0.18
	Trade balance	0.44	0.50	0.50
Exchange rate (€/$)		-0.62	-0.56	-0.48

(1) Increase in imports of Asian region (non-Japan) of 10 %.

Even though, net asset positions apart, the euro area's current account is in balance and is not implicated in the bilateral imbalances between the United States and its lenders, the costs of a disorderly unwinding could be substantial for Europe, if it is accompanied by a recession in the United States.

It is not clear, what combination of the three core adjustment scenarios just described is the most likely. Various authors have made the case that the driver of global imbalances lies in either the US fiscal deficit, the lack of US savings, East Asian central bank interventions, a global savings glut, a lack of global investment opportunities, or a combination of these. Other authors argue that global imbalances are not even a problem, but rather the result of optimal resource allocation. The solution to the imbalances varies depends on the viewpoint. A hard landing with spill-overs into the rest of the world is not therefore inevitable.

As the simulations have shown, one important factor in determining the outcome is the degree to which an adjustment in the US external balance would be accompanied by a reduction in the imbalances of the lender countries. A reduction in the current account surplus of East Asia and the Middle East would ease the adjustment pressure on the euro area proportionately. This would mean that, from a European perspective at least part of the shock of a rising euro-dollar exchange rate would be cushioned by a simultaneous rise in Asian currencies. Even in a benign scenario, a correction for the US deficit is likely to be accompanied by a sizeable devaluation of the dollar, with an according rise in the exchange rate of the euro. This exchange rate realignment would require substantial adjustments in the euro area to an altered price structure.

3. European options to address global imbalances

Policy scenarios

It has been suggested (mostly by US authors) that the relative attractiveness of the United States to absorb global excess savings is partly linked to the unattractiveness of investing in Europe. This could be eased by higher growth rates in the euro area and higher net imports.

Expansionary fiscal and monetary policies might be considered to be the fastest way to bring about higher growth and import demand in the euro area. Such policies can, however, only induce a cyclical acceleration of growth, while having no or even a negative impact on long-term growth. As the short-run expansionary effect of the policy change wears out and turns negative, so would the increased import demand. Fiscal and monetary policies therefore would not

bring about a lasting improvement in the US current account deficit. Furthermore, there is no room for manœuvre on the fiscal side in the euro area and monetary policy is already accommodating.

Although the role of structural reforms in helping to reduce current account imbalances has taken a prominent place in the policy debate, empirical research on the issue has so far remained relatively sparse. A common tenet in policy circles seems to be that growth-enhancing structural reforms in the euro area will foster euro-area import demand and thereby contribute to reduce the US trade deficit. Neither economic theory nor empirical evidence provide much support to the idea of a long-term negative relation between growth and the level of the current account. However, theory does not rule out the possibility that reforms may temporarily bring a deterioration of the trade balance by providing a bigger stimulus to demand than to supply (see Box 2).

Labour and product market reforms rank among the most important means of raising euro-area growth in the medium run. However, QUEST simulations show that such reforms, while lifting the euro area's growth potential, have very limited implications for trade balances.

Table 9: **Effect of euro-area wage reductions** (1)(2)

	Year:	1	2	3
Euro area	GDP	0.41	0.78	1.00
	Trade balance	-0.11	-0.19	-0.22
USA	GDP	0.00	0.01	0.02
	Trade balance	0.04	0.05	0.07
Exchange rate (€/$)		-0.30	-0.11	-0.01

(1) Reduction in ex-ante wages by 3.7%.
(2) Percentage deviation from baseline.

Table 9 shows the simulation of labour market reforms that lead to a 1% increase in euro area GDP after three years. This is modelled as a change in the wage-setting rule, which lowers ex ante wages by 3.7%. Wage moderation stimulates investment spending and leads to an increase in output and employment levels and to lower unemployment, which also boosts private consumption in spite of the original income loss. The scenario results in a negligible appreciation of the euro-dollar exchange rate, and practically no improvement in the US trade balance. This result is intuitive, because the scenario has no built-in mechanism that would drive aggregate demand to rise faster than aggregate supply. In addition, it should be noted that only a part of the changes in the euro area current account is mirrored in the United States' current account, because other countries, notably European states outside the euro area, absorb a substantial share of the current account impulse.

