

## **EURO AREA IN THE CONDITIONS OF GLOBAL IMBALANCE<sup>1</sup>**

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### **Abstract**

The world economy has been tormented by global imbalance for some time. One of its manifestations is the current crisis. The global imbalance has noticeably affected the development of advanced countries in the world.

The main intention of this paper is to review the status of the euro area in the global economy in terms of the global imbalance through the analysis of the development of the current account of the balance of payments, the terms of trade, as well as through the relationship between savings and investments. Furthermore, this paper aims to identify the potential risks of this development in the future, which might impede the return to equilibrium in the global economy.

### **Keywords**

Global imbalance, current account of the balance of payments, terms of trade, savings, investments, eurozone

**JEL Classification:** E21, E22, F32

### **Introduction**

The contemporary global economy is developing under the influence of a widening global imbalance and the persisting global crisis. The International Monetary Fund classifies countries as advanced, developing and emerging economies. The global economy has been transformed from the so-called bipolar

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<sup>1</sup> "This contribution is the result for the project VEGA 1/0542/09 The Perspectives of Slovak Republic in the conditions of global imbalance (50 %) and the project of PMVP 2315023 The Adjustment of Balance of Payment in Eurozone Conditions - Impact of Euro Adoption on the Balance of Payment of Slovak Republic (50 %)."

world, where countries were explicitly divided into rich and poor, and global economic growth was determined by developments in the U.S. and Europe into a world that can be described as multipolar, in which emerging and developing economies have been assigned a significant role from a global perspective [Menbere Tiruneh Work, 2007, p. 29].

The present driving forces of the global economy are the emerging economies, which have not been affected by the financial crisis to such an extent as their more advanced counterparts. In the case of advanced economies development has been suggestive of a deepening balance of payments deficit since 1999 (with moderate improvements in 2009), whereas emerging economies have recorded a long-term surplus (since 2000); savings in advanced economies are not sufficient enough to cover investments (savings were at 17.8% of GDP in 2010, whereas investments were at 18.4% of GDP), which indicates precisely the opposite developmental trend when compared to emerging economies, where, due to vigorous economic growth, cheap labour force and increasing exports, savings have exceeded investments (savings are at 32.4% of GDP and investments are at 30.8% of GDP). The development of the terms of trade is more stable in advanced countries, since emerging and developing economies demonstrate a rather one-sided export-orientation to raw materials and goods with low added value, whose prices have significantly fluctuated on the world market [Jana Kotlebova, 2010, pp. 315 to 339].

**Graph 1**

***Terms of trade of goods and services – advanced, emerging and developing economies (% change 1990 – 2010)***

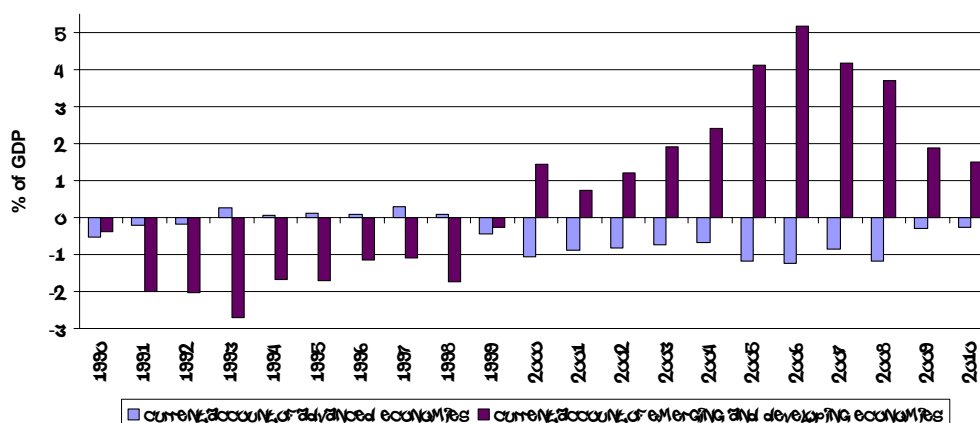


Source: author’s own processing, data from [www.imf.org](http://www.imf.org)

Countries with deficits face increasing pressures in obtaining financing. This foster adjustment through upward pressure on domestic interest rates, downward pressure on the real exchange rate, and slowing domestic economic activity. Surplus countries face similar pressures in the opposite direction, with rising economic activity and appreciation of the real exchange rate the main forces that prompt balance-of-payments adjustment [Stewen Dunaway, 2008, p. 7].

