Cover sheet

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THE EUROPEAN ECONOMY: THE RECOVERY CONTINUES, BUT FOR HOW LONG?

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THE EUROPEAN ECONOMY: THE RECOVERY CONTINUES, BUT FOR HOW LONG? [*]

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Introduction

Europe's[1] slow recovery after its double-dip crisis continued in 2016, with the continent's growth rate reaching 1.8 per cent. While by no means a spectacular pace, it fits into the broader pattern of the previous two years, and given the weak performance of the global economy, as well as mounting geopolitical uncertainties, it is not to be underestimated. The recovery, mainly driven by consumption and renewed investment, has had a strong impact on labour markets, with unemployment rates across the continent decreasing for the third year in a row. Inflation, heavily subdued in 2015 and bordering on deflation, picked up. Government balances continued to improve and average public debt edged slightly downwards. The legacies of the crisis, however, are still holding Europe back.

The year 2016 will not be remembered for major economic events and turning points, but rather for two unexpected political shocks that rocked Europe and the world. Brexit, and the impacts it is likely to have on existing trade and investment patterns, dealt a heavy blow on the whole integration process. The strong belief that the European Union was an irreversible enterprise, an unbreakable polity that was slowly but steadily approaching an ever closer union, is now probably nothing more than an illusion. Additionally, the election of Donald Trump in the US is widely believed to bolster inward-looking, highly protectionist economic policies not just across the Atlantic, but all over the world. The consequences of these two political events, especially their long term effects on trade flows, can create a real turning point for the future of Europe.

This contribution aims to analyze the economic performance of the EU and its member states, focusing on developments in 2016, but also placing them into a wider context. As with our contributions to previous *Annual Reviews* (Benczes and Szent-Iványi, 2015, 2016), we identify some evidence of convergence, but also highlight the heterogeneity of member state performance in the areas of economic growth, inflation, unemployment and government finances.

2017 marks the tenth anniversary of the global financial crisis, which soon turned into a global economic crisis (Trichet, 2010), and led to Europe's sovereign debt crisis. The second half of the contribution reflects on the European origins of the crisis, and provides a less evident interpretation, focusing on current accounts and external imbalances. Although

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[1] Unless otherwise stated, Europe refers to the EU28. Europe and EU are used as synonyms.

considered today as a sovereign debt crisis, we argue Europe's crisis was a private debt crisis in its origins (see especially Baldwin and Giavazzi, 2015). We explore this argument by scrutinizing the external positions of eurozone member states in the years preceding the crisis. While substantial attention has been dedicated to external imbalances in the US and China in both scholarly and policy circles, there was much less attention on the inherent problems of the euro area during the pre-crisis era (Barnes *et al.*, 2010). With a firm eye on current accounts, however, the contribution will also identify post-crisis structural and competitiveness problems that may prolong the recovery of some of the crisis-hit economies.

Section I discusses the global economic and political context, which is followed in Section II by a presentation of Europe's main economic indicators in terms of economic growth, inflation, employment and general government positions. Section III presents the arguments on the relationship between current account imbalances and the crisis, and Section IV discusses external balance and competitiveness related issues post-crisis. The contribution ends with some brief concluding remarks.

I. The Global Context – Politics over Policy

Global output expanded by 3.0 per cent in 2016, but differences in country performances were rather substantial. By and large, advanced economies performed well below the world average (1.7 per cent), while emerging markets and developing economies managed to significantly outperform advanced economies by an average growth rate of 4.0 per cent. While this is slightly faster than the previous year, it nonetheless represents longer term deceleration. Needless to say, there were significant variations within these two groups.

The USA performed around the average of advanced economies (1.6 per cent), but the American data were undeniably surprising following a 2.6 per cent growth rate in 2015 and 2.4 per cent in 2014. In Japan, it was business as usual with its 0.7 per cent growth rate. Among emerging markets and developing economies, China (6.6 per cent) and India (7.4 per cent) strongly outperformed others, while Sub-Saharan Africa (1.4 per cent) and Nigeria in particular (-1.7 per cent) produced weak numbers in 2016 (see Table 1).

Table 1: The global economic context – Global and regional GDP growth rates

	2012	**2013**	**2014**	**2015**	**2016***
World	3.3	3.2	3.3	3.1	3.0
Advanced economies	1.1	1.2	1.9	2.2	1.7
EU	-0.5	0.2	1.6	2.2	1.8
USA	2.2	1.7	2.4	2.6	1.6
Japan	1.7	1.4	0.0	0.5	0.7
Emerging and developing economies	5.3	4.9	4.5	3.8	4.0
Brazil	1.9	3.0	0.1	-3.8	-3.1
China	7.9	7.8	7.3	6.9	6.6
India	5.3	6.3	7.0	7.2	7.4

Russia	3.4	1.3	0.6	-3.7	-1.0

Source: European Commission (2016a, p. 185).
Note: * indicates forecast data.

China continued its deliberate transition to a new regime with the aim of gearing the Chinese economy away from investment and industry towards domestic consumption and the service sector (Lu, 2017). Yet, the change came with significant challenges and even surprises: while private investment did slow down somewhat, it did not come with buoyant domestic private consumption, cementing the current account in surplus at 2.5 per cent (IMF, 2016b). As a response to weak private consumption, the government fuelled public investment in physical infrastructure, postponed the much awaited consolidation of state-owned enterprises, and was not willing to cool down credit expansion either in 2016.

