Exporting Assets: EMU and the Financial Drivers of European Macroeconomic Imbalances

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Exporting Assets: EMU and the Financial Drivers of European Macroeconomic Imbalances

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ABSTRACT
European Economic and Monetary Union has fostered an unstable complementarity in European financial markets between the growth models favoured by European savers (in the northern ‘core’ of Germany and other exporting states) and its borrowers (in the debt-fuelled and demand-driven eurozone periphery, including countries like Greece and Ireland). In the 2000s, the result of this development was a sharp decrease in real interest rates across the eurozone periphery, leading to rapid but inflationary growth. This eroded the competitiveness of exporters in the European periphery, making them more reliant on capital inflows to pay for growing current account deficits. Those deficits became problematic after the disruption of eurozone financial markets beginning in 2008. The policy response to the crises has focused on reducing the competitiveness gap between the core and periphery – while overlooking the financial forces that contributed to those competitiveness differentials in the first place. Indeed, it is the fragile and perverse complementarity in eurozone financial markets – more than any external shock or competitiveness differences – that lies at the root of Europe’s ongoing crisis.

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Euro; balance of payments; macroeconomic imbalances; growth models

As prospective eurozone members prepared to irrevocably fix their exchange rates in the late 1990s, Milton Friedman (1997) took to the op-ed pages to rain on their parade. Sounding a note of scepticism about European economic and monetary union (EMU), he argued that:

[The euro] would exacerbate political tensions by converting divergent shocks that could have been readily accommodated by exchange-rate changes into divisive political issues. Political unity can pave the way for monetary unity. Monetary unity imposed under unfavourable conditions will prove a barrier to the achievement of political unity.

Friedman’s chief concern, shared with many – particularly US-trained – economists, was rooted in Robert Mundell’s notion of optimal currency areas (OCAs). In the world of OCA theory, the euro looked like a dubious proposition: because eurozone members were so economically distinct, shocks to the currency area would inevitably affect the various parts of the zone differently. Member states, robbed of exchange rate flexibility and their own monetary tools, also lacked bloc-level adjustment tools – such as easy intra-European migration or a federal government willing to transfer funds around the bloc. As a result, the critics argued, national governments would come to resent EMU as a policy straightjacket (Jonung and Drea 2009).
This paper offers an opportunity to concede that those sceptical Americans had a point – but also to issue a corrective to their concerns. It was not some externally generated shock that led to the politicisation of macroeconomic adjustment in Europe (i.e. ‘the crisis’). Instead, the crucial shock was an endogenous consequence of creating EMU itself: by eliminating currency risk and – theoretically – reducing default risk for the eurozone periphery, EMU created a new market for financial assets generated from borrowing in countries like Greece and Ireland. The growth (and collapse) of this financial asset market is an essential part of the crisis narrative.

Before continuing, this argument requires some orientation within the broader context of this special issue. The collective goal of these papers is to consider whether the common shock of European integration has treated certain national economic models better than others. In a general sense, it also calls for a reassessment of whether European integration creates problems when merging national economies that possess distinct economic institutions (c.f., Hope and Soskice 2016, Johnston and Regan 2016 and the introduction to this special edition). This contribution is focused on the financial drivers of macroeconomic imbalances within the euro area.

The key claim here is that EMU fostered an intrinsically unstable complementarity in European financial markets between European savers (in the northern ‘core’ of Germany and other exporting states) and borrowers (in the faster-growing eurozone periphery, including countries like Greece and Ireland). The well-known result of this development was a sharp decrease in real interest rates across the eurozone periphery, leading to rapid but inflationary growth (Belke and Dreger 2013, Chen et al. 2013, Diaz-Sanchez and Varoudakis 2015). Within the currency area, inflation in the periphery grew problematic by driving up the real cost of exports while reducing the real cost of imports, producing large current account deficits (Johnston and Regan 2016).

Despite this erosion of competitiveness, however, European macroeconomic imbalances only became problematic after the disruption of European financial markets (Fuller and Jones 2015a). The increasingly Europeanised market for financial products had been beneficial in the short term: it generated rapid growth in borrowers’ nontradable sectors and offered an expanding menu of savings options to the European core. In the long run, though, this perverse compatibility of core and periphery growth models led to larger current account and financial account imbalances. The periphery became increasingly dependent on the eurozone core for the capital to sustain their demand-driven growth while Germany grew more reliant on (peripheral) external demand and capital exports. This fragile and perverse complementarity in financial markets – more than any external shock or competitiveness differentials – lies at the root of Europe’s present crisis.

The paper develops this argument over the course of three sections: The first critiques the theoretical assumption that the balance of payments (BoP) is primarily driven by developments in the current account rather than the financial account. This is a mistake: markets for financial products also exert a great deal of influence over a country’s BoP. The second section applies this insight to the eurozone crisis. It argues that existing crisis narratives are fundamentally handicapped by their emphasis on the trade balance and competitiveness, such as measured by nominal unit labour costs (NULCs). By focusing the timing of European BoP reversals, it presents a more complete explanation of the crisis – one that incorporates the financial drivers of the BoP.