**Graph 2**

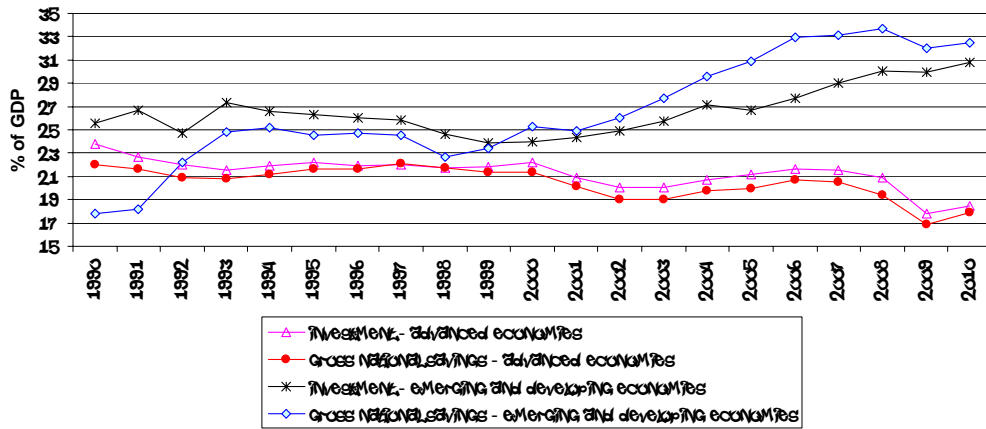
**The current account of balance of payments in major country groups ( % of GDP)**



Source: author's own processing, data from [www.imf.org](http://www.imf.org)

**Graph 3**

*The development of savings and investments in major country groups ( % of GDP)*



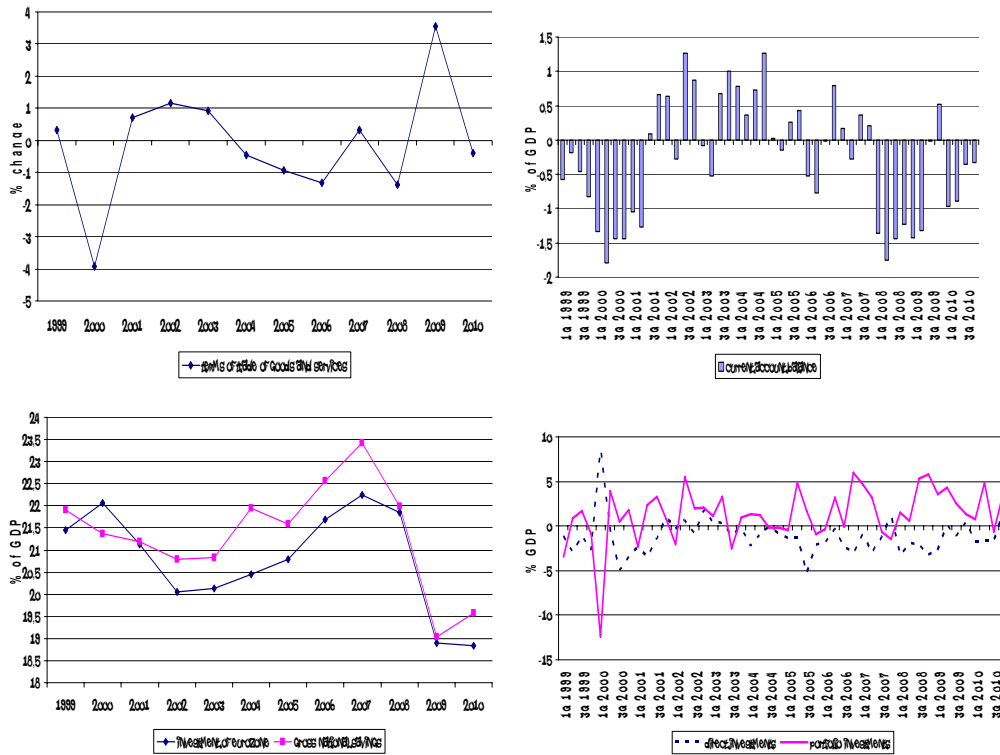
Source: author's own processing, data from [www.imf.org](http://www.imf.org)