A slightly larger current account deficit can be generated by product market reforms, which increase competition amongst producers of goods and services and increase the process responsiveness of demand. Such a liberalisation can be simulated in QUEST as a reduction in mark-up prices.[19] As a consequence, firms increase output – together with investment – while real wages also increase in the medium term. The boost in consumption due to higher employment, higher wages and lower prices exceeds the increase in GDP, leading to a slightly negative trade effect in Europe. The euro appreciates vis-à-vis the dollar and the US trade balance shows a small improvement (Table 10). Clearly, however, this scenario does not do enough to solve the US current account problem.

Table 10: **Effect of euro-area product market reforms**(1)(2)

	Year:	1	2	3
Euro area	GDP	0.63	0.72	1.00
	Trade balance	-0.42	-0.95	-1.05
USA	GDP	-0.16	-0.15	-0.11
	Trade balance	0.11	0.32	0.32
Exchange rate (€/$)		-8.21	-7.89	-7.37

(1) Reduction in mark-ups over marginal costs by 5.2 percentage points.
(2) Percentage deviation from baseline.

The only viable euro-area policy option to affect the US current account deficit over a more extended time period is for international investor preferences to switch from the United States to the euro area. This can be modelled as a higher risk premium for investment in the United States

[19] This requires a decrease in the mark-up over marginal costs by 5.2 percentage points.

Box 2: Structural reforms and current account imbalances: some recent literature

The available empirical evidence suggests that structural reforms in the euro area may temporarily alleviate current account imbalances although their effect may be only modest and depends on the types of reforms considered. Furthermore, in most model simulations, it seems that the only way in which reforms can be shown to have a significant negative effect on the euro-area current account is by making the assumption that reforms will foster capital inflows into the euro area.

Kennedy and Slok (2005) explore the link between current account balances and structural reforms with a panel regression on 14 OECD countries. The authors find no support for the idea of a systematic link between the current account position and trend growth. Product and financial market deregulation, however, may have a negative impact on the current account. In contrast, regression coefficients are not meaningful in the case of labour market indicators and show a wrong sign in the case of FDI restrictions. The authors conclude that structural reforms may impact the current account in the short- to medium-run although the link may be tenuous and may vary with the types of reforms put in place.

Faruqee et al. (2005) use a variant of the GEM model of the International Monetary Fund to simulate scenarios of adjustment to global imbalances, among them the possible contribution of structural reforms in the euro area. They conclude that labour market reforms can only have a limited impact on the euro-area's net saving, particularly if uncertainties related to the reform process weigh on consumer confidence. Product market reform may have a somewhat more significant effect on the current account but spillovers from the euro area to the USA remain fairly small and seem to partly depend on concurrent assumptions regarding increased appetite for euro-area assets. Also based on the GEM model, **IMF (2005)** concludes that the build-up of the US trade imbalances and the rise in the dollar in the late 1990s can be explained by the combination of a productivity shock in the USA and increased appetite for US assets (in most macroeconomic models, the impact of productivity shocks on exchange rates and trade balances are relatively modest). Following this line of reasoning, a pick-up in productivity in the euro area combined with increased demand for euro-area assets would help restore global imbalances.

Obstfeld and Rogoff (2005a; 2005b) construct a simple general equilibrium model with fixed endowments and assess the changes in relative prices that would result from a closing of the US current account deficit. The central assumption is that current account imbalances are resolved by a shift in demand from the USA to the rest of the world. Several interesting conclusions can be drawn from the exercise:

- First, the magnitude of the required depreciation of the dollar real effective exchange rate would be substantial, ranging from 15% to 30% depending on the model assumption. This shows that an adjustment to global current account imbalances cannot take place without significant price changes.
- Second, whereas discussions on the implications of the adjustment to current account imbalances tend to focus on the tradable sector, reducing the US trade deficit will also have a strong impact on prices in the non-tradable sector both in the USA and in the rest of the world. A reversal of the US trade deficit will weigh on the euro-area's export sector but also give a boost to its non-tradable sector.
- Finally, the necessary dollar depreciation will be larger if prices are sticky. On the other hand, it could be mitigated by factor mobility across sectors and an acceleration of productivity gains in the rest of the world (but only provided that it takes places in the non-tradable sector).

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compared to that in Europe, for instances as a result of structural reforms (Table 11).