The third section turns back to the goal of this special issue, comparing the perverse complementarity of growth models under EMU to the US–China ‘Chimerica’ relationship that emerged in the 2000s. It argues that the key difference between these two cases is that EMU’s intertwined growth models are not truly interdependent: the dependency is largely one-way. The final section concludes that this asymmetry has led to a one-sided ‘hard landing’, driven by policies that leave one crucial driver of the crisis – the eurozone core’s insatiable demand for financial assets – undisturbed.

**Interpreting the BoP**

Previous works in this volume have addressed the problems posed by integrating Northern European export-led regimes into EMU alongside a number of consumption-oriented economies. This paper
identifies the same set of problems but differs in one key way: it emphasises intra-European trade in financial products over trade in goods and services. That is, I focus extensively on the financial account within the BoP (per the IMF, ‘financial account’ rather than ‘capital account’ is now the appropriate term).

This has the effect of forcing us to reconsider our conventional understanding of the BoP. In particular, financial account imbalances reveal a ‘creditor/debtor’ dynamic whereas current account imbalances are conceptualised in a ‘surplus/deficit’ manner. This section will first argue that observers are predisposed to look to the current account before the financial account when explaining macroeconomic imbalances. The second breaks down why this emphasis on the current account is inappropriate – or at least incomplete.

The legend of the competitiveness thesis

There is an unrecognised tendency among many journalists, policy-makers, and academics to assume that the current account of the BoP essentially clears ‘first’. This habit can be seen in a number of different ways: it is evident in the everyday usage of the terms ‘surplus’ and ‘deficit’ country, in academic efforts to highlight the competitiveness problem in the eurozone periphery, in the current account centric policies of macroeconomic adjustment, and even in some of the basic models of the BoP that many students learn in monetary economics (such as in Paul Krugman and Maurice Obstfeld’s widely used International Economics text, discussed further below).

The first point is superficial but worth mentioning. In casual usage, it is quite common to see the concepts of the trade balance, current account balance, and BoP subtly conflated. In particular, entire national economies are often characterised by their current account position: Paul DeGrauwe (2012), who otherwise recognises that creditor–debtor dynamics feature heavily in the process of European macroeconomic adjustment, nevertheless uses ‘surplus’ and ‘deficit’ to classify countries’ economic circumstances 17 times in five short pages. Likewise – despite acknowledging that capital flows played a major role in the emergence of the eurozone crisis – Financial Times columnist Martin Sandbu (2015) introduces us to his Europe’s Orphan by positioning countries by the traditional deficit–surplus dichotomy.

But the terms we use are important. Referring to Germany as a surplus country or Greece as a deficit country implicitly privileges the current account. After all, ‘deficit countries’ usually have financial account surpluses (i.e. an inflow of capital in excess over outflow). A more appropriate treatment would use both the ‘surplus/deficit’ and ‘creditor/debtor’ labels together (c.f. Wolf 2013, Skidelsky 2014). Interestingly, the latter set of terms appears to be more common in works that are more sceptical of Germany’s savings behaviour.

The second and third points are closely related. In both the policy and academic communities, crisis narratives and solutions have tended to prioritise current account phenomena over the financial account. Academics zeroed in on the deterioration of inflation, rising labour costs, and fiscal incompetence in countries like Greece and Ireland (Papademos 2007, Belke and Dreger 2013, Johnston et al. 2014). The standard narrative became what Charles Wyplosz (2013) describes as ‘the competitiveness legend’: a conventional wisdom that intra-European imbalances were ultimately driven by inflation (especially rising unit labour costs) and the accompanying appreciation of peripheral states’ real exchange rates. This depressed exports while enabling a surge of imports.

The status of the competitiveness thesis has a lot to do with its widespread acceptance within the European institutions – and in the capitals of Europe’s biggest creditors. Early in the crisis, the European Commission (2009) threw its weight behind the idea, issuing a special report on eurozone competitiveness differentials. Major European creditors like Germany and the Netherlands saw the crisis – beginning as it did in Greece – as the consequence of excessive borrowing and irresponsible spending. Dutch Prime Minister Mark Rutte and his then-Finance Minister, Jan Kees de Jager argued (2011) that, ‘some countries played fast and loose with the very rules designed to guarantee budget discipline’, leaving countries like the Netherlands to ‘foot the bill’. In short: there has been a tendency to
point the finger at governmental excesses in borrowing and spending as a major driver of the crisis. The ECB (2012) has broadly adopted the thesis as well, though it has taken a broader view of competitiveness.

This narrative – along with implied rhetorical slights such as employing the derogatory term, ‘PIIGS’, to refer to Portugal, Italy, Ireland, Greece, and Spain – seems to apportion blame for the crisis to the periphery. Surplus countries have balked at taking any of the blame themselves, arguing that doing so would be tantamount to punishing them for success (Schaeuble 2011). Instead, Berlin and the European institutions have driven forward a programme of asymmetrical adjustment, putting the burden on Europe’s indebted periphery (de Grauwe 2012, De Grauwe and Ji 2013). The European Fiscal Compact as well as the EU’s ‘six-pack’ legislative reforms directed member states to rein in government spending in order to prevent future crises. The subsequent ‘two-pack’ then gave the Commission broader oversight of member states’ national budgets. The implication is clear: the crisis was one of imbalances caused by overspending – by governments in particular. The solution, then, must be austerity and the deliberate depression of domestic prices in the pursuit of more cost competitiveness (i.e. ‘internal devaluation’) (Blyth 2013).

