

Working Paper

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Still focused on public deficits. Some remarks on the euro area stability programmes 2012-2015.

This version: October 21, 2012.

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Keywords: Euro area crisis, fiscal deficit, financial balances accounting identities, macroeconomics imbalances, austerity, stability programmes

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Abstract:

Using the financial balances accounting identity, we analyze whether there is evidence in recent national accounting data and the projections of the Stability Programmes (SP), that the focus on fiscal deficits to the exclusion of other economic magnitudes risks further deterioration of the euro area economy's growth rate. We find that, in the past and with focus on shrinking public deficits, growth forecasts have almost always been deteriorating from one SP batch to the next, while the macroeconomic situation is not markedly different from the beginning of the euro area crisis, 2010. We conclude that continued fiscal austerity and disregard of current account imbalances is likely to lead to further deteriorating data that fails to live up to current growth forecasts. This will lead in turn to further growth forecast downward revision in the next SP batch. A simple simulation of a deterioration in the external economic environment indicates that a symmetric rebalancing of the current account imbalances might be more feasible than the current, asymmetric rebalancing.

1. Introduction.

April 2012 has seen the publication of the third batch of stability programmes (SPs) in the euro area since the onset of the monetary union's economic crisis in early 2010. The insight that the causes of the crisis are more complex than fiscal overspending starts percolating through policy circles. Yet the SPs, which project fiscal plans over the next four years, are evidence that the focus on fiscal deficits is still center stage in the governments' crisis responses.

In this paper we analyze whether there is evidence in the national accounting data of the past few years and the projections of the SPs, that the focus on fiscal deficits to the exclusion of

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other economic magnitudes risks further deterioration of the euro area economy's growth rate. In a first step, we examine heuristically whether the change in the projections of the financial balances over the last three batches of SPs, indicates there exists a systematic effect of fiscal balancing on growth projections. We also scrutinize forecasts by the European Commission and the IMF for similar indicators. In a second step, we use what we have learned from looking at the historic data and SPs through the financial balance lens to analyze whether the current SPs seem to make realistic prognoses. To that end, we compare their projections to historic data and simulate a deterioration of the external economic environment. We also comment on how the new European Union legislation regarding macroeconomic imbalances and fiscal spending limits might influence SP forecasts and national policies. As in two previous analyses, Brecht et al. (2010) and Semieniuk et al. (2011), we rely on the method of examining simple accounting identities, growth rates and their plots instead of trying to estimate statistical relationships supported by more elaborate economic theory. This is because we are interested in approximate medium-term trends of the ensemble of growth and financial balances variables and the overall plausibility of eurozone governments' forecasts; it is not our aim to provide quantitative prediction of single variable.

We find that the financial balances analysis provides a convincing story that links the constantly overoptimistic SP growth forecasts, that have to be corrected downwards in the subsequent SP version to the SPs' exclusive focus on correcting fiscal deficits. We also find that the current SPs still suffer from this narrow focus, and that the new European Union legislation has (not yet) been successful in widening the focus, suggesting that their forecasts about the medium-term macroeconomic situation will be obsolete by 2013. In addition, our simulation results suggest that a more negative external environment might frustrate governments' efforts to achieve their SP aims again this year, and that a common, symmetric rather than a national approach to correcting imbalances would likely be more effective.

Section two introduces the stability programmes in the evolving legislative environment. Section three describes the historical data for financial balances and growth during the crisis. Against these empirics, section four examines how the projections of financial balances and growth of successive SP batches during the crisis have changed as new data became available. It also contrasts the current projections with those of the European Commission's spring 2012 forecast and the IMF's April 2012 World Economic Outlook. Section five evaluates the usefulness of two previous SP analyses conducted using accounting identities, Brecht et al. (2010) and Semieniuk et al. (2011). Section six analyses this year's SPs by means of the financial balances and growth rate forecasts and carries out the simple simulation of a deterioration in the external economic climate. It also contains a text box analyzing the European institutions' response to the SPs. Section seven concludes with a discussion of our findings and their relevance to the ongoing crisis.

