Box 2.1. Unwinding External Imbalances in the European Union Periphery

The Great Recession forced a painful adjustment in external imbalances in the periphery of the European Union. Current account deficits soared in the years leading up to the crisis, with rapid growth in credit and domestic demand and strong increases in unit labor costs relative to the euro area. By 2007, the current account deficit averaged 10.0 percent of GDP in Greece, Ireland, Portugal, and Spain and 17.7 percent of GDP in the Baltic economies of Estonia, Latvia, and Lithuania. Because the nominal exchange rate is fixed, these economies have had to unwind the large imbalances through demand contraction and a decline in inflation and wage growth relative to their trading partners, a process known as internal devaluation. To shed light on how this process is proceeding, this box compares the experience of the Baltics with that of the other economies and discusses some challenges ahead.

Estonia, Latvia, and Lithuania

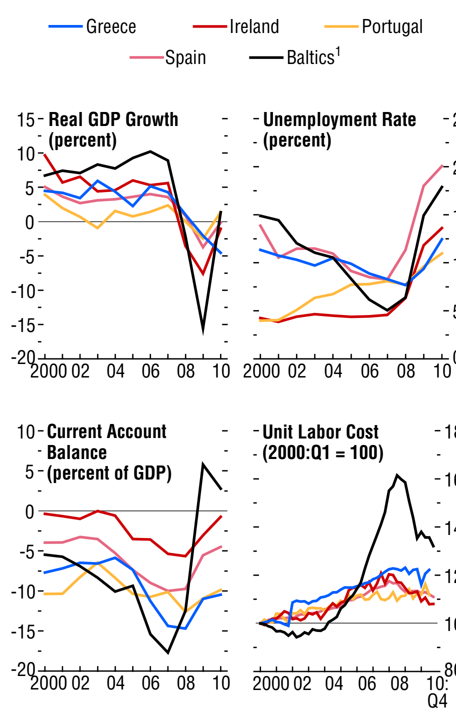
These Baltic economies have eliminated their current account deficits, but the contraction in economic activity has been unusually large. GDP contracted by an average of 15.5 percent in 2009, and the unemployment rate rose by 12.8 percentage points during 2007–10. In terms of external adjustment, these economies' current accounts swung from a deficit averaging 17.7 percent of GDP in 2007 to a surplus averaging 5.8 percent of GDP in 2009, which may be above the long-term level. Indeed, the current account surplus declined in 2010, and the challenge is now to sustain recent improvements in competitiveness to support growth in productive sectors. Unit labor costs also fell sharply relative to the euro area, by 18.1 percent from their peak. The sharp rises in unemployment, as well as the flexibility of these economies' labor markets and large cuts in both public sector and private sector wages, accelerated internal devaluation and the restoration of competitiveness.

The sharp recession meant that the adjustment initially occurred through a contraction of imports, but exports subsequently contributed to the rebalancing. In 2009, the ratio of imports to GDP fell by an average of 14.6 percentage points. In 2010, imports rebounded and exports rose above their 2007 level, possibly reflecting the decline in unit labor costs and the recovery in global trade. In terms of saving and investment, the adjustment has so far been due mainly to a contraction in investment. A decline in public saving, mainly due to decreased government revenue during the recession, has been partly offset by a rise in private saving to more sustainable levels.

Greece, Ireland, Portugal, and Spain

A painful but more gradual process of external adjustment is under way in these economies. GDP contracted by an average of 4.0 percent in 2009, and the unemployment rate rose by an average of

Figure 2.1.1. Economic Activity and External Adjustment in the EU Periphery



Sources: Haver Analytics; and IMF staff calculations.
[1]Baltics: Estonia, Latvia, and Lithuania. Aggregates for the Baltics are simple averages except for current account balance, which is calculated as the sum of the balances.

The authors of this box are Florence Jaumotte and Daniel Leigh.

Box 2.1 *(continued)*

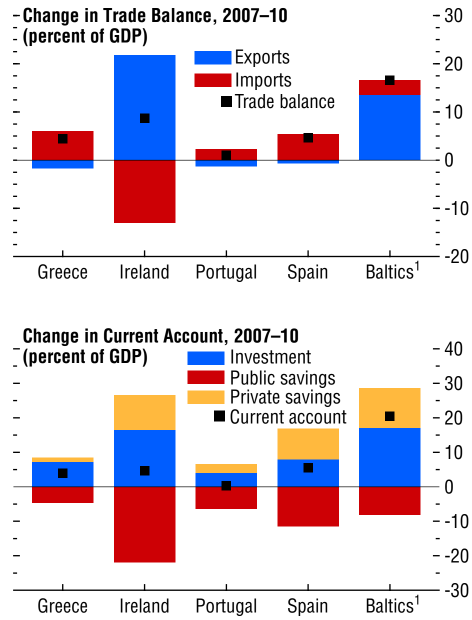
7.0 percentage points during 2007–10. The external adjustment process started later than in the Baltic economies, with the ratio of the current account deficit to GDP falling by 4.3 percentage points—from 10.7 percent of GDP in 2008 to 6.4 percent of GDP in 2010. The current account deficits of Ireland and, to a lesser extent, Spain have moved toward more sustainable levels, but they remain excessively large in Greece and Portugal, at 10.4 and 9.9 percent of GDP, respectively, in 2010. The decline of unit labor costs relative to the euro area averaged 5.1 percent for these economies, but this is skewed by the 10.2 percent decline in Ireland; the decline was more modest in the other three countries.

There are signs of a turnaround in all four of these countries. They initially adjusted through import contraction, but exports started contributing to the adjustment in 2010. Reflecting the smaller contraction in income, the fall in the ratio of imports to GDP in 2009 was smaller than in the Baltics—an average of 4.8 percentage points compared with 14.6 percentage points. In 2010, there was a rebound in both imports and exports, but exports generally increased more, thus furthering the external adjustment process. Exports as a share of GDP rose by much more in Ireland, possibly reflecting the greater decline in unit labor costs there. In real terms, exports grew strongly in Ireland, Portugal, and especially Spain, largely as a rebound. In terms of saving and investment, the adjustment has so far consisted mainly of a contraction in investment, as in the Baltic economies, and the large fall in public saving has been partly offset by a rise in private saving. Wage moderation has played a relatively modest role in Greece, Portugal, and Spain, where labor markets are less flexible than in the Baltics.

A number of policies can contribute to the remaining adjustment that will be required, and many are already being implemented. In Greece and Ireland, they are an integral part of the authorities' adjustment programs, which are supported by the international community. The policies include measures on both the supply side and the demand side of the economy:

- Labor cost adjustment can be facilitated by promoting decentralized wage bargaining, removing indexation mechanisms, and reducing dismissal costs. In addition, building a national consensus so that the burden of the adjustment is shared broadly through wage moderation can help prevent a protracted period of high unemployment.
- Reforms to increase productivity growth also contribute to improving competitiveness.
- The fiscal consolidation under way to address these economies' elevated government debt levels will also contribute to the external adjustment. In the short term, raising taxes or cutting government spending improves the current account balance by restraining domestic demand, including imports. Over the medium term, it would be helpful to create room to cut taxes, thereby supporting private investment and the supply side of the economy.

Figure 2.1.2. External Adjustment in the EU Periphery



Sources: Haver Analytics; and IMF staff calculations.
[1]Baltics: Estonia, Latvia, and Lithuania. Aggregates for the Baltics are calculated as sums of individual country data.