This narrative of austerity-induced cost competitiveness and the remedy are fundamentally focused on the current account. The one policy nod to the potential dangers of excess savings, the macroeconomic imbalance procedure included within the six-pack, remains vague in terms of its construction and enforcement. When considering whether the new procedure might be leveraged against Germany’s large current account surplus/financial account deficit, Daniel Gros and Matthias Busse (2013) opined, ‘nothing of concrete substance is likely to follow’. And nothing has.

Returning to the fourth illustration of the implicit prioritisation of the current account, we find ourselves in a somewhat unexpected place: economics textbooks. Interpreted through the lens of intertemporal trade, the financial account is merely a means of converting a present current account surplus into a future current account deficit (or vice versa). This is evident from Figure 1, a fairly standard illustration of how intertemporal trade – temporary macroeconomic imbalances – permits countries to increase their aggregate level of satisfaction (Krugman and Obstfeld 2006). This sort of treatment implies something subtle: financial interactions are merely the shadow of individuals’ desire for more tangible goods and services. In a sense, this model implies that there is only a current account: the financial account simply reflects a future current account balance. The rate at which we discount future consumption determines the return earned by financial instruments. This view ignores the possibility that financial products are governed by their own market dynamics – connected to (but not wholly dependent on) developments in goods markets. In a sense, economic textbooks have not been updated to reflect the contemporary reality of ‘financialisation’ (cf. Magdoff and Sweezy 1987, Epstein 2005, Stockhammer 2008).

Finally, it is worth pointing to one more plausible reason behind the general tendency to look to the current account before the financial account: in the postwar era of capital controls, this approach used to be far more appropriate to the circumstances. Financial flows during the heyday of the Bretton Woods era did primarily exist to facilitate trade; consequently, the financial account really was more a shadow of the current account (Helleiner 1993). By comparison, today’s financial markets are far more integrated – and capital moves across borders for a much wider variety of reasons.

**Reframing the BoP**

The critical tone of the preceding paragraphs begs an obvious question: is there anything wrong with this? Why shouldn’t the current account be given causal primacy over the financial account? To answer this, we must first briefly recap how the BoP works – and how double-entry bookkeeping functions across borders.

For purchases of goods, the BoP accounting of the transaction is relatively straightforward (see Table 1). To avoid reading country-specific information into this example, let us use the hypothetical
cases of Earth and Mars. Say that a Martian coffee merchant wishes to import $100 of Earth coffee. The Martian importer gets $100 worth of coffee in exchange for exporting $100 of cash; in return, the Earthling exporter receives $100 of cash in exchange for exporting $100 worth of coffee. This would result in a current account deficit and net capital outflows for Mars – and the reverse in Earth. If Mars wants coffee, it must find acceptable funds by selling either goods or assets. If Earth sells coffee, it

Table 1. BoP accounting of current account transaction.

<table>
<thead>
<tr>
<th>Credit</th>
<th>Debit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earth $100</td>
<td>$100</td>
</tr>
<tr>
<td>(goods exports)</td>
<td>(goods imports)</td>
</tr>
</tbody>
</table>

Figure 1. A typical textbook illustration of current account deficits and surpluses.
generates revenue – currency – that they then need to use somehow, either by importing goods or buying financial products. Otherwise, they face the proverbial mattress problem: if you do nothing with your accumulated funds, they lose value rather than earning a return (as in, what happens when you put cash in a mattress).

The Martian constraint is tighter than the one on Earth: it is easier to dispose of extra capital than it is to conjure money from thin air. This asymmetry is consistent with the fact that European current account adjustments have been undertaken by countries with current account deficits (de Grauwe 2012), though debtor countries are not without weapons of their own (Frieden 2015).

The BoP treatment of financial transactions gets stickier by comparison. Nearly every financial product – including plain old cash – leads a double life. For an ordinary bank customer, the cash in a checking account is an asset; for the bank, it is a liability. This is because the bank has essentially borrowed that money from the customer and the customer can demand it back at any time. The same double life exists for your mortgage, except that you hold the liability and your bank has the asset. Similar principles apply to our Earth–Mars example: if Earth investors buy $10m in Martian government bonds, the Martian seller receives cash while Earth receives the bonds. This single transactions appears in two places on the balance sheets of both countries involved (i.e. quadruple-entry bookkeeping, see Table 2). Mars gains cash at the expense of a balancing financial liability they must pay (the bonds); Earth loses cash but gains a balancing financial asset of ostensibly equal worth (the bonds, again).