India could have become *the* positive story of 2016, as strengthened terms of trade, reduced external vulnerability and nominal interest rate cuts paved the way for a remarkably strong performance, but the financial chaos caused by the unexpected withdrawal of the most widely used banknotes from circulation made the final balance dubious, leaving the prospects for 2017 rather uncertain.[2]

It is expected that Brazil faced the last year of recession in 2016 by experiencing a drop of 3.1 per cent of its GDP. Both consumption (-4.1 per cent) and investment activities (-11.3 per cent) experienced a drastic reduction (IMF, 2016d). Nevertheless, as the new government did not hesitate to engage in much-needed macroeconomic reforms (especially in public finances), Brazil has now good chances for positive growth in 2017. Its recovery, however, is fragile thanks to both economic and political tensions. In fact, the whole Latin American continent had a bad year in 2016 with an average growth rate of -0.6 per cent.

Recession continued in Russia in 2016 due to low oil prices and economic sanctions against the Putin regime. According to the IMF (2016c), the setback could have been even more devastating without the effective policy responses of the Russian government, including fiscal stimulus and the adoption of a flexible exchange rate regime.

Geopolitics and the consequent humanitarian crisis put serious drags on economic activity as well. Crises in the Middle East, terrorist attacks across the world, including major capital cities in Europe, institutionalized uncertainty and fear. Undeniably, the flows of refugees to the EU had an impact on the British vote to exit the EU. Although Europe is still struggling with its economy, this time the major threat to the very idea of an ever closer union has come from the realm of politics.

[2] The two largest denomination banknotes, the 500 and 1,000 rupee notes, were the bases of the huge Indian underground (or cash) economy. The government aimed at clearing up the economy by refusing the acceptance of these two banknotes as legal tender.

II. Europe's Performance: Growth, Inflation, Public Finances and Labour Markets

Europe generally maintained its growth momentum in 2016, with real GDP growing by 1.8 per cent. While this represents a slight slowdown compared to 2015, it is nonetheless a noteworthy performance given the global economic situation as well as the rising political and economic uncertainties within Europe and beyond. As in 2015, private consumption continued to be the main driver of growth, still reflecting the rise in disposable incomes. Investments also contributed significantly to Europe's performance. The growth of exports, however, slowed due to two major causes: the effects of the euro's earlier appreciation have tapered out and global trade flows significantly weakened. The fall in growth rates across much of the emerging world clearly had a negative impact on Europe's performance as well. Legacies of the crisis, especially in terms of high public and private debt, as well as a high share of non-performing loans in some, mostly crisis-hit, countries also continued to be a drag on economic growth.

Many individual member states recorded relatively good growth performance. As with previous years, the newer member states outperformed the older ones yet again. As shown in Table 2, countries like Romania, Slovenia, Malta, Poland and Estonia all grew by more than 3 per cent, and some other new members like Hungary (2.2 per cent) also performed above the EU average. In terms of the older member states, Ireland continued its highly dynamic recovery following the crisis. Most surprisingly however, the UK was the best performing large member state. While most experts predicted an immediate and sharp market reaction to the country's referendum result to leave the EU, the UK thrived in 2016. While UK-based firms have in general refrained from large investments, dynamic consumer spending has more than made up for the gap. Germany also showed good performance with 2 per cent growth, but growth in France was a relatively low 1.1 per cent. The slow acceleration of economic growth in Italy continued, reaching 1.5 per cent, which was an excellent performance after years of stagnation. Among the old members, the performance of Spain (2.8 per cent) and Denmark (2.6 per cent) was also noteworthy.

With the exception of Cyprus, still suffering from the aftermath of its banking and sovereign debt crisis of 2012-2013, no member state economy contracted in 2016. Bulgaria (0.9 per cent), Finland (0.8 per cent) and Croatia (0.7 per cent) all registered relatively weak growth rates, and although Greece continued to limp on with 1 per cent, this was nowhere near the growth rate the country would need in order to make up for the losses in living standards it suffered due to its sovereign debt crisis.

Table 2: Average EU growth rates (in per cent) and the best and worst performing Member States

	2012	**2013**	**2014**	**2015**	**2016***
EU average	-0.5	0.2	1.6	2.2	1.8
Standard deviation	2.5	2.2	1.9	4.7**	1.2

Best performers	Estonia (4.3) Latvia (4.0) Lithuania (3.8) Malta (2.9)	Malta (4.5) Luxembourg (4.2) Lithuania (3.5) Romania (3.5) Latvia (2.9)	Ireland (8.5) Luxembourg (4.7) Hungary (4.0) Malta (3.5) Lithuania (3.5)	Ireland (26.3) Luxembourg (6.2) Hungary (4.5) Malta (4.1) Lithuania (3.9) Poland (3.8) Romania (3.7)	Romania (5.2) Ireland (4.1) Luxembourg (4.1) Slovenia (3.6) Malta (3.4) Poland (3.4) Estonia (3.2) Lithuania (3.1) UK (3.1)
Worst performers	Cyprus (-3.2) Portugal (-4.0) Greece (-7.3)	Greece (-3.2) Cyprus (-6.0)	Croatia (-0.5) Finland (-0.7) Cyprus (-1.5)	Croatia (0.7) Finland (0.2) Cyprus (-0.2)	Cyprus (-0.3)

Source: authors, based on European Commission (2016a, p. 158).