**Position of the Euro Area in Global Imbalance**

The entire euro area belongs to the advanced economies. An opposite developmental trend was observed in the years of the crisis, from 2008 until 2010, in terms of trade when compared to the years of 1999/2001. The terms of trade correspond to the index ratio of export prices to that of the index of import prices. To improve the terms of trade there is less export demand to cover imports, which leads to savings in exports, which may be diverted into consumption and capital formation; in the case of deteriorating terms of trade, it is necessary to export other goods and services for a given volume of imports, which causes the reduction in consumption and capital formation. There was a deteriorating terms of trade in the years of the crisis in the euro area.

**Graph 4 – 7**

**Terms of trade of goods and services, current account of balance of payment, relation between savings and investments and capital and financial account of balance of payment in eurozone**



Source: author’s own processing, data from [www.imf.org](http://www.imf.org), [www.ecb.int](http://www.ecb.int)

The current account of the balance of payments in the euro area demonstrated an opposite developmental trend prior to the crisis, which was typical for the advanced economies as a whole. The development of the terms of trade corresponds with the development of the current account of the balance of payments, which has vaulted into deficit in the euro area since 2008 (after the years of current account surplus from 2002 until 2007), which may be explained by the decline in exports. The predominant part of foreign trade in the euro area (including both export and import) is carried out mainly with the USA, United Kingdom, Switzerland, China and the other EU member states. If the economy reaches the current account deficit of the balance of payments, consumption is greater than the generated GDP, which leads to the decrease in foreign assets and to the increase in foreign liabilities incurred by domestic entities, and there is a

growing amount of foreign debts. In terms of the capital and financial account deficit of the balance of payments the euro area foreign portfolio investments exceed foreign direct investments. In the case of FDI the greatest activity has been recorded by Luxembourg (FDI inflows 368.7% of GDP and FDI outflows of 420.7% GDP in 2009, while other countries move about 1 to 2% of GDP).

From the perspective of the relationship between savings and investment, the euro area does not demonstrate the same developmental trend as the advanced countries of the world. We can notice that savings had increased in the euro area from 2002 until the emergence of the crisis (in 2010 they were at 19.6% of GDP), whereby they were higher than investments (in 2010 investments were at 18.8% of GDP).

**Table 1: Net financial assets by institutional sector in eurozone (2010 Q3 in bil. EUR)**

<b>Institutional sector</b>	<b>Total financial assets (debit)</b>	<b>Total financial liabilities (credit)</b>	<b>Net financial assets (worth)</b>
Non-financial corporations	17 089	25 929	- 8 840
Insurance corporations and pension funds	6 875	6 904	- 29
Monetary financial institutions	32 912	32 009	903
Other financial intermediaries	14 343	14 054	289
General government	3 511	8 805	- 5 294
Households	18 562	6 691	11 871
Rest of the world	16 221	14 735	1 486

*Source:* author's own processing, data from [www.ecb.int](http://www.ecb.int)