Netted out, such a transaction would seem to have no impact on the BoP – but this is misleading for two major reasons. First, when Earth buys Martian debt, it changes the balance sheet structures of both ‘countries’. Earth trades highly liquid cash for somewhat less-liquid Martian government bonds. On Mars, this means that the former bondholders convert their assets into cash. Mars – as the debtor – then faces the mattress problem: those who sold the bonds have new liquid capital that needs to be used somehow. On one hand, they can lend those funds out for consumers and businesses to use. On the other hand, Mars can save it – meaning they need to find assets to buy. The second point – closely related to the first – is that, if Martian banks are less internationalised than Earth banks, the liquidity generated within Mars is likely to stay on Mars (for a discussion of how this works in the eurozone, see Choi and Park 2014).

As Martian banks sell their higher quality but less-liquid financial assets and replace them with cash, the supply of liquid capital within Mars expands. This depresses interest rates as the Martian banks then distribute some of that cash by lending it. This is where the story becomes familiar again: the inflation generated by credit-fuelled domestic spending will cause a real appreciation of the borrowing country’s currency. That can further drive buyers to import while punishing exporters, worsening export competitiveness. To returning to our original Martian coffee importer: he or she might not have bought $100 in coffee under other circumstances. But, given falling interest rates and an appreciating currency, they decide that buying the coffee is worthwhile after all. In this case, the financial account essentially clears ‘first’: it is the presence of extra capital which causally precedes the decision to import; the Martian desire for more coffee is a necessary but insufficient explanation for the growth of the Martian current account deficit.

<table>
<thead>
<tr>
<th>Table 2. BoP accounting of financial account transaction.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Credit</strong></td>
</tr>
<tr>
<td>Earth $10m (portfolio assets)</td>
</tr>
<tr>
<td>Mars $10m (cash)</td>
</tr>
</tbody>
</table>
**Back to empirics**

Returning to the real world, there is a wealth of evidence that shifting demand conditions for financial products (and housing assets, which are sometimes substitutes) do indeed act as a driver of a country’s current account.

Analyses by Ricardo Caballero *et al.* (2008, 2009) have shown that trade in financial products is crucial to understanding contemporary macroeconomic imbalances. Indeed, they argue that macroeconomic imbalances emerge in part from the heterogeneous capacity to generate assets across the world: capital flows to where the credible borrowers are. Moreover, the fact that global interest rates remained low even during periods of intense borrowing reinforces the message that quality assets remain relatively scarce when compared to the number of people looking to stock up their portfolios. As the developed world has aged and institutions like sovereign wealth funds have developed, the demand for high-quality savings products has skyrocketed. It is, in effect, a sellers’ market—though, in our financial account centred terminology, that means a debtor’s market: debtors ‘supply’ financial assets through the act of borrowing.

The United States is the best positioned to take advantage of this, due to the strength of its financial markets and regulation, its history of relatively rapid growth, the diversity of products on offer, the appeal of investing in dollars, and the ultimate safety offered by US Treasury Bills (Cooper 2008, Schwartz 2016). The key contrast lies between those countries which have specialised in debt-fuelled consumption—countries like the US and UK, but also Greece and Ireland—and what Herman Schwartz calls the ‘repressed rich’, countries which drive wages down and savings up. In these economies—like Germany or Japan—the extra capital generated by export activities gets invested abroad, where asset markets are more dynamic (Schwartz 2009).

This observation is buttressed by the fact that the real exchange rate has been shown to exert less influence over the US current account balance than housing or stock prices (Fratzscher et al. 2010). Marcel Fratzscher and Roland Straub (2013) also found that for each 10 per cent increase in American equity prices, the current account dropped by one per cent. However, that relationship was far weaker in most other countries, suggesting that the financial phenomena only dominate current account phenomena under certain circumstances, or in certain political economies. Other research argues that the US, UK, and France—but not Germany or Japan—experience such current account reverberations from financial phenomena (Holinski and Vermeulen 2012). Further research into when financial variables take on more importance is underway, if short of arriving at definitive conclusions (Chinn et al. 2014).

In sum, the conventional narration would hold that the imbalances in our Earth–Mars example reflect supply and demand conditions in the market for coffee. From the financial perspective, the imbalance is partly dependent on supply and demand conditions in the market for debt. The upshot, evident from the widespread support for the competitiveness thesis as well as emerging analyses of financial BoP drivers, is that both forces are almost certainly at work. Nevertheless, the policy response across Europe remains very much stuck on the notion of current account primacy.

**Understanding European (im)balances**

Erik Jones (2015) has rightly pointed out that the crisis has been overdetermined: a number of different but generally complementary forces were all pushing in the same direction—for greater borrowing in the periphery and lending from the eurozone core, setting the stage for a catastrophic sudden stop. Robert Unger (2017) has developed an excellent quantitative iteration of that argument, finding that proxies for competitiveness, appetite for borrowing in the periphery, and (to a lesser extent) appetite for saving in the core were all statistically significant in explaining the development of European macroeconomic balances.