Notes: the 'best performers' are the countries which showed rates at least one standard deviation higher than the EU average. 'Worst performers' are at least one standard deviation lower. * indicates forecast data. ** excluding Ireland, as its high growth rate would distort the standard deviation.

After heavily subdued inflation and indeed deflation in many member states in recent years, the pace of consumer price growth picked up somewhat in 2016 to 0.3 per cent (see Table 3). This is a highly welcome development, as it moves the EU further away from the danger zone of deflation. Higher inflation was mainly driven by energy price increases in the second half of the year. Most individual member states remained far from the European Central Bank's (ECB's) two per cent target, signalling that there is still plenty of scope for the Bank's growth supporting, expansionary monetary policies. While deflation was present in some member states, especially the ones which were struggling with domestic demand and growth, including Cyprus, Croatia and Bulgaria, it is surprising that Romania, the country which showed the best growth performance in 2016, also saw a one per cent decrease in the level of its consumer prices.

Table 3: Average EU inflation rates (harmonized indices of consumer prices, in percentages) and countries with the lowest and highest values

	2012	2013	2014	2015	2016*
EU average	2.6	1.5	0.5	0	0.3
Standard deviation	0.9	1.0	0.7	0.6	0.7
High inflation	Hungary (5.7) Estonia (4.2) Poland (3.7) Slovakia (3.7) Czech Republic (3.5)	Estonia (3.2) Romania (3.2) Netherlands (2.6) UK (2.6)	Austria (1.5) UK (1.5) Romania (1.4) France (1.2)	Malta (1.2) Austria (0.8) Sweden (0.7) Belgium (0.6)	Belgium (1.7) Sweden (1.1) Austria (1.0) Malta (1.0)
Low inflation or deflation	Greece (1.0) Sweden (0.9)	Bulgaria (0.4) Cyprus (0.4) Portugal (0.4) Sweden (0.4) Latvia (0.0) Greece (-0.9)	Spain (-0.2) Portugal (-0.2) Cyprus (-0.3) Greece (-1.4) Bulgaria (-1.6)	Spain (-0.6) Lithuania (-0.7) Poland (-0.7) Slovenia (-0.8) Bulgaria (-1.1) Greece (-1.1) Cyprus (-1.5)	Spain (-0.4) Slovakia (-0.5) Bulgaria (-0.9) Croatia (-0.9) Romania (-1.0) Cyprus (-1.1)

Source: authors, based on European Commission (2016a, p. 166).
Notes: countries with 'low inflation or deflation' are the ones which showed inflation rates at least one standard deviation below the EU average. 'High inflation' countries are at least one standard deviation higher. * indicates forecast data.

While in the last couple of years the ECB and national central banks outside the EMU were eagerly looking for different sorts of unconventional policy actions with the hope of boosting aggregate demand, fiscal policy seemed to be rather neutral.[3] This has however changed more recently when the European Commission (2016b), called for more proactive fiscal policies in order to support central banks (the ECB in particular) and to provide better chances for accelerated output growth in the near future. Evidently, the near to zero nominal interest rates can make fiscal policy actions rather effective in terms of fiscal multipliers, if such policies are ready to engage in a more positive fiscal stance.

Due to the long years of contractionary (2010-2013) and neutral (2014-2015) fiscal policy, substantial fiscal space opened up for most of the member states in 2016. Excessive deficit procedures (EDPs) do not threaten too many countries either. Most of the nations under EDP – such as Spain, France, Greece, Portugal, Croatia and the UK – were granted an extension to get their public finances in order by 2017. In 2016, both Greece and Portugal managed to knock their fiscal deficit below 3 per cent. Only three countries, France, the UK and Spain, violated the threshold last year; though at least none of them experienced a worsening fiscal position compared to 2015 (see Table 4). Luxembourg, Germany and Estonia, on the other hand, produced quite remarkable surpluses in 2016, repeating their performance of the previous year.

Table 4. Average general government budget balances (in per cent of GDP) in the EU, and best/worst performers

	2012	**2013**	**2014**	**2015**	**2016***
EU average	-3.8	-3.5	-3.0	-2.0	-1.5
Standard deviation	2.6	3.3	2.5	1.8	1.4
Best performers	Germany (0.1) Luxembourg (0.1) Estonia (-0.3) Bulgaria (-0.5) Sweden (-0.9)	Luxembourg (0.6) Germany (0.1) Sweden (-0.9)	Estonia (0.7) Germany (0.3)	Luxembourg (1.6) Germany (0.7) Sweden (0.2) Estonia (0.1)	Luxembourg (1.3) Germany (0.6) Estonia (0.5) Sweden (0.0)
Worst performers	Ireland (-8.0) UK (-8.3) Greece (-8.6) Spain (-10.3)	Spain (-6.8) Greece (-12.2) Slovenia (-14.6)	Croatia (-5.6) UK (-5.7) Bulgaria (-5.8) Spain (-5.9) Portugal (-7.2) Cyprus (-8.9)	UK (-4.3) Portugal (-4.4) Spain (-5.1) Greece (-7.5)	France (-3.5) UK (-3.5) Spain (-4.6)

Source: authors, based on European Commission (2016, p. 175).
Notes: the 'best performers' are the countries which showed rates at least one standard deviation higher than the EU average. 'Worst performers' are at least one standard deviation lower. * indicates forecast data.