2. Stability programmes and other legislation.

2.1 Stability programmes and the Stability and Growth Pact.

The annual stability programmes (SPs) are required of euro area member states under the preventive arm of the Stability and Growth Pact (SGP). By forcing governments to project their budgetary policy four years into the future, this exercise aims at ensuring more rigorous budgetary discipline in line with the SGP's stipulations.² This discipline has until recently been believed sufficient by European policy makers to create the economic homogeneity needed for monetary union; in the European context it is termed "stability". The last three years' SPs were published while the euro area was in an economic crisis. They provide snapshots of the governments' plans for the state's role in restoring this stability. Moreover,

² The SGP requires that member states not incur budget deficits larger than 3 per cent of gross domestic product (GDP) and hold government debt at no more than 60 per cent of GDP. Failure to comply might result in financial sanctions for euro member states (see EC 2012c for the relevant legal texts).

since the majority of euro area members are currently in breach of the SGP rules and required to return to lower deficits at dates set by the European Commissions, the SPs show how governments intend to square their rapid deficit reductions with the attempt to restore economic growth. As we argued in previous analyses, this intention might amount to trying to square circles.

2.2 Fiscal Compact and Macroeconomic Imbalances Procedure.

The possibility that euro zone governments are immersed in squaring circles has also been entertained by the European Union institutions. This resulted in a pair of new legislation. First, the majority of member countries reached the conclusion that even tighter fiscal rules were necessary to recover from the crisis.³ 25 member states signed a so-called fiscal compact. It binds member states by law to reach medium-term balancing of the budget, i.e. budget deficits not larger than 0.5 per cent (pc) of GDP, and to reduce debt of above 60 pc of GDP debt by a certain amount each year. If ratified, it might trigger sanctions against eurozone members in the case of trespasses.

Second, two regulations (1174/2011 and 1176/2011) alert about macroeconomic imbalances. A set of ten indicators and thresholds for each make up a scoreboard, based upon which the European Commission (EC) decides whether imbalances are present. If the score is too high, the imbalances are deemed excessive. In that case, the EC can recommend an action plan to remove them. Ultimately, the Council may impose sanctions, if agreed-upon targets for removing imbalances are not met by the member state in question. The EC published its first scoreboard report this February (EC 2012a). It identified imbalances warranting further investigation in six euro area countries in addition to Greece, Ireland and Portugal that are

³ This conclusion was conditioned by the strictures of the monetary union: the additional fiscal discipline is aimed at calming financial markets and thus reduce borrowing costs for member states governments.

already under tighter surveillance due to their adjustment programmes (ibid.19). Among the imbalances mentioned are large current account (CA) surpluses and deficits, an indicator that SPs have hitherto ignored.

2.3. Analysing the stability programmes in the evolving legislative environment.

The following sections analyse the forecasts of the financial balances and growth in the SPs and contrast them with actual developments. Until this year, only the SGP gave guidance to the prognoses. Hence the SPs were couched around bringing the public deficit to -3 pc, the target deficit. Other macroeconomic variables emerged only as byproducts, but analyzing whether they were realistic, could indicate whether the entire SP was likely to be realistic. The new legislation might be expected to widen the singular focus on the fiscal balance. But the fiscal compact merely reinforces the SGP. If anything, it increases the focus on fiscal deficits because it imposes additional binding constraints (balanced medium-term budget, debt reduction if greater than 60 pc of GDP).

As concerns the imbalance procedure, the inclusion of the scoreboard indicators would widen the focus. For the current SPs, however, observing the new macroeconomic imbalance indicators is only voluntary (ECOFIN 2012a: 2). And there is no sign that the SPs actually do heed the first scoreboard report by the EC from February 2012. The SP forecasts are still focused on projecting a fiscal deficit reduction; therefore, our analysis of the consequences for other balances is warranted as in earlier years. Only the EC working papers that examine the SPs mention it. In Box 2 in section 5 below, we briefly comment on how the Macroeconomic Imbalance Procedure influences the existing EC and Council assessments of the SPs. The next section will describe the financial balances and growth data during the crisis against which we can analyze how SP projections have been revised over the years.