The interpretation offered here is intended to complement both arguments while continuing to push for the adoption of a more finance-centric interpretation of the crisis. It adopts Jones’ qualitative
openness to contingency while positioning itself within a theoretical framework that emphasises the financial account in creating BoP imbalances more generally. And it largely accepts Unger’s vision of the crisis and its myriad of causes while rejecting one of its crucial methodological choices. The first part of this section presents a general financialised account of the crisis; the second then drills into specific country experiences to highlight how shifting demand conditions in the market for financial products demonstrably played a lead role in causing the crisis.

**The toxic complementarity: a general narrative**

EMU was born at a time of low global interest rates and an intense global hunt for yield. There has been excess demand for saving (i.e. for financial products to be held as assets) for much of the post-2000 era (Caballero et al. 2008). As noted previously, interest rates remained low despite the surge in borrowing during the 2000s boom. In this environment, any new sources of quality assets would be a boon to current account surplus countries needing somewhere to stash their excess currency. For much of Northern Europe, the advent of the eurozone turned the Southern periphery into the partner they needed to support their ageing and savings-hungry populations.

Saving in the peripheral European economies posed a number of advantages for the newly formed EMU’s core. In the late 1990s and early 2000s, each of the countries in the eurozone became substantially more attractive as borrowers: Eurozone members faced no currency risk on intra-EMU investments once exchange rates were irrevocably fixed (in 1998 for most founding members; in 2001 for Greece). Ostensibly, assets produced within the eurozone were also subject to the new risk-reducing macroeconomic framework of the Maastricht criteria and the Stability and Growth Pact (SGP), including a cap on deficits at 3 per cent of GDP and debt at 60 per cent of GDP. Reacting to these changed circumstances, capital flooded into the state sector in Greece and the private sector in Ireland and Spain, seeking to take advantage of the high interest rates. This influx caused the interest rates on peripheral eurozone assets to fall precipitously, converging on German rates. This is particularly important to the small borrowers because they had (and have) fewer options than France and Germany when it comes to borrowing: they are highly dependent on intra-EMU capital flows whereas France or Germany receive more funding from outside the currency area, then invest within it (Choi and Park 2014).

This dynamic requires someone in the borrowing country to take on a new liability – and not all someones are created equal. As recent history demonstrates, the highest quality assets within a national system are often the first ones purchased by foreign savers. Looking at Figure 2, we can see that Greek government debt accounted for 23 per cent of all outstanding Greek liabilities in 2007 – but Greek sovereign bonds accounted for over 40 per cent of all Greek liabilities held outside the country. Limited to short-term portfolio investment alone, the share of capital inflows spent on government debt climbs to nearly 75 per cent. Each of the conventionally named periphery countries except for Ireland follow the same pattern: government bonds make up a much larger share of financial exports than domestic borrowing. This makes sense: particularly in countries with less developed financial markets, government bonds are often the most liquid, most reliable, and best-understood of financial products. When foreigners come looking to buy a savings product, government debt is often at the top of the list.

The fact that Greece, Italy, and Portugal have seen government assets departing in higher numbers than the Spanish or Irish is down to three factors: One, government debt levels in Spain and Ireland were far lower in general – meaning there were simply fewer government bonds to export. Two, the Irish financial system is more developed than the other periphery economies, meaning Ireland has a much broader ‘menu’ of savings products that they can export. Third, the Spanish non-financial sector, especially focused on construction and infrastructure investment, accounted for a greater share of its international borrowing. As a percentage of inflows, Spain received more FDI (relative to other sorts of financial flows) than even the per-capita champions
of inward FDI, Ireland. Ultimately, the provenance of a country’s ‘best’ products can vary – as can the breadth of the products on offer – but there is certainly more than a suggestion here that foreign buyers come for the good stuff first.

This is potentially quite problematic: it means that capital importers effectively substitute cash for the higher quality assets within their domestic system, giving the borrower a boost in terms of loanable funds but also transforming the balance sheets of domestic institutions. Instead of a Greek bank holding sovereign bonds, for instance, the bank would exchange those bonds for foreign cash – which they would then lend to individuals and businesses. This dynamic calls into question one of Unger’s approaches to separating the credit-pull and competitiveness influences on current account imbalances: he uses domestic non-financial sector liabilities as a proxy of how much credit is being ‘pulled’ from elsewhere, but that variable could just as easily be a manifestation of a domestic system awash in foreign liquidity (i.e. a ‘push’ dynamic). In the end, the result is the simultaneous expansion and degradation of the balance sheets in borrowing countries: the best assets are extracted and replaced with lower quality ones.

In the short run, this complementarity looks like a win–win. In the years following the launch of the euro, savings from countries like Germany and the Netherlands flooded into the currency area’s smaller peripheral states: the savers got to diversify and buy relatively high-return products originating in the higher growth periphery; the borrowers got lower interest rates and a period of extremely rapid economic growth. For a brief moment, the two growth models – export oriented in the core; debt-and-demand driven in the periphery – appeared to be working well together.

