

Macroeconomic imbalances within the EU: How are macroeconomic imbalances connected with the recent debt crisis? Assess whether the “Macroeconomic Imbalance Procedure” is a good instrument to deal with such problems

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Figure 1: Divergence of CA between north and south

Figure 2: General gross government debts

1. Introduction

This paper investigates if there are macroeconomic imbalances in the EMU or not. Especially concerning the recent debt crisis in many European countries, it is important to analyze the driving factors of these imbalances and the connection between imbalances and the increasing government debts. In order to prevent crisis such as the euro crisis, the EU implemented a mechanism to identify imbalanced developments. We need to identify which indicators are chosen by the EU to measure an imbalance and which of them shows a divergent development.

The most important imbalance according to the EU's "*Scoreboard for the surveillance of macroeconomic imbalances*" is the development of the current account balance of some European countries. The aggregated current account balance of the EU fluctuates around zero but one can observe that the single countries have various developments. In general, Northern European countries have current account surpluses while countries which are located more in the South of Europe are facing current account deficits. How do these CA imbalances affect other macroeconomic indicators and how are they related to the recent debt crises in Europe?

Besides the definition of the CA as exports of goods and services minus imports of goods and services, the CA balance can also be seen as the difference between gross domestic savings and gross domestic investments. Under this assumption, the imbalances represent massive capital flows moved from the North to the South of the EMU. Capital flows have increased enormously in recent years due to the innovations in the information- and communication technology. Therefore, the presence of current account imbalances and the investigation of their driving factors is one of the most important points in the global economy.

In the first part, the aim of this paper is to present the theoretical framework which helps to understand the relationships between the current account balances and other developments in an economy. Based on this analysis, the paper will assess in the second part whether the "Macroeconomic Imbalance Procedure" of the EU is a good instrument to eliminate the imbalances. What are the Indicators and how do they measure an imbalance? If there is an imbalance, according to these indicators, how accurate will the procedure of the EU deal with specific situations and how good is the instrument in general? Although the imbalance procedure is related to the whole EU, in this paper we will focus on the EMU since the debt crisis mainly affects the monetary union countries.

2. Theoretical Framework

In order to analyze the situation of the current account (CA) imbalances in the EMU, it is essential to build up the theoretical relationships between the CA and other economic forces first, especially the relation of government debt to the CA. This will present the base for further analysis.

Besides the definition of the CA as the trade balance of a country, measuring exports and import of goods and services, the CA can also be seen as the difference between gross domestic savings and gross domestic investments. Those conclusions are drawn by the equation of the gross domestic product. Under the assumption of an open economy model, this equation has the following form: $Y = C_H + C_{St} + I + EX - IM$. Through some modulations, it will yield to the definition of the CA in this context. Thus, the CA balance is: $S = I + CA$ or $CA = S - I$. According to this identity, in a country that runs a CA surplus, the domestic savings will be larger than the domestic investments. Analogously, in a country with CA deficits, the domestic savings are smaller than the domestic investments. Since the global balance of all current accounts in the world has to be zero, countries with saving surpluses will finance the deficits of the rest of the world (Rübel 2013; European Commission 2012a). In the context of current account analysis, it is important to consider also the capital balance which is the counterpart to barely all current account transactions.¹ Moreover it takes into account all financial transactions between the domestic and foreign economies in a particular period of time. These transactions include foreign direct investments, assets, stocks and bonds, treasury securities and currency etc (Rübel 2013).

If a country runs a CA surplus, it will invest the excess savings in another country and therefore run a capital account deficit. Hence, the capital account of a country with CA deficit will be positive. But why is country becoming an international importer or exporter of capital? In order to answer this question, we need to identify the driving factors behind the domestic saving and investment positions. For this purpose, the domestic savings have to be separated into the public and private² sectors of an economy. Thus, the total savings involve every decision made by private households, the business sector and the public sector (Rübel 2013).

By transforming the national identity from above, we can express the equation also as the following: $S_p + (EX - IM) = I_p + (G - T)$. Assuming that the private savings are as large as their investments, the CA balance would equal to the government budget. According to this

¹ <https://stats.oecd.org/glossary/detail.asp?ID=154>

² Private savings = Households + Business