[3] On the eurozone, see Hodson's contributions to this and previous *Annual Reviews*.

Despite a downward trend, public debt is still a noteworthy issue in the EU (see Table 5). Debt overhang has become a serious burden on most member states, repressing private investment and consumption, and making the eurozone highly susceptible to further crises (Corsetti, 2015). Interest payment on public debt nonetheless remained at manageable levels in the three worst performers: 3.4 per cent in Greece, 3.9 per cent in Italy and 4.3 per cent in Portugal.

Table 5: Average general government budget balances (in per cent of GDP) in the EU, and best/worst performers

	2012	**2013**	**2014**	**2015**	**2016***
Mean	68.7	72.3	73.4	71.7	71.2
Standard deviation	35.4	38.1	37.9	37.7	38.0
Best performers	Estonia (9.7) Bulgaria (16.7) Luxembourg (21.8)	Estonia (10.2) Bulgaria (17.0) Luxembourg (23.5)	Estonia (10.7) Luxembourg (22.7) Bulgaria (27.0)	Estonia (10.1) Luxembourg (22.1) Bulgaria (26.0)	Estonia (9.9) Luxembourg (21.0) Bulgaria (29.0)
Worst performers	Ireland (119.5) Italy (123.3) Portugal (126.2) Greece (159.6)	Ireland (119.5) Italy (129.0) Portugal (129.0) Greece (177.4)	Italy (131.9) Portugal (130.6) Greece (179.7)	Portugal (129.0) Italy (132.3) Greece (177.4)	Portugal (130.5) Italy (132.8) Greece (179.7)

Source: authors, based on European Commission (2016, p. 178).
Notes: the 'best performers' are the countries which showed rates at least one standard deviation higher than the EU average. 'Worst performers' are at least one standard deviation lower. * indicates forecast data.

In line with a growing economy, job creation was strong in 2016, and labour markets improved across Europe (Table 6). Nonetheless, considerable slack still remains, and unemployment rates, standing at 8.6 per cent, are still to meet their pre-crisis levels. The employment rate however was higher in 2016 than before the crisis, increasing to above 71 per cent. The Czech Republic (4.2), Germany (4.6) and the UK (4.9) had the lowest levels of unemployment, but countries like Malta, Hungary and Austria also recorded levels below 6 per cent. The decrease in the unemployment rate continued in the Southern countries as well, many of which had been battling very high levels for years. Spain's good growth performance had a strong impact on the labour market, but even the more weakly growing countries managed to decrease their unemployment rate. Much of the new employment across the EU, however, are part time contracts, and many countries in Europe suffer from high structural unemployment.

Table 6: Average EU unemployment rates (in per cent of total labour force) and the best and worst performing member states

	2012	**2013**	**2014**	**2015**	**2016***
EU average	10.5	10.9	10.2	9.4	8.6

Standard deviation	5.0	5.4	5.2	4.8	4.3
Best performers	Austria (4.9) Luxembourg (5.1) Germany (5.4)	Germany (5.2) Austria (5.4)	Germany (5)	Germany (4.6)	Czech Republic (4.2)
Worst performers	Portugal (15.8) Croatia (16) Greece (24.5) Spain (24.8)	Portugal (16.4) Croatia (17.3) Spain (26.1) Greece (27.5)	Cyprus (16.1) Croatia (17.3) Spain (24.5) Greece (26.5)	Cyprus (15) Croatia (16.3) Spain (22.1) Greece (24.9)	Croatia (13.4) Spain (19.7) Greece (23.5)

Source: authors, based on European Commission (2016, p. 169).
Notes: the 'best performers' are the countries which showed unemployment rates at least one standard deviation below the EU average. 'Worst performers' are at least one standard deviation higher. * indicates forecast data.

III. The Current Account and the Crisis

According to Ben Bernanke (2005), former chair of the Federal Reserve, the road to the economic and financial crisis of 2008 was paved by the so-called global savings glut which allowed advanced economies like the US and some of the European nations to relax substantially their credit constraints.[4] Some researchers tried to warn against the downside risk of the increasing external imbalances in developed economies. Blanchard (2007), for instance, identified this phenomenon with exceptional clarity as a consequence of the great moderation, i.e. unusually low central banking interest rates, the proliferation of financial innovation and the consequent credit boom.[5] By contrasting the current account deficits of rich nations on the one hand and external deficits in Latin America of the early 1980s and Mexico in the early 1990s on the other hand, he managed to demonstrate that this time the banking sector or especially fiscal policy played only a marginal role. According to Blanchard, the global crisis was the result of the saving and investment decisions of the private sector of the rich countries. While emerging countries also played a highly significant role, this was rather different than in the 1980s or 1990s: their excess savings generated a massive outflow of capital, which found its ultimate destination in advanced economies. The depressed investment climate in Asia (Chinn and Ito, 2007) along with exchange rate manipulation in China (Clarida, 2006) significantly contributed to this trend.