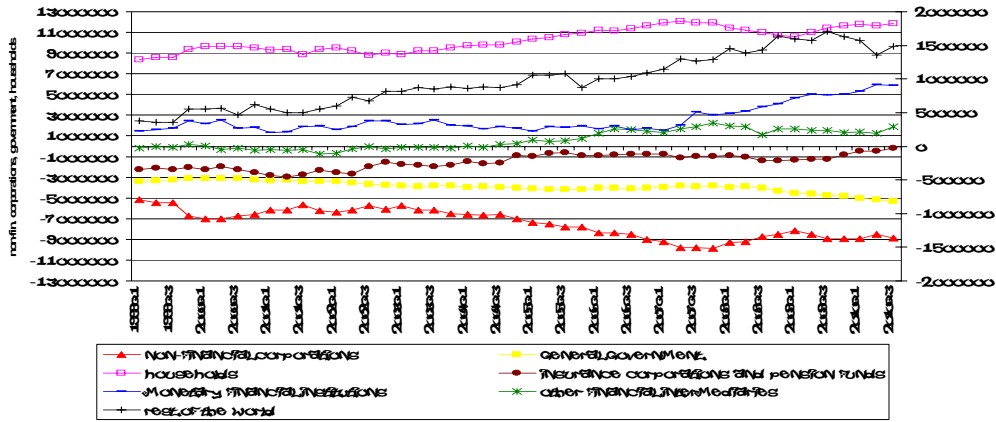
In a closed economy, there should be equilibrium between savings and investments, whereas in an open economy, savings are compared not only to investments but also to the current account of the balance of payments. Equilibrium between the current account of the balance of payments and the total sum of individual savings in the form of net financial assets means that countries with higher rates of household savings (which is typically a sector with high financial assets) will not be able to maintain a current account surplus of the balance of payments if other sectors in the economy will incur great financial liabilities.

As shown in Graph 8, in the case of the non-financial corporations and of a national government, there is a decline in net financial assets in the euro area, while in other sectors; there is an upward trend, which has been slightly violated

as a result of the crisis. The steepest increase in net financial assets is accrued in monetary financial institutions and the rest of the world.

**Graph 8**

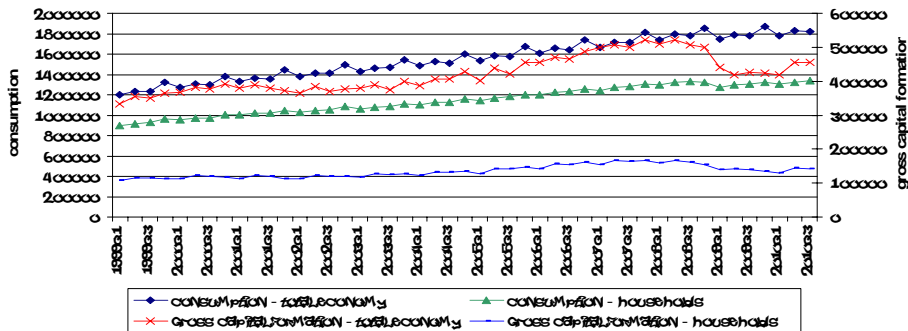
*Net financial assets by institutional sector in eurozone (in mil. EUR)*



Source: author's own processing, data from [www.ecb.int](http://www.ecb.int)