3. Evolution of the euro area growth and balances 2009-2012.

Since 2010 the macroeconomic environment in the eurozone has deteriorated.⁴ Using AMECO May 2012 data of the national accounts it can be seen that the economies had initially rebounded from the crisis year 2009 and the euro zone GDP grew 1.9 pc in real terms in 2010, its growth rate decelerated to 1.5 pc in 2011 and it is widely expected to contract in 2012. Figure 1 shows that the sources of growth were different from pre-crisis times. Positive growth came mostly from exports and some public expenditure, while investments were a drag on growth. Meanwhile, unemployment increased to 10.1 pc in 2010 and to 10.2 pc in 2011 and believed to be at 11 pc for 2012. Financial balances of the Euro area contracted (see Appendix 1 for an explanation of financial balances). The public balance was -6.4 pc of euro area GDP in 2009, -6.2 pc in 2010 and, pending revisions, -4.1 pc in 2011. The foreign financial balance had already shrunk to 0.1 pc of euro area GDP in 2009 from 0.6 pc in 2008, and crossed over into negative territory to -0.2 in both 2010 and 2011, pending revisions. Conversely, the CA crossed the origin from -0.1 per cent of euro area GDP in 2009 to 0.1 and 0.2 per cent surplus in 2010 and 2011.⁵

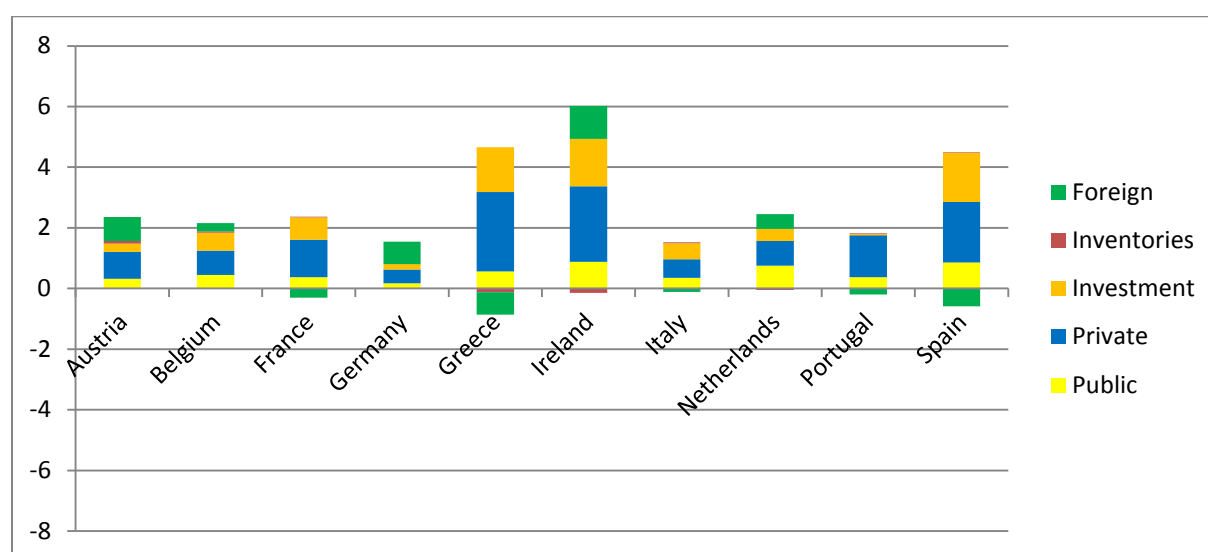
Behind the euro area veil, different member states underwent dissimilar developments. Southern member states and Ireland had to cope with stagnant or even negative growth, with Greece being in recession throughout and Ireland, Portugal and Spain, experiencing a contraction either in 2010 or 2011. Italy's growth rate also fell from 1.8 per cent in 2010 to 0.4 in 2011 and is expected to contract in 2012 by over one percent.

⁴ We focus on a subset of ten eurozone countries, Austria, Belgium, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal and Spain. The remaining countries data are included in statements about the entire euro area. Since our analysis contains the largest economies, their data largely reflect euro area data.