Yet, concerns over the possible – and negative – long-term consequences of external imbalances appeared only sporadically within the eurozone. With the launch of the single currency the general expectation was that capital flows from the EU core to its periphery would speed up the convergence and integration process of the latter.[6] Capital flows were supposed to contribute to the restructuring of these economies by helping them climb the development ladder i.e. by moving away from resource and (unskilled) labour-intensive

[4] For a different view on the origins of the crisis, see Taylor (2009).
[5] On the growing US external deficit and its impact on the rest of the world, see especially Obstfeld and Rogoff (2005) and Frankel (2007).
[6] In line with macroeconomic theory, 'poorer countries should run larger current account deficits, and, symmetrically, richer countries should run larger current account surpluses' (Blanchard and Giavazzi, 2002, p. 148).

production to human capital and technology-intensive structures. Financial integration was not only seen as a mechanism through which resource allocation could become more effective between lenders and borrowers, but also as a process that could bolster the synchronization of business cycles, a preeminent condition of any optimum currency area (Fidrmuc, 2004; Mongelli, 2008). By eliminating the chances of asymmetric shocks, monetary policy was believed to be able to function at its optimum.

The intensified capital flows among member states (mainly from the core to the more dynamic periphery), the active involvement of the financial intermediaries in cross-border transactions and the consequent huge shifts away from equilibria in current account positions, and the increasing gap in the savings-investment decisions were interpreted as the natural consequences of a well-functioning EMU. No-one seemed to bother about current account imbalances, especially in light of the fact that the overall external position of the eurozone was more or less in balance vis-à-vis the rest of the world (Gros and Alcidi, 2013). What is now considered as an institutional design flaw of EMU was celebrated as a positive feature for almost a decade (Baldwin and Gros, 2015). The European Commission (2008), for instance, equated the alleged success of the single currency with intensified capital flows among member states, which made it possible for the Greek and Spanish economies to thrive.[7]

The Maastricht Treaty and its convergence criteria required countries to converge towards one another only in terms of nominal variables, and it left real variables such as unemployment, unit labour cost (ULCs, measuring competitiveness) or current account position untouched. Contrary to the main proposition of the endogenous theory of optimum currency areas (Frankel and Rose, 1998), differences in real variables were not eliminated. Financial integration did not support the much-awaited structural transformation of the borrower countries. Capital flows financed mostly the enhancement of non-tradable sectors, barely boosting the export capacities of the periphery. Housing bubbles in Ireland and Spain were mostly fed by those unprecedented financial flows.

The total elimination of the exchange rate risk fed a credit boom in the periphery; even a minor difference in yields triggered substantial financial flows (Lane, 2010). Private investors did not segment the market; they perceived it as a single one – just like rating agencies or other major financial institutions worldwide (Feldstein, 2012). With the benefit of hindsight, it was in fact the single currency which helped some countries in the core to sharpen their productivity and to improve their external positions, leaving some others (in the periphery) to experience deterioration in their relative positions in terms of competitiveness and build up huge external deficits.

Needless to say, the crisis-hit countries were not all alike. Greece was the typical example for short-sighted politics, tolerating, if not even endorsing, creative accounting and misreporting

[7] The European Commission (2008) did not remain silent on intensifying differences in terms of economic growth, inflation rates or real effective exchange rates within the eurozone, but these divergences were identified as the certain accompanying phenomena of the catching up process..

(e.g. Visvizi, 2012). Portugal, following its accession at a highly overvalued exchange rate, suffered from serious set-backs from its very first day in the eurozone, shortly facing the highest cumulative current account imbalance in the EU. Ireland and Spain witnessed a massive inflow of capital that fuelled a bubble in the real estate sector and contributed to rampant credit demand (see Table 7).

Table 7. Cumulative current account and general government balances, and change in debt-to-GDP ratio, 1999 to 2007

	Cumulative current account balance (per cent of GDP)	**Cumulative general government balance (per cent of GDP)**	**Change of debt-to-GDP ratio (per centage points)**
Portugal	-96	-36	17.4
Greece	-84	-47	4.2
Spain	-60	2	-25.5
Ireland	-21	14	-22.7
Italy	-8	-26	-9.9
France	6	-23	4.2
Austria	16	-19	-1.6
Germany	27	-19	3.5
Belgium	47	-5	27.4
Netherlands	48	-5	15.8
Finland	61	33	-10
Luxembourg	98	23	1

Source: Baldwin and Giavazzi (2015, p. 36) and AMECO.

It is often claimed that massive deficits in the current account come together with huge imbalances in the public sector (also called a twin deficit). According to Table 7, this was the case in Portugal and Greece, but not in Spain or Ireland, where the cumulative general government balance was positive and their public debt ratio declined. On the other hand, Germany, Austria and the Netherlands experienced surpluses in their current account while the general government displayed deficit. In short, the relationship between the current account and the general government was not at all straightforward among EU countries.