Unfortunately, the sort of beneficial complementarity at work here could (and did) disappear overnight. If a country runs out of high-quality financial products – or, alternatively, credible borrowers willing to borrow – its BoP becomes compromised. Funding a BoP imbalance through sales of domestically produced financial products is not like funding one through sales of ordinary goods and services. Unlike with producing goods, where you are unlikely to run out of steel or cars in the short run, the ‘export’ product in such a borrowing economy can effectively disappear in an instant – a ‘sudden

Figure 2. Government liabilities in selected countries: 2007. Sources: OECD non-consolidated financial balance sheets; IMF International Investment Position.
stop’. This is what happened in 2009 when George Papandreou admitted that the Greek government was far more indebted than it had led on (Jones 2013).

In a worst-case scenario, this can leave both savers and borrowers with compromised growth models. Consider the periphery’s tendency to rely on domestic demand (rather than exports) to drive economic activity (Regan 2015): if credit dries up, demand falls and growth slows. For the saver, this means fewer exports and slower growth as well as potential defaults that threaten their foreign savings. Worse, the EMU combination of fixed exchange rates and high periphery inflation (due to the previously heightened domestic demand) makes it difficult to restore a more conventional comparative advantage on the current account, complicating any efforts to restore macroeconomic balance through boosting exports of goods and services.

The apparently benign complementarity fostered by EMU turned out to be quite dangerous. The thriftier the core became – and the more they sold abroad – the more they needed Greek/Irish/Spanish borrowing in order to maintain the return on their saving. Conversely, the more the Greeks or Irish borrowed, the more they needed German/Dutch/Austrian surpluses to sustain their economic growth. Once the periphery’s solvency appeared in question, the complementarity – and any semblance of symmetry – fell apart amidst a sudden stop (Merler and Pisani-Ferry 2012): core savers instead turned to minimising losses on their original investments. For the periphery, suddenly facing widespread capital flight, they were faced with the choice of bowing to the core’s wishes or refusing creditors’ demands and crashing out of financial markets altogether.

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**The market for financial products in action**

The eurozone ‘crisis’ is essentially a BoP crisis: the eurozone periphery has struggled to raise enough capital to pay for foreign spending – and, in some cases, for government expenditure as well. In the short run, EMU has coped with the crisis through IMF-style bailouts and by allowing the TARGET2 payment system to temporarily finance current account deficits (Jones 2012b, Auer 2014, Schelkle 2017).

Existing data certainly suggest that relatively high inflation in the periphery has led to those countries’ exports growing more expensive than exports from lower inflation eurozone economies. However, setting aside the valid debate over the usefulness of unit labour costs as an economic variable (Felipe and Kumar 2011, Knibb 2015), NULCs indicate little on their own. Indeed, both the current account and financial account driven narratives of the crisis envision such inflation.

Nevertheless, it is easy to see why the NULC-based explanation has so much cachet. Figures 3 and 4 depict the coevolution of current account balances and NULCs since 1998 in Portugal and 2002 in Greece. It suggests that both countries’ current account balances deteriorated as labour costs rose faster than the eurozone average. Once those NULCs dropped, the countries swung back towards more balanced current account positions. There are problems, however, with this simple explanation. First, rising unit labour costs do not seem associated with a loss of export shares among eurozone members (Jones 2015). Second, the NULC interpretation does not hold up well when looking at the timing of events. The remainder of this section draws out these timing inconsistencies.

Look first at Portugal. While it is true that the Portuguese current account does not turn back towards balanced until after NULCs dropped below the European average, it is also true that Portuguese NULCs had been falling consistently since 1998 – and yet the current account continued to deteriorate. Indeed, the Portuguese deficit more than doubled between 2003 and 2008 despite experiencing eurozone-average wage inflation. While the data seem to support the competitiveness thesis in aggregate, the timing is wrong; indeed, the real reversal in the Portuguese current account balance occurred after its credit rating came under pressure in 2010. The timing in Greece is even further from what we would expect from the competitiveness thesis. There, the current account reversal clearly precedes the shift in labour costs, which do not begin falling rapidly until 2011. On the other hand, the initial downgrades of Greek sovereign debt do track more closely with when the deficit began to disappear.

Put simply: events in both countries are more consistent with a post-crisis negative demand shock in the market for Greek/Portuguese financial products than a pre-crisis negative supply shock in the market for Greek/Portuguese goods and services. Furthermore, the capital inflows of the early-to-mid-2000s were also more consistent with a positive demand shock in the market for financial products: these countries’ interest rates fell dramatically, even as they borrowed more and more.

Other countries further suggest that competitiveness alone is an insufficient explanation. Consider Table 3 and the divergent stories of the Netherlands and Italy. These two countries are highly similar in some respects: both are global top-20 economies with historically substantial export sectors. Both have also traditionally struggled to keep labour cost growth below the eurozone average – their NULC performances are markedly similar. Italy outperformed the Netherlands for the five years from 1999 to 2003, the reverse was true from 2004 to 2008, and they have performed almost identically since. Despite these similarities, the Netherlands has maintained a current account surplus throughout the entire period. Italy, in contrast, has alternated between surpluses and deficits. These patterns are, once again, inconsistent with the competitiveness thesis – at least not if competitiveness is limited to wage inflation.

