Box I.3: **Rebalancing in the euro area: an update**

Current accounts in a majority of euro area countries are now close to balance or in surplus. As shown in Table 1, current account deficits exceeding 1 % of GDP in 2015 are foreseen only in Greece, Cyprus and Latvia. The euro area should register a record surplus of 3.5% of GDP in 2015, which is in value (about EUR 360 billion) one of the largest in the world. In light of their output gaps, which are larger than those of their competitors, Ireland, the Baltics and Malta exhibit bigger current account surpluses if adjusted for the cyclical component, while the opposite holds for Greece, Spain, Cyprus and Slovakia. For the remaining euro area Member States, cyclical factors play a minor role in determining present current account figures.

Current account balances improved substantially since the start of the financial crisis, with double-digit improvements recorded in the current account/GDP ratio of broadly half the euro area Member States, namely those that had sizable deficits in the late 2000s. As for the countries that recorded surpluses at the start of the crisis, only those of Germany and the Netherlands have grown.

Current account improvements in deficit countries since the start of the crisis are only partly explained by cyclical developments, since the output contraction in these countries was largely accompanied by reduced potential output. [1] In Germany, by contrast, cyclical developments have worked towards reducing the surplus, but this has been overwhelmed by an increase in the non-cyclical component of the German surplus. [2]

Two broad phases can be distinguished in the rebalancing process since the financial crisis. The first phase largely coincided with market-driven sudden stops and reversals of large current account deficits and the deterioration of public finances, which, in some cases, was followed by tensions in government bond markets and fiscal consolidation measures. The second phase started in the second half of 2012 and was characterised by easing financial market tensions, falling spreads, and a reduced pace of fiscal consolidation.

Table 1:
Cyclically adjusted current accounts and trade-weighted output gaps

	CA 2015	Cycl. adj. CA 2015	CA change 2007-15	Cycl. contr. 2007-15	CA change 2013-15	Cycl. contr. 2013-15
BE	2.1	2.4	-1.8	-0.5	3.5	-0.2
DE	7.9	8.6	0.9	-1.6	1.0	-0.2
EE	-0.3	3.0	15.3	7.7	0.1	0.2
IE	5.7	8.7	11.2	-1.2	1.3	-3.6
EL	-1.6	-4.2	14.2	3.8	0.7	-3.0
ES	1.2	0.2	10.8	1.5	-0.3	-1.5
FR	-0.9	-1.3	0.2	0.6	1.1	0.4
IT	2.2	1.4	3.6	0.6	1.3	-0.3
CY	-3.9	-5.2	7.2	2.8	-1.8	0.5
LV	-2.3	0.5	18.9	4.2	-0.3	-1.4
LT	-0.2	2.4	14.6	2.5	-1.8	-1.5
LU	4.6	5.6	-5.5	1.0	-0.3	-4.8
MT	0.6	5.1	4.5	-6.9	-2.4	-0.3
NL	9.0	8.3	1.7	-0.2	0.5	-1.1
AT	2.4	2.6	-0.8	-1.2	0.2	0.6
PT	1.2	0.4	11.2	0.0	0.3	-1.5
SI	5.4	6.2	9.4	3.2	0.6	-3.7
SK	1.8	0.5	7.3	7.2	1.0	-0.4
FI	-0.7	-1.5	-4.8	1.2	1.2	-0.3
EA19	3.5	3.3	3.1	0.0	1.0	-0.4

Note: current account data refers to the national account concept; NIIP data are based on BoP6. Cyclically-adjusted budget balances control for domestic and foreign output gap only. For the methodology to purge current account balances from the cyclical component see Salto and Turrini (2010). Data source: European Commission, Ameco, Eurostat.