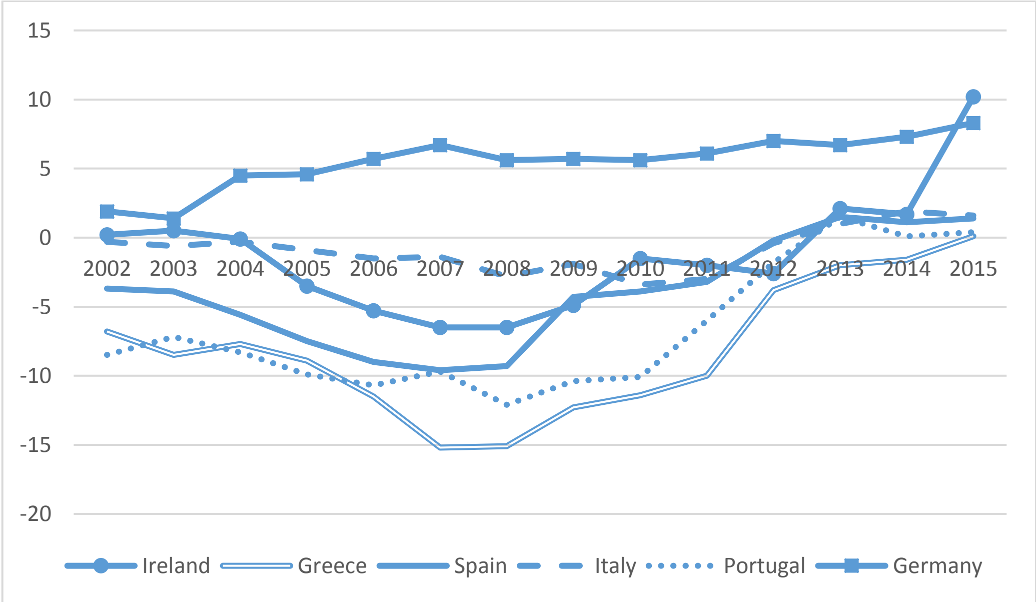
The lack of a straightforward relationship between the external and the internal balances is due to the savings-investment behaviour of the private sector, a factor that had been totally neglected in pre-crisis analyses on the sustainability of the eurozone. In each of the crisis-hit economies, private investment significantly outgrew private domestic savings. The investment boom in Spain and Ireland was financed by foreign savings, coming from the core, especially from Germany. But the direction of capital flows – especially in a single market – can be easily reversed (Edwards, 2004). Both the global financial crisis of 2007-2008 and the Greek debt crisis of 2009-2010 in particular made foreign savers more cautious in their lending activities, resulting in a drying-up of foreign sources in the periphery, and in turn, in a collapse of their economies. Yet each of these countries, facing huge external deficits and a sudden stop in capital flows, had to face the same simple recipe for adjustment: having been

left without their own currencies and monetary policies, the only solution was internal devaluation i.e. a mix of public expenditure cuts, reduced wages and disinflation.

It is true that the crisis-hit EMU countries did manage to close the export-import gap by 2016 (Figure 1), with Ireland the star performer. But this also came in the form of stagnant or reduced import activities which may slow down their convergence processes. Somewhat perversely, even catching up nations such as the Czech Republic, Poland, Hungary or Slovakia ran substantial current account surpluses in the last few years mostly due to the accelerated export activities of foreign (e.g. German) multinationals.

A recovery in the periphery cannot be realised, however, without adjustment in the core countries. In other words, Germany and other surplus countries like the Benelux states should change their behaviour and instead of saving they should engage in consumption (and import) on a massive scale in the future. Currently, Germany has a staggering surplus (over 7 per cent) in its current account.[8] In fact, at the time of writing, none of the crisis hit EMU economies can claim Germany as their number one export destination. The Irish export sector (in goods), for instance, relies mostly on the highly deficit-prone Brexit-bound UK (26 per cent), whereas the almost stagnating Italian (20.5 per cent) and French (26 per cent) economies, respectively, are the main absorbers of exported goods from Greece and Spain. Germany is ranked only second or third as the main trading partner of the crisis hit economies; that is, there is plenty of room for further increase if Germany is ready to take on such a role.[9]

Figure 1. Current account position in selected countries, 2002-2015



Source: authors, based on Eurostat (2017).

[8] The value is even larger in the Netherlands (10 per cent).
[9] Thanks to German multinationals, the German market is much keen on importing goods from Austria, the Czech Republic, Hungary and Poland where its share in these countries' export is over one-third.