Italy also raises timing questions similar to Portugal and Greece (see Figure 5). The meandering decline of Italian labour costs since the broader eurozone crisis began does not correlate with the

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**Table 3.** Comparison of Italian and Dutch inflation and current account balances.

<table>
<thead>
<tr>
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</thead>
<tbody>
<tr>
<td></td>
<td>Relative NULC inflation (%)</td>
<td># of years in CA deficit</td>
<td>Relative NULC inflation (%)</td>
</tr>
<tr>
<td>Netherlands</td>
<td>1.23</td>
<td>0</td>
<td>−0.13</td>
</tr>
<tr>
<td>Italy</td>
<td>0.23</td>
<td>3</td>
<td>1.22</td>
</tr>
</tbody>
</table>

Source: AMECO European Macroeconomic Database.

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**Figure 5.** Evolution of Italian current account balance: 2008–2016. Sources: European Commission, Fitch Ratings, Eurostat.
sudden and dramatic fluctuations seen in the country’s current account balance beginning in late 2011. Why not? In Italy, 2011 was the chaotic year of Silvio Berlusconi’s ouster. Berlusconi’s inability to wrangle his ruling coalition and cabinet led to a collapse in his credibility amidst public chastisement from the ECB and other European leaders (Jones 2012a). Numerous ratings downgrades and, ultimately, Berlusconi’s resignation followed. The panic over the safety of Italian sovereign debt during the chaos does explain the swift change between 2011 and 2013: absent the ability to export assets, Italy had less incoming capital to spend abroad. A sudden stop in capital inflows is more consistent with the rapid current account reversal than the gradual decline in Italian labour costs (Merler and Pisani-Ferry 2012).

Finally, each of the countries depicted in these figures has experienced slower wage growth and more positive current accounts since 2008. The same trend can be seen in Spain, Ireland, France, and others. But this should not be at all surprising: it has been achieved by design. As discussed previously, EU crisis measures have been characterised by an embrace of austerity – under the guise of the fiscal compact treaty, the six-pack of legislative reforms that effectively revived the SGP, and the bailout conditions offered to Greece, Ireland, and Portugal. The goal of these policies has been to engineer a so-called internal devaluation, whereby price competitiveness could be restored through wage cuts rather than a currency devaluation (Fuller and Jones 2015b, Matthijs and Blyth 2015). In other words, the evidence in support of the competitiveness thesis is overlooking a key variable: the presence of an aggressive policy aimed at suppressing consumption – a policy predicated on the competitiveness thesis itself! This is consistent with studies that find a competitiveness-imbalance link but suggest that the causality is backwards (Gabrisch and Staehr 2015).

Another ‘Chimerica?’

In the mid-2000s, Niall Ferguson and Moritz Schularick (2007) coined a term that went viral within the world of international monetary relations: Chimerica. It was a clever turn of phrase, succinctly suggesting that China and America had fused into a single, monstrous, multi-headed economy. In that situation, the Chinese export-led regime – fostered by deliberately depressed currency values – generated large profits and a substantial surplus of foreign exchange. Needing a place to stash these savings – and with options limited because so few markets were large enough to accommodate a big entrant like the Bank of China – the Chinese reinvested a large share of their surplus into the United States. The two countries’ growth models thus became intertwined: the US needed cheap Chinese capital to sustain its level of borrowing and spending; China needed the US to buy their products and as a place to invest the resulting gains. This interdependence became less desirable after the financial crisis: US consumers and businesses sought to deleverage, borrowing less rather than more. China became less confident in the basic ability (or willingness) of American debtors to repay. Moreover, Chinese policy-makers were not thrilled about their extensive exposure to the value of the US dollar. Unlike in Europe, though, there was little chance of an EMU-style sudden stop: China was simply too invested in the United States to withdraw its capital so completely – doing so would only damage the value of their own portfolio. Instead, China has slowly moved away from its policy of depressing the value of renminbi and reduced or diversified its foreign exposure (Ferguson and Schularick 2011).

Initially, EMU exhibited the same high degree of complementarity between the export-driven growth models in the core and the debt-driven consumption models of the periphery: the core got new markets for physical and savings products; the capital-hungry periphery got radically improved access to funds. Post-Keynesian economist Englebert Stockhammer (2016: 374) puts the dilemma succinctly:

At the root of the crisis is a buildup of debt, fuelled by debt-driven and export-driven variants of neoliberal grown models. These growth models were enabled by the neoliberal design of Euro area economic policy framework, which encouraged financial deregulation and cross-country capital flows while eliminating the possibility of nominal exchange rate adjustments.
As close as he is to the mark, there is something overly deterministic in Stockhammer’s account: cross-border buildups of such exposures are not unknown – and not all such situations end in sudden stops and bailouts (though many do). Chimerica, after all, exhibited the exact same debt buildup.