As shown in Table 1, starting from 2013, current account improvements in countries that started with large deficits has continued at a much slower pace, stopped, or even reversed. The improvement in the output gaps of these countries imply that the deterioration of current account balances was largely due to the beginning recovery of the business cycle. Over the same period, however, the euro area's surplus increased rapidly to more than 3.3 % of GDP, mainly due to dynamics in the largest Member States. In Italy, declining demand as a result of weak growth led to a substantial improvement in the current account balance. Germany's surplus increased further due to muted corporate investment, which offset a slight improvement in household demand. By contrast, the narrowing of France's current account deficit was led by lower construction investment. In all three countries, current account improvements were mainly due to developments in the private sector, but also helped by a tightened fiscal stance.

In light of the strong contraction of domestic demand during the early phase of adjustment, current account improvements in deficit countries were to a large extent linked to reduced imports (see Graph 1), although this trend has recently reversed somewhat. Regarding exports, with the exception of Ireland, growth was relatively subdued or even negative before 2012, and the

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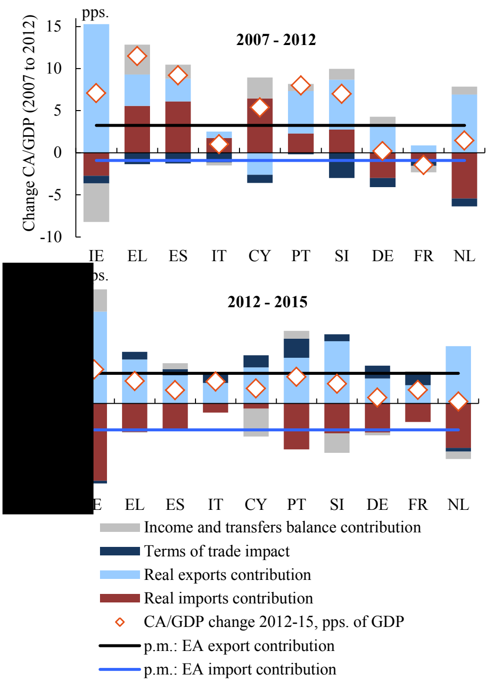
(1) See also European Commission (2014), *European Economy* no. 2, European Economic Forecast, Winter 2014. For another perspective see Tressel and Wang (2014): 'Rebalancing in the Euro Area and Cyclicality of Current Account Adjustments' *IMF Working Papers* 14/130: If the definition of 'cyclical' encompasses not only the business cycle, but also property and financial indicators, a far larger portion of current account adjustment is due 'cyclical' factors.

(2) See also European Commission (2015), *Country Report Germany 2015*.

positive contribution to current account dynamics was due the fact that GDP growth remained below export growth. Export growth resumed after 2012 and has since been by far the strongest determinant of current account improvements in most countries. The contribution of exports to current account changes over the 2012-15 period was stronger in most countries than in the 2007-12 period. Moreover, declining oil prices in 2014 contributed to the improvement through terms-of-trade effects.

Graph 1: **Contributions to current account adjustment: current account components**

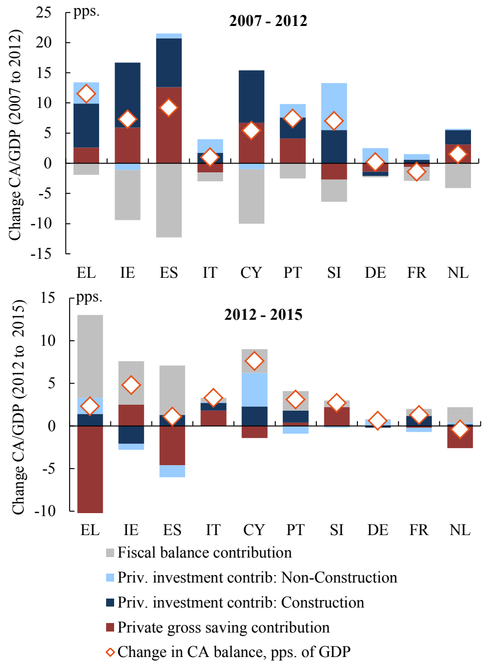


Source: AMECO, European Commission

The different role played by domestic demand during rebalancing can be gauged from Graph 2, which disentangles different components of the savings-investment balance in selected euro area economies. The early phase of rebalancing was largely driven by the contraction of private domestic demand components across the board. Private investment contracted in most countries, notably those running large current account deficits. The contraction was particularly pronounced in construction investment.