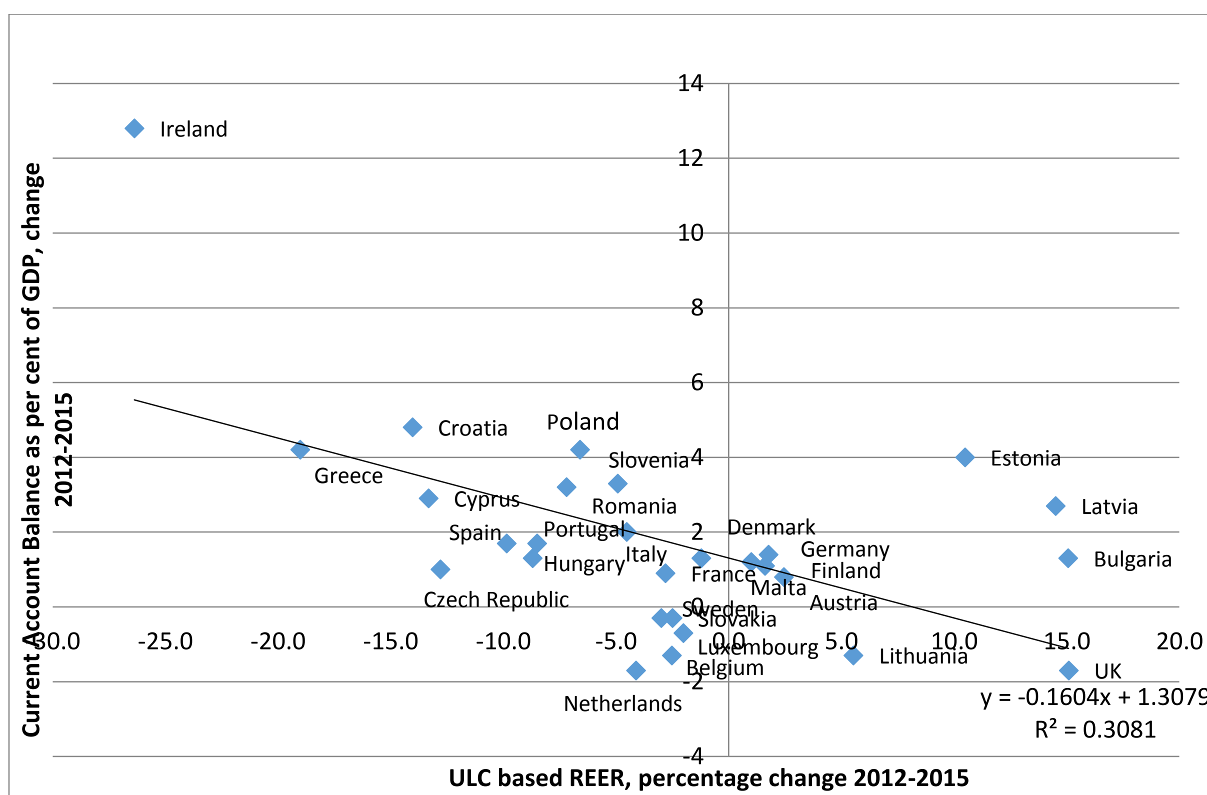
IV. The Current Account and Competitiveness Post-Crisis

Divergence in external imbalances between member states is often seen as a symptom of differences in competitiveness. Large current account deficits can be an indication of deficiencies in competitiveness, while countries with surplus balances can be seen as possessing a competitive edge over others. A deficit caused by weak export performance is a sign of issues with costs, or other aspects of competitiveness, which can usually be explained by the real appreciation of the exchange rate. Wages may grow faster than productivity, leading to rising ULCs. A deficit driven by income transfers can also reflect anomalies in competitiveness: foreign companies present in the economy may have few incentives to reinvest their earnings and decide to repatriate their profits. Broadly speaking, structural competitiveness issues can also be reflected in current account positions: the country may be unable to offset increasing ULCs in certain (low value) export sectors by moving to higher value added production (Szent-Iványi, 2017).

As demonstrated in Section III, pre-crisis divergences in current account balances in the eurozone were not necessarily caused by deteriorations in competitiveness, but rather by a fundamental mismatch between savings and investments. Indeed, the export performances of many periphery countries running large current account deficits remained relatively robust, including Spain and Ireland, but also the Baltics (Kutasi, 2014). While they did experience sizeable increases in their ULCs, these were mainly driven by the non-tradable sectors (Kang and Shambaugh, 2015) and could be interpreted as the ultimate effect of convergence and catching up.

It is worth examining the drivers of current account balances in the post-crisis era and whether these balances have become better indicators of national competitive positions. Figure 2 shows the relationship between changes in the current account balances of member states, and changes in their real effective exchange rates, based on ULCs, between 2012 and 2015. The scatter plot shows a moderate relationship between the two variables in the period following Europe's double-dip crisis. Current account balances deteriorated, or improved at a slower pace in countries that experienced appreciations in their REERs. The relationship, however, can reflect other dynamics as well. Severe internal devaluations in countries like Ireland, Greece or Cyprus have led to an improvement in the current accounts through a decrease in purchasing power and, in turn, a contraction of imports, although even in these cases it is expected that the export sector will also benefit at some point in the future.

Figure 2. Changes in competitiveness and current account balances, 2012-2015



Source: authors, based on data from European Commission (2016, pp. 174 and 182)

Real effective exchange rates based on ULCs, however, are rather simple measures of competitiveness, capturing primarily cost aspects of export competitiveness. Factors affecting the quality of exports, or changes in the country's attractiveness for certain kinds of foreign investment are not reflected in changes in REER. It can thus also make sense to look at broader measures of competitiveness, such as the ranking based on the World Economic Forum's Global Competitiveness Index (GCI; WEF, 2016). This composite indicator combines hard data (measuring cost and qualitative aspects of competitiveness for the entire economy) and soft data (such as surveys among corporate executives) to produce a holistic view of a country's competitive position. Most member states experienced relatively minor changes in their positions between 2012 and 2016. Table 8 lists the countries which saw a change of four or more places in their positions, either in terms of improvement or deterioration.

Table 8: Changes in GCI positions, 2012-2016

Largest improvements	Largest deteriorations
Bulgaria (+24); Romania (+15); Latvia (+15); Malta (+11); Lithuania (+9); Czech Republic (+7); Ireland (+6); Poland (+5); Greece (+4); Slovakia (+4); Spain (+4)	Cyprus (-36); Hungary (-21); Finland (-6); Denmark (-4);

Source: authors, based on WEF (2016).