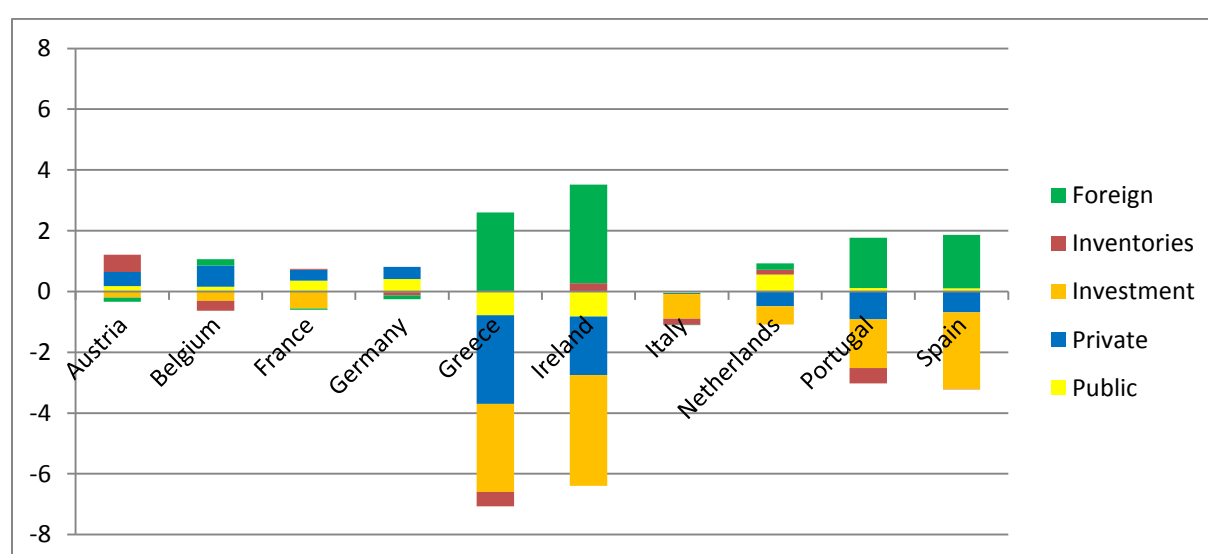
⁵ The current account (CA) plus capital account equal the financial account and the foreign financial balance is equal to the negative financial account. Since the capital account is usually very small compared to the CA, a positive foreign financial balance typically corresponds to a negative CA and vice versa. We will frequently refer to the CA, since it is a more intuitive variable than the financial balance.

Fig. 1. Average Growth Contributions for selected euro area countries.

First panel: 1999-2008



Second panel: 2009-2011



Source: AMECO (update May 2012).

In these countries except Italy, unemployment rates soared, in Spain's case to above twenty percent. The foreign financial balances of some of the states became more balanced, although starting from very high levels, corresponding to strongly negative CAs. Italy's CA actually became more imbalanced. The private balances in these countries were uneven but on average more positive than before the financial crisis hit in 2007 and 2008. In all countries the public financial balances also edged closer to zero, but were more negative than allowed under the

SGP in 2011. In part, these reductions were mandated by adjustment programmes. In May 2010 the so-called troika of European Central Bank, EC and International Monetary Fund (IMF) published the first adjustment programme for Greece, followed by similar programmes for Ireland and Portugal in February and June of 2011. These countries embarked on structural reforms as laid out in the programmes and their updates. By summer 2012 Spain had increasingly come under pressure to also subject itself to an externally prepared programme. Another characteristic that unites the southern countries and Ireland are the high premia over German Bunds on bond interest rates they have to pay to refinance themselves.

At the other end, the middle and Northern European countries saw diverse but generally more clement developments. Growth rates in Austria, Belgium, France, Germany, and the Netherlands were positive in both 2010 and 2011, in Germany even above the average of the past couple of decades. Private financial balances were large and positive. Foreign financial balances – all negative except France’s – edged closer to balance in 2009 after record imbalances before the financial crisis. But while Austrian and Belgian balances continued to fall towards the origin through 2010 and 2011, the Netherlands’ balance’s absolute value increased again, while Germany’s almost stagnated. France’s CA deficit increased from 2008 to 2011, the only CA deficit country in the euro area with this development. It is also sometimes deemed to be next in having to pay high interest rates on its bonds (Carnegy 2012). The core countries’ public balances generally shrank from 2009 to 2011.

4. Comparisons of the 2010, 2011 and 2012 stability programmes.

Over the past three publication periods of the SPs, circa February 2010, April 2011 and April 2012, the four year forecasts of the SPs have changed considerably. The reason is that the subsequently published real data has diverged significantly from the forecast values. In this

section we identify patterns in these changes. We also contrast the current SPs with the 2012 EC Spring Forecast and the IMF's World Economic Outlook (WEO).

4.1. Real GDP growth rates.

The growth forecasts have deteriorated in most SPs since 2010. We divide our country sample into CA surplus and deficit countries. The deficit countries again consist of two groups. The first group is Greece, Ireland and Portugal. These countries revise their growth forecasts downward considerably already from their 2010 to 2011 SP version (see Fig. 2 also for what follows) and again from 2011 to 2012, albeit less strong in Ireland and Portugal. Medium-term growth rates remain largely constant.