Private consumption generally contributed to current account improvements as well: its share of GDP fell, considerably in countries such as Spain and Ireland. The contribution of government savings by contrast was negative because of the recession-driven deterioration in fiscal balances.

Graph 2: **Contributions to current account adjustment: savings - investment balance**



Source: AMECO, European Commission

The picture changes substantially in more recent years. Investment stopped providing a positive contribution to current account dynamics, not only because of the stabilisation in construction investment, but also because of the recovery in non-construction investment in countries such as Ireland, Spain and Portugal. While the productive investment recovery has had a negative effect on recent current account dynamics in these countries, it should create the basis for a stronger tradable sector in the future. The recovery in consumption implied deteriorating current account balances in most countries, apart from Italy, where declining consumption was a major driver of current account developments. Conversely, progress in fiscal consolidation has translated into current account improvements, with considerable gains recorded in Greece and Spain. It is unlikely that a similar positive contribution by the government sector to current account dynamics would be maintained in the coming years.

Despite current account positions having moved close to balance or in surplus in most euro area countries, stock external imbalances remain high, as revealed by Net International Investment Positions (see Table 2). After years of major deteriorations, the Net International Investment Position (NIIP) of most countries with large stocks of net foreign liabilities is stabilising, but progress towards a more prudent position remains minor, while the NIIP of countries with largely positive positions such as Germany and the Netherlands has been growing for years. At present, on the basis of the forecast for potential growth and inflation, current account positions expressed in cyclically-adjusted terms are above the levels required to stabilise the NIIP in almost all euro area countries, in particular in the former deficit countries (with the exceptions of Greece and Cyprus). However, more prudent current account balances may be required in some cases to ensure a satisfactory pace of reducing net foreign liabilities. As a benchmark, achieving a NIIP/GDP ratio of -35 % over a 10-year period would require medium-term current account improvements in Greece, Cyprus, Spain, and Portugal.

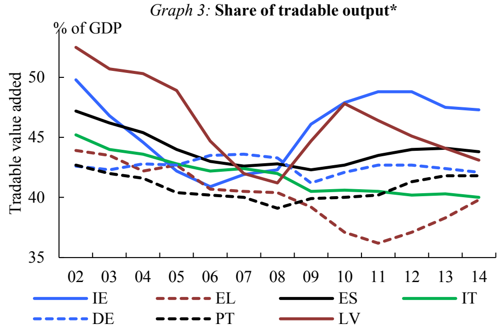
Table 2:
Current account balances required for external sustainability

	NIIP as % of GDP, end-2014	Cyclically adjusted CA as % of GDP 2015	CA required to stabilise NIIP 2015-16	CA req. to reduce NIIP to -35% until 2024
BE	54.0	2.4	1.0	:
DE	36.0	8.6	1.1	:
EE	-42.0	3.0	-4.7	-3.8
IE	-97.0	8.7	-3.5	3.7
EL	-109.0	-4.2	-0.1	4.8
ES	-88.0	0.2	-1.2	3.1
FR	-16.0	-1.3	-0.3	:
IT	-26.0	1.4	-0.3	:
CY	-156.0	-5.2	0.2	9.4
LV	-62.0	0.5	-5.8	-2.5
LT	-44.0	2.4	-5.4	-3.7
LU	43.0	5.6	1.8	:
MT	38.0	5.1	-0.2	:
NL	64.0	8.3	1.5	:
AT	2.0	2.6	0.2	:
PT	-105.0	0.4	-2.7	3.5
SI	-44.0	6.2	-0.6	-0.4
SK	-68.0	0.5	-3.8	-0.2
FI	12.0	-1.5	0.1	:

Note: current account data refers to the national account concept. The current account required to stabilise the NIIP is based on GDP deflator and potential GDP growth for the 2015-16 period. The current account required to reduce the NIIP/GDP ratio below -35% is the average current account required over the 2015-2024 period based on the current forecasts for GDP deflator and potential until 2016, DG ECFIN's medium-term forecasts until 2021, and assumptions underlying DG ECFIN's debt sustainability analysis until 2024. All current account benchmarks assumes zero valuation effects on average and a capital account balance as a share of GDP equal to the median value over the 2012-14 period.

Once the rebalancing process in the euro area has run its course, countries with large net foreign liabilities will need to maintain sufficient current account surpluses. The success of policies put in place by the ECB and a domestic demand recovery in core euro area countries should contribute towards this end. Rebalancing will be compatible with a recovery in potential growth in net debtor countries provided that growth is sufficiently export-driven. For this to happen, the necessary shift from non-tradable to tradable activities needs to continue in these economies. As shown in Graph 3, while this shift has started only recently in Greece, it appears to have peaked in Ireland and Spain, and reversed in countries that went through current account rebalancing at an earlier stage, like Latvia. Price and cost competitiveness gains would help such a shift, but developments in REER indicate that competitiveness improvements since 2013 have slowed down in countries like Spain and Portugal. The major slowdown in inflation recorded in competitor countries since 2014 is also reducing the extent of competitiveness gains in Greece and Cyprus.

Graph 3: **Share of tradable output***



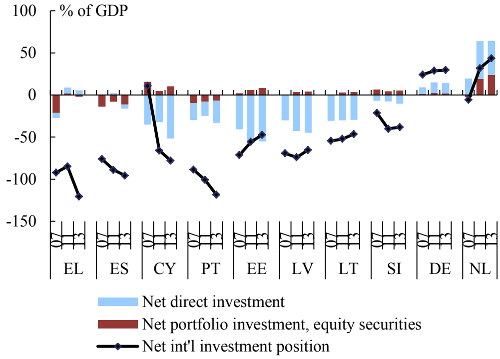
Source: European Commission computations on data from Ameco and Eurostat.
* Tradable output is defined as the sum of manufacturing, agriculture, transport and trade services.

Rebalancing should also be helped by structural reforms. In countries with large stocks of foreign liabilities, further structural reforms should raise productivity growth and facilitate the reallocation of capital and labour toward exporting firms. However, the scope for exports also depends on external demand. Weak demand in the core euro area implies that debtor countries have to focus relatively more on dampening import demand rather than expanding exports in order to reduce their net external liabilities. For the relatively closed economies in the euro area's south, that would weigh on GDP growth, which in turn would require higher current account surpluses to narrow the NIIP as a share of GDP. Conversely, structural reforms to reinvigorate domestic demand and growth in surplus countries would also help to ease the debt burden in the euro area periphery, not only by increasing demand for exports, but by raising euro area inflation closer to 2%.

In the external debtor countries, structural reforms should also improve attractiveness to foreign direct investment, which offers an alternative route towards the easing the burden of negative NIIPs. Net foreign liabilities in the euro area periphery are largely in the form of net market debt, except those in Ireland [3] and the Baltic countries (see Graph 4). A stronger reliance on FDI and equity inflows in the euro area's periphery would contribute to the stability of foreign investment and to the extent of risk sharing with foreign investors.

[3] Note that the Irish NIIP indeed is characterised by large FDI positions from non-EU investors. However, it is also strongly affected by Ireland's status as a centre of European bond funds, which are accounted for as debt assets matching equity liabilities. For this reason, the Irish net equity liabilities would be beyond scale in Graph 4.

Graph 4: **NIIP composition (based on BoP6)**



Source: European Commission computations based on data from AMECO and Eurostat.