Table 11: **Product market reforms and risk premium shock** (1)

	Year	1	2	3
Euro area	GDP	0.11	0.46	1.00
	Trade balance	-0.61	-1.65	-1.71
USA	GDP	-0.07	-0.11	-0.18
	Trade balance	0.12	0.63	0.69
Exchange rate (€/$)		-14.50	-14.88	-15.06

(1) Percentage deviation from baseline.

The effects of the scenario on the euro area follow several channels. The euro appreciation results in a loss of competitiveness, leading to a notably negative trade balance. The negative impact of this effect on GDP is, however, more than offset by higher consumption due to lower import prices and higher investment as a result of capital inflows in the wake of shifting investor preferences. Notably, if combined with structural reforms, this scenario increases euro area GDP despite the substantial negative trade shock.

The USA, on the other hand would improve its trade balance although owing to the dollar depreciation, the nominal trade balance would only improve by about half the real shift in trade. The negative impact of the interest rate premium and higher import prices, however, reduce GDP. But even the risk premium scenario shows that the impact that the euro area can have on the US deficit is very limited.

Desirability of euro-area options

It is, of course, one question to examine what policies might create a euro-area current account deficit, and ostensibly reduce global imbalances. Whether it is desirable to deliberately create a current account deficit is a separate matter. Clearly the policies that lift growth potential, such as product and labour market reforms should be pursued in their own right. The benefits of a current account deficit are less obvious.

First, with the East Asian and Middle Eastern current account surplus unchanged, a higher euro-area deficit would mean that the imbalances are carried by more shoulders, namely the United States and the euro area together. This might increase the sustainability of the global financial system somewhat, but does not remove its fundamental problem. If the euro area contributes to a further accumulation of large negative global net asset positions, the eventual global adjustments might be only delayed rather than avoided altogether, and ultimately become more violent.

Second, it must be considered that the euro area starting position from which to create a current account deficit is not as comfortable as is often suggested. While the situation is clearly not as menacing as that of the United States, it nevertheless limits the ability of the euro area to borrow large sums over an extended period.

Third, the desirability of a current account deficit in the euro area is also determined by the structural differences between the euro area and the lender countries. Two aspects appear particularly pertinent. First, in terms of the global allocation of resources it is odd that poor labour-abundant countries lend money to wealthy capital-abundant countries. The flow of resources would be more efficient the other way round. Second, in order to prepare for the effects of an ageing society and the foreseeable need to finance pensions, it is economically efficient to build up net assets in younger and more dynamic countries.[20] The build-up of a net debtor position by contrast exacerbates the financial problems associated with the ageing of the population.

Finally, the fact that only a part of a euro area current account deficit actually improves the current account in the United States means that there is a risk that not only might it not prevent or significantly mitigate a disorderly unwinding of the US imbalances, but might also leave the euro area worse prepared than it otherwise would be.

[20] This argument might not hold strictly for China, which as a result of its one-child policy is also facing a substantial ageing problem. In the light of the enormous labour market reserve, however, even here the growth is likely to continue at a rapid pace for a foreseeable future.

4. Conclusions

The counterpart to the US current account deficit is to be found in Asia (which is posting large surpluses) and not in the euro area (where the current account is close to balance). A transfer of demand from the US to Asia is therefore most important for an orderly adjustment to the imbalances. The contribution of the euro area to this process can only be relatively modest particularly since demographic ageing requires the euro area to improve its net foreign asset position and its starting position is negative. As a consequence, a reduction of external imbalances will require a much steeper devaluation of the dollar against Asian currencies than against the euro. However, if imbalances were to unwind disorderly and the Asian currencies do not appreciate, the burden of the dollar depreciation could fall disproportionately on the euro.

The euro-area's macroeconomic policies are very restricted. There is no room for manœuvre on the fiscal side and monetary policy is already accommodating. Structural reforms in Europe could help the rebalancing process to the extent that they boost domestic demand. However, empirical evidence suggests that their contribution to reducing the US deficit will probably be modest (even if their positive impact on the euro-area economy is substantial).

This does not mean that the role of structural reforms in the euro area should be downplayed. In addition to boosting long-term growth, more flexibility would enhance the economy's resilience in face of shocks. An unwinding of global imbalances can potentially imply massive restructuring of the euro area economy, accompanied by the necessity to move factors from one type of output to another. Where factor mobility is low, the misallocation and loss in output and welfare, respectively, are likely to be high. Reforms that reduce rigidities may therefore prove to be crucial in the event of a disorderly rebalancing of current accounts.