The second groups is France, Italy and Spain. Holding growth forecasts steady from the 2010 to 2011 programme, they lower their forecasts remarkably from 2011 to 2012, with Italy and Spain forecast to be in recession for the year 2012. While France predicts to return to its earlier medium-term growth rate, both Italy's and Spain's growth rates now predict medium-term growth rates to be lower, 0.9 and 0.8 percentage points (pcp) lower than in their 2011 forecasts.

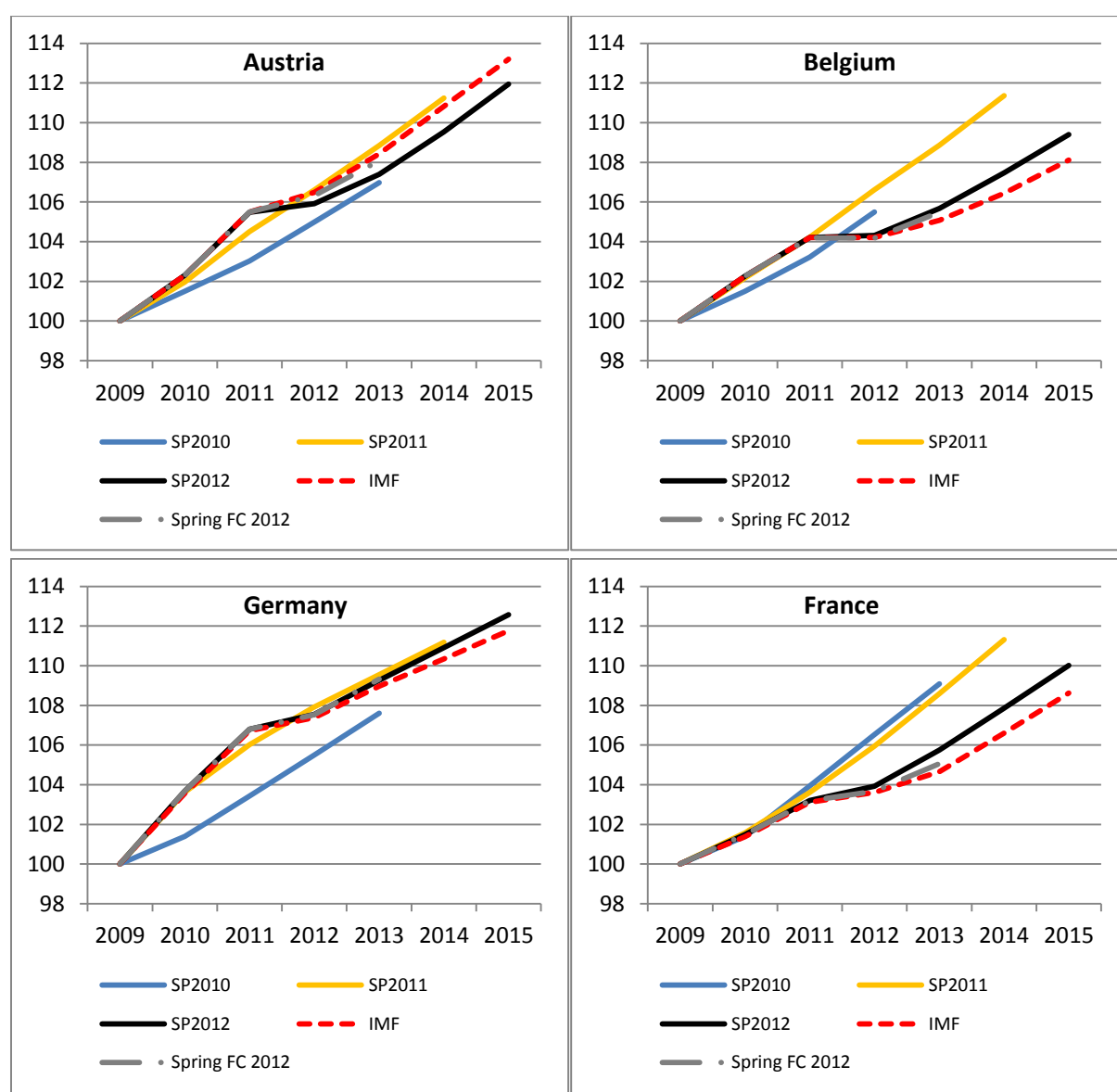
CA surplus countries also divide into two groups. One is Netherlands and Belgium. These countries actually raise their four year growth forecast in the 2011 SPs in the presence of surprisingly good growth in the years 2010 and 2011. However, Netherlands already reduces the growth rate predictions for the medium-term. A significant growth reduction for the year 2012 is then projected in the 2012 SP for both, with Netherlands experiencing a recession. Medium-term growth forecasts remain unchanged.