**Graph 9**

*Consumption and gross capital formation in eurozone (in mil. EUR)*

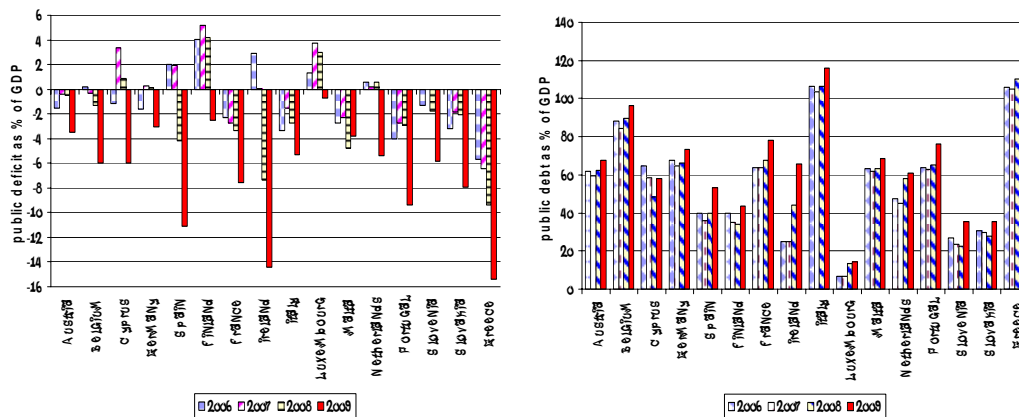


Source: author's own processing, data from [www.ecb.int](http://www.ecb.int)

From the perspective of consumption and investment development, it is possible to monitor an increase in consumption both by households and the national government in the entire euro area economy. In the case of investments there was a decline in Q3 in 2008, mainly in households and non-financial companies. This

developmental trend can be explained by low interest rates on the money market and the prevailing mistrust in financial markets, and future inflation growth expectations. Consumption growth has an impact on the growth of demand for goods and services, which also creates conditions for production growth. On the other hand, the appreciating currency can be an obstacle to increasing exports and can encourage imports into the euro area.

**Graph 10 - 11**  
**Public deficit and debt euro area countries ( % of GDP)**



Source: author's own processing, data from [www.ecb.int](http://www.ecb.int)

The current account deficit of the balance of payments means that the economy consumes more than it produces, its investments are higher than its savings or public expenditure is higher than the revenue. In the case of the euro area it can be observed that since 2008 there has been a current account deficit of the balance of payments, savings in relation to investments have evolved quite positively, however, public finances appear to be as very problematic aspects of development. In 2009 public deficit reached 6.3% of GDP in the euro area (in the first half of 2010 it was 6.7%) and public debt was 79.2% of GDP (in the first half of 2010 it was 81 to 82.4%). As it can be observed on the Graphs from 10 to 11, during the year 2009, 13 (out of 16) countries exceeded the Maastricht criterion (3% of GDP) in terms of public deficit and 9 countries in terms of public debt (60% of GDP).

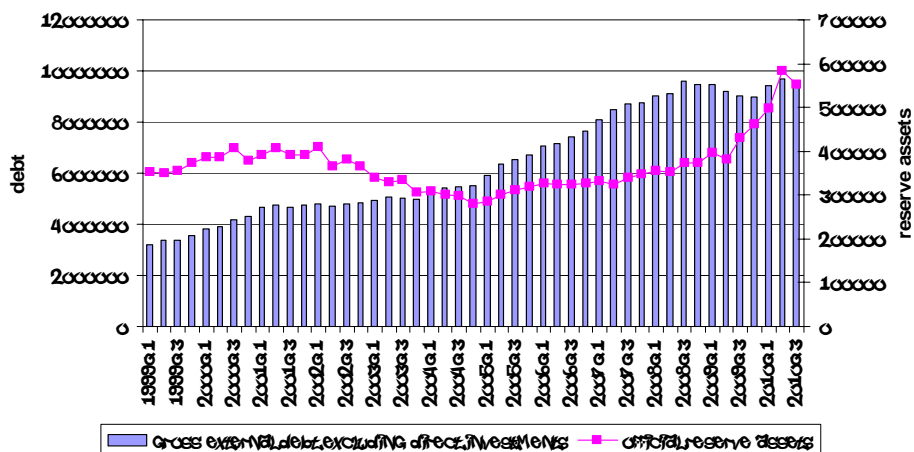
Countries, in which there is a higher generation of savings over investment during periods of instability on foreign markets, tend to generate higher foreign exchange reserves. In the global economy, the volume of foreign exchange reserves continues to rise, although since 2005 foreign exchange reserves have been