There are a couple of key differences between these cases. The most important of these being that the Bank of China retained (and used) the power to engineer a nominal appreciation of its currency, reducing the complementarity at the heart of the relationship. But Germany has this power, too – at least in some ways: it could engineer a softening appreciation of its domestic currency through wage increases and domestic inflation. Unlike China, Germany has opted against this route, arguing that it is tantamount to self-harm against its export growth model – and would further invite future irresponsibility in borrowing.

Indeed, the biggest and most important difference between these cases is that China was in no position to dictate terms to the USA. In contrast, the growth model complementarity within EMU was more one-sided. China needed US markets for financial products (due to their depth, reliability, and variety) in a way that Germany does not need relatively tiny Greece. In fact, the entire GDP of Greece represents less than 10 per cent of German domestic lending (which is relatively small by European standards). In other words, Germany did not have to accommodate a smooth mutual extrication in the same way that China and the USA do – and they apparently lacked the cross-national solidarity to do it willingly (Matthijs and Blyth 2015).

Ultimately, the crisis in the eurozone was not just due to a perverse complementarity of growth models operating in a neoliberal (and monetarist) space – that complementarity was also asymmetrical enough that both parties were not equally invested in a ‘soft landing’ adjustment. The eurozone core could force adjustment onto the periphery. Moreover, core politicians have consistently articulated the moral view that they should. It is worth reminding ourselves at this juncture that the words for ‘debt’ in Austria, Germany, Luxembourg, and the Netherlands – almost the entire eurozone creditor-core – are all the same as their words for ‘guilt’. Accordingly, Kees de Jager’s successor as Dutch Finance Minister, Jeroen Dijsselbloem has implied that the indebted periphery did not deserve solidarity because they spent their money on ‘liquor and women’ (Baume 2017). Bailing out such reckless borrowers, the argument goes, would invite moral hazard.

Concluding thoughts

The European approach to rectifying its imbalance problem has ‘worked’ insofar as NULCs have fallen in the periphery and the current account balances of troubled eurozone economies have indeed reversed themselves. However, imposing strict austerity on any economy will always tend to have this effect: as contractionary measures depress spending, imports and wage inflation are all but certain to fall. The problem is that this ‘solution’ is superficial: Greece no longer has an enormous current account deficit – but it also lacks a viable growth model. Where Germany could just export elsewhere, Greece had nowhere to turn for more capital – and retooling towards an export-driven economy is proving to be a long-term project at best.

Any solution to the crisis must disrupt the demonstrated complementarity between export-led and debt-driven economic models. However, doing so requires recognising that EMU’s imbalances are about more than Greeks’ or Spaniards’ excessive desire to borrow-and-spend; they are also about Germans’ and Austrians’ desire for quality assets and capital income. Instead of retooling both sides’ growth models to accommodate each other, the German-led European approach has simply been to eliminate the debt-fuelled growth model in Europe – without offering much in terms of a replacement. The core’s export-driven approach, on the other hand, remains intact.

A more radical approach to the problem has emerged from Europe’s nationalist-populist parties. For them, the solution is simple: abolish the EU altogether (or at least the common currency). Many of these movements – particularly from the left – point to German economic policy as the reason to end an unbalanced union. France’s Jean-Luc Mélenchon has described Germany as ‘a danger',
imperialistically seeking expansion and the imposition of its economic will (Nougayrède 2017). Anti-austerity protests sometimes feature signs associating Angela Merkel with Nazi imagery (Gouliamaki 2012).

There is another way to approach the current dilemma, using a remedy that technically already exists: the macroeconomic imbalances procedure. Like the excessive deficit procedure (referring to government budget shortfalls rather than BoP deficits), the idea of the macroeconomic imbalance procedure is to set benchmarks and rules intended to prevent the accumulation of large BoP imbalances. In theory, this could be as useful in preventing financial account deficits as it would be in preventing current account deficits. For instance, Germany could theoretically be compelled to boost domestic spending should its capital exports grow too large.

In practice, however, the macroeconomic imbalance procedure has become another source of asymmetry between the treatment of the current and financial accounts. The Commission’s own (2015) description of the procedure tellingly states that:

In general the risks are higher for current account deficits than for current account surpluses because the former raise concerns about the sustainability of the external debt of a country.

It would be just as true to observe that current account surpluses raise concerns about the external debt sustainability of partner countries. Whether due to the political strength of Germany within the EU or to the appeal of the competitiveness thesis, even this potentially useful procedure is primarily focused on debt or rather than creditor behaviour. As a result, current account deficits of four per cent of GDP or higher trigger the procedure; the limit is six per cent of GDP for surpluses (de Grauwe 2012, Gros and Busse 2013, Moschella 2014).

In sum: a truly symmetric and binding macroeconomic imbalance procedure would provide a mechanism to encourage core and periphery economies to develop mutually accommodating growth models within the EMU framework. When combined with a common low-risk European debt instrument (i.e. a ‘eurobond’), this would provide two key benefits: (1) a means of reducing macroeconomic divergence in the first place and (2) circuit-breakers to limit the impact if debt in one part of the union grows out of control.

Yet this solution requires us to recognise that excessive demand for assets can be just as destabilising as excessive demand for goods and services – and that requires a change of tack in Berlin and Brussels.

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