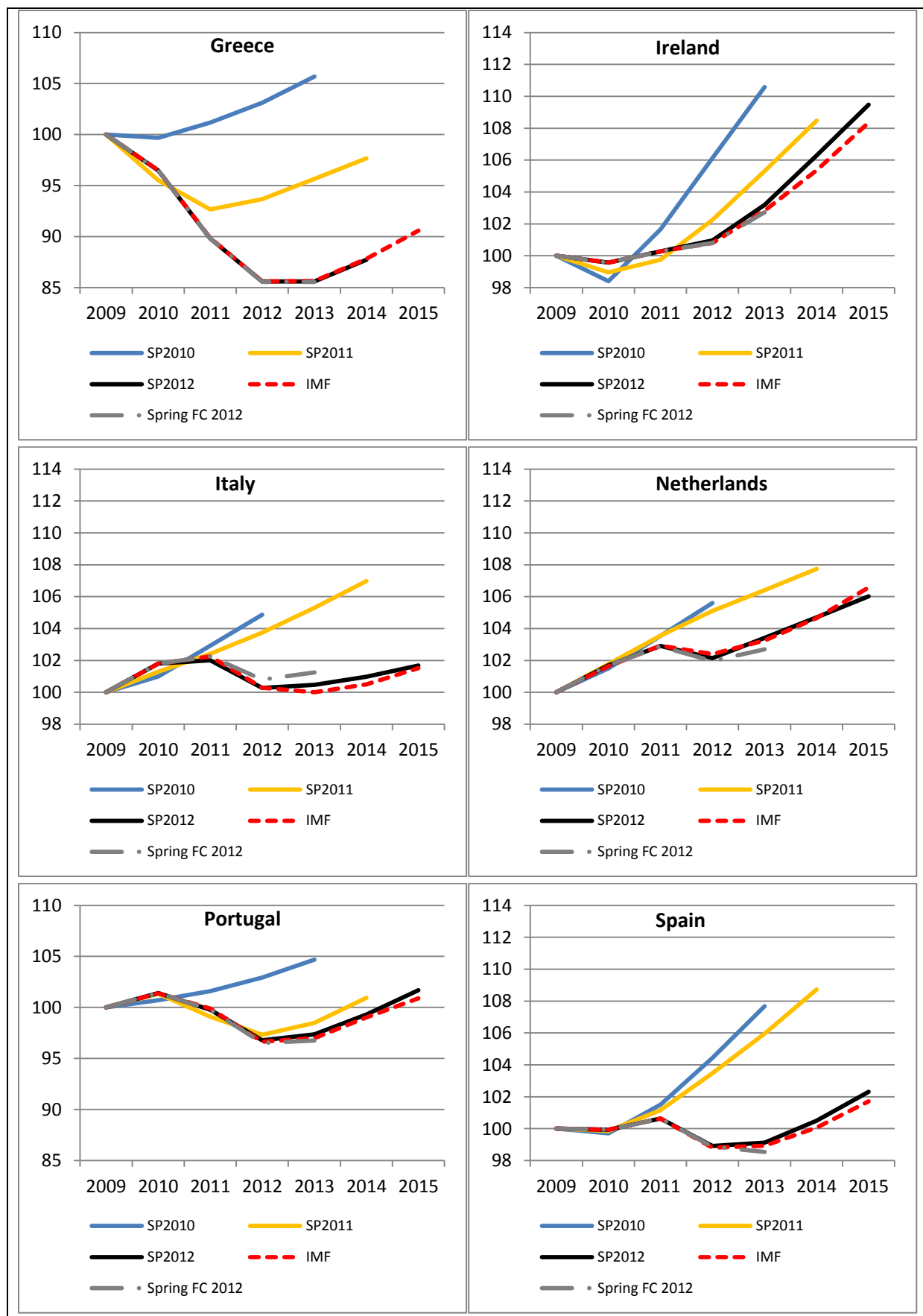
Austria and Germany constitute the other group. Both also revise their growth rate forecast upwards from 2010 to 2011 but then overachieve their predicted growth rates for 2011. They