generated by emerging economies. In terms of denominations, foreign exchange reserves are held mainly in USD and EUR, while the share of the USD is steadily declining, and there is a growing share in EUR, which is the result of the exchange rate development of the major currency pair. As it is shown in Graph 12, in accordance with the aforementioned, official foreign reserves have risen in the euro area, currently they are around 552 billion EUR, however, there is an increasing gross external debt (currently at 120% of GDP). Most of the foreign exchange reserves of the euro area are in gold and then in securities denominated in foreign currencies, whereas the greatest gravity in foreign reserves is attached to USD and GBP. In connection with the current happenings in the world economy, emerging economies such as China and Russia are negotiating about the replacement of the world currency, which is currently the USD, as an alternative they consider the SDR (in some studies it is the Chinese yuan renminbi). In any case, there has been an increasing share of the euro in foreign exchange reserves of all countries in the world since the establishment of the euro area.

**Graph 12**

**Gross external debt excluding direct investments and official reserve assets in mil. EUR (eurozone 16)**



Source: author's own processing, data from [www.ecb.int](http://www.ecb.int)

**Conclusion**

In March 2011 the ECB published its macroeconomic projections for the euro area in 2011 and 2012.

**Table 2**

**Macroeconomic projections for the euro area (average annual percentage changes)**

<b>Indicator</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>
HICP	1,6	2,0 – 2,6	1,0 – 2,4
Real GDP	1,7	1,3 – 2,1	0,8 – 2,8
Private consumption	0,7	0,6 – 1,4	0,4 – 2,2
Government consumption	0,8	- 0,3 -	-0,5 – 0,9
Gross fixed capital formation	-0,8	0,5	0,7 – 5,5
Exports (goods and services)	10,9	0,4 - 3,4	3,0 – 9,2
Imports (goods and services)	9,0	4,9 – 9,5	2,8 – 8,4
		3,5 – 7,7	

Source: <http://www.ecb.int/pub/pdf/other/ecbstaffprojections201103en.pdf>

As the above Table 2 shows, in 2011, there is an anticipated increase in private consumption, a slight decrease in public expenditure, whereas there is a positive increase in investments. In the case of foreign trade in the euro area there is a lower activity expected on both the export and import side. Overall, real GDP, under a pessimistic scenario, should grow by 1.3% and under an optimistic scenario, by 2.1%. However, the ECB anticipates a continuous recovery of the economy in the euro zone, where exports would be the main driving forces in the economy.

On the other hand, as seen in our analysis, the increasing domestic and foreign debt, may negatively affect the exchange rate in the euro area. An increase in consumption together with a decrease in investments will support the increase of imports in the euro area. As a result of rising commodity prices on the world market, the recovery of foreign trade and economic growth will be difficult due to rising costs. The development of global trade and of the euro area is largely influenced by internationalisation in terms of various production chains, i.e. the production of goods provided by various manufacturers located in different countries. Therefore, the instability of the international financial markets also reflects a trade slump in the entire global economy. Moreover, rising inflation has also contributed to the given negative developmental trend. In the case of the ECB, there are negotiations about the increase in key interest rates. These factors will create difficult conditions for production growth, which may endanger the future growth of the economy. As a result of these factors, there may be an increase in unemployment, which only puts further pressure on public finances. It is therefore not surprising that the euro area is preparing the so-called European Stability Mechanism (ESM), which will replace the currently valid agreements of

the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM) in June 2013. At the same time, there are several measures taken to consolidate public finances at local levels in EU member states. New investments should have key importance to progress in terms of economic growth and stability in the euro area. We do not expect that the ECB would accede to a noticeable increase in its key interest rates since in terms of investment stimulation higher interest rates could be an obstacle to granting new loans to corporate entities.

Emerging economies throughout the financial crisis have increased their investments in science and research, since they act as the right sources of innovation and creativity which are the best foundation for stronger economic growth. Investments in science and research in 2008 in the euro area were around 2% of GDP (the highest in Finland, 3.73%), in the U.S. they constituted 2.77% and in Israel, for example, 86%. That attitude should be acquired by the euro area countries.

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statistical data [www.ecb.int](http://www.ecb.int), [www.imf.org](http://www.imf.org)