Evidently, there was no correlation between changes in GCI rankings and changes in current account balances over the given period. This may be a result of two factors. First, the GCI measures aspects of competitiveness which would not show up in the current account, or would have an opposite effect on its balance as exports do, including factors which determine how favourable location a country is for various types of foreign direct investments. Second, this lack of any relationship can suggest that the impact of competitiveness on the current account balance is even lower in the post-crisis period than what Figure 2 suggested. It is nonetheless worthwhile examining the current account and competitive positions of some individual countries in more detail, especially the best and worst performers indicated in Table 8.

Bulgaria has seen the greatest improvements in its competitiveness (despite a large appreciation in its ULC-based REER in recent years), which was accompanied by a substantial improvement in its current account position. A number of reforms in recent years, including the strengthening of the financial sector after a large bank failure in 2014, simplifying the procedures for starting businesses, EU-funded public investments in infrastructure, judicial reform and fiscal consolidation have all contributed to improving competitiveness. Rising ULCs reflect a catching up process with the rest of the region, given that Bulgaria has the lowest wages in the EU. However, it also represents bottlenecks in the labour market, which suffers from skills shortages and emigration (IMF, 2016e). Increasing domestic demand is likely to return the country's current account into a deficit in the coming years, seen as normal for convergence countries. Latvia also showed similar dynamics to Bulgaria, and the country's journey is highly interesting: its large improvement came after significant deterioration following the crisis, and, at least in terms of its competitiveness ranking, the country was in a similar position last year where it started a decade before. In Romania, the improving rankings were accompanied by a lower current account deficit and depreciating REER. The country's high profile anti-corruption drive has been well regarded internationally[10], reforms aimed at stabilizing the banking system, prudent government policies, and a well performing economy driven by domestic consumption have all supported Romania's performance.

On the other hand, Cyprus and Hungary were the two biggest losers in terms of competitiveness in recent years. Cyprus suffered heavily following a banking and sovereign debt crisis in 2012-13, and was forced to enter into a bailout agreement with the IMF and the European institutions, leading to a number of austerity measures. The Cypriot government successfully stabilized the economy by the end of 2015 and was able to exit the bailout agreement early in 2016 (IMF 2016f, 2016g). The country's REER depreciated by more than 13 per cent between 2012 and 2015, a welcome sign of improving competitiveness. Public debt however remains high, banks are still plagued by a high proportion of non-performing loans, both of which significantly harm potential growth (IMF 2016g). While Hungary had a surplus in its current account for years, and its REER also depreciated substantially, the deterioration of public institutions, policy instability, the lack of investment in healthcare and

[10] *Politico*, 12 February 2016.

education, and increasing corruption have hit the country's competitive position hard. Hungary's economy has been performing well in the past years, driven by strong export performance, but the favourable macroeconomic performance could not counterbalance long term structural decline.[11] Feeble consumption and investment growth indicate that the strong current account surplus is likely to remain. The country which was the star performer of Central and Eastern Europe in the nineties is now the lowest ranked in the region, and only three EU member states, Croatia, Cyprus and Greece have worse competitive positions.

Conclusions

The European economy continued its recovery in 2016, albeit at a slightly slower pace. Driven mainly by consumption and investment, the relatively good growth performance generated somewhat higher inflation, more jobs and improving government balances. The sustainability of the recovery, however, is questioned by a number of external factors: the slowdown of the global economy, the weakening expansion of international trade, the election of Donald Trump, and, most importantly, Brexit, which poses perhaps the most serious threat to the European project in its entire existence.

Europe's good performance has opened up some fiscal space for most governments, although public debt remains high and decreasing it will be an issue for years to come. European publics however have clearly tired of austerity politics and have been turning away from the mainstream political parties most closely associated with these. The rise of right and left wing populism, and the political challenges such parties can mount, should also be seen as significant threats to Europe's future economic performance. Although there are signs in early 2017 that the global economy may have started to pick up,[12] it is questionable when and how exactly such a trend may exert an impact on the public mood.

The second half of the contribution focused on re-assessing the role of external imbalances in the crisis, as well as how external imbalances and member state competitive positions have evolved post-crisis. Studying the current account positions and the competitiveness of member states implies the explicit acknowledgement that the crisis was not exogenous to the EU but it was rather endogenous to it, a direct consequence of how EMU was designed. If the EU wants to prevent its member states from further struggles and even situations close to default, it needs to redesign the architecture of the eurozone and preferably the whole EU in such a way that promotes real convergence. While crisis-hit economies (especially Greece and Portugal) are still expected to undertake a lot in terms of structural reforms, core countries with large surpluses in their current accounts should also change their behaviour and increase their aggregate demand by boosting household consumption and public spending. Whether such a change should necessarily mean a total rebalancing of the current divide between so-called supply-side growth strategies of the core and the demand-driven growth strategies of

[11] *Financial Times*, 9 June 2015.
[12] *The Economist*, 16 March 2017.

the periphery (Hall, 2012) is a question that needs careful analysis. What this contribution did find, however, is that current account balances have become much less reliable indicators of export competitiveness than what standard textbook arguments imply.

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