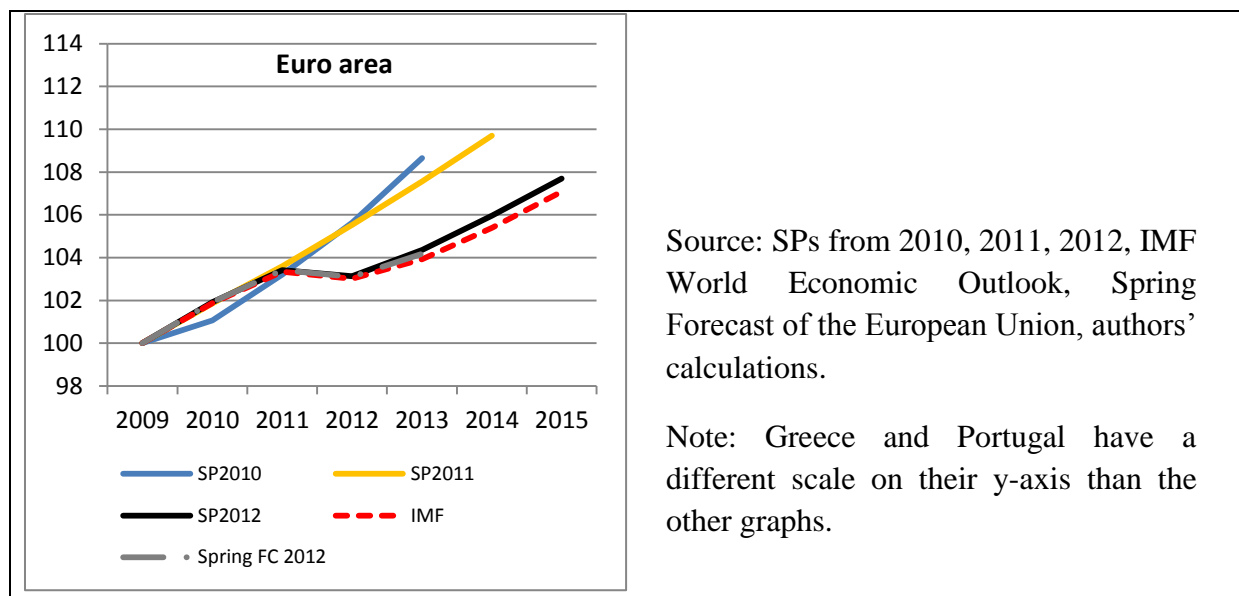
essentially remain with their optimistic short-term outlook from 2011. Germany revises its medium-term growth down from 2 to 1.5 per cent already in 2011 and sticks to that in the most recent SP, Austria raises it slightly from 1.9 to 2.2 per cent of GDP.

In summary, short-term growth rates were either revised downwards repeatedly or once or not (Austria and Germany). Medium-term growth rates predictions have equally often been revised downwards or remained constant.

Fig. 2. Five different real GDP growth rate index forecasts, 2009=100.







4.2. Sectoral Balances.

The foreign financial balance has the most divergent patterns of all sectoral balances (Fig. 3).

Countries with positive foreign financial balance fall into two groups: Ireland, Portugal, Spain and Greece fall into the group of generally sinking foreign financial balances or “CA improvers” both in their predictions and their historical data since 2008. The first three countries even all forecast flipping their balance in their 2012 SP. Ireland already balanced its foreign financial balance in 2011 and forecasts it dropping further to -1.1 pc of its GDP in 2013. Spain and Portugal believe they can flip their balance in 2013 and 2014 respectively. In their earlier SPs they had predicted maintaining a positive foreign financial balance. Greece predicts a steady fall from 16 pc of GDP in 2008 to 2 pc in 2014.

France and Italy are different. Both countries increase their foreign financial balance in 2010, and revise their forecasts upwards from the 2010 to the 2011 SP. Only in the 2012 SP version, when it becomes evident in the historical data that the 2010 balance was not that large after all, both countries correct their forecasts downward, while both country’s foreign financial balances remain positive throughout 2015.

Fig. 3. Financial balances from SPs of 2010 (blue bars), 2011 (red bars), 2012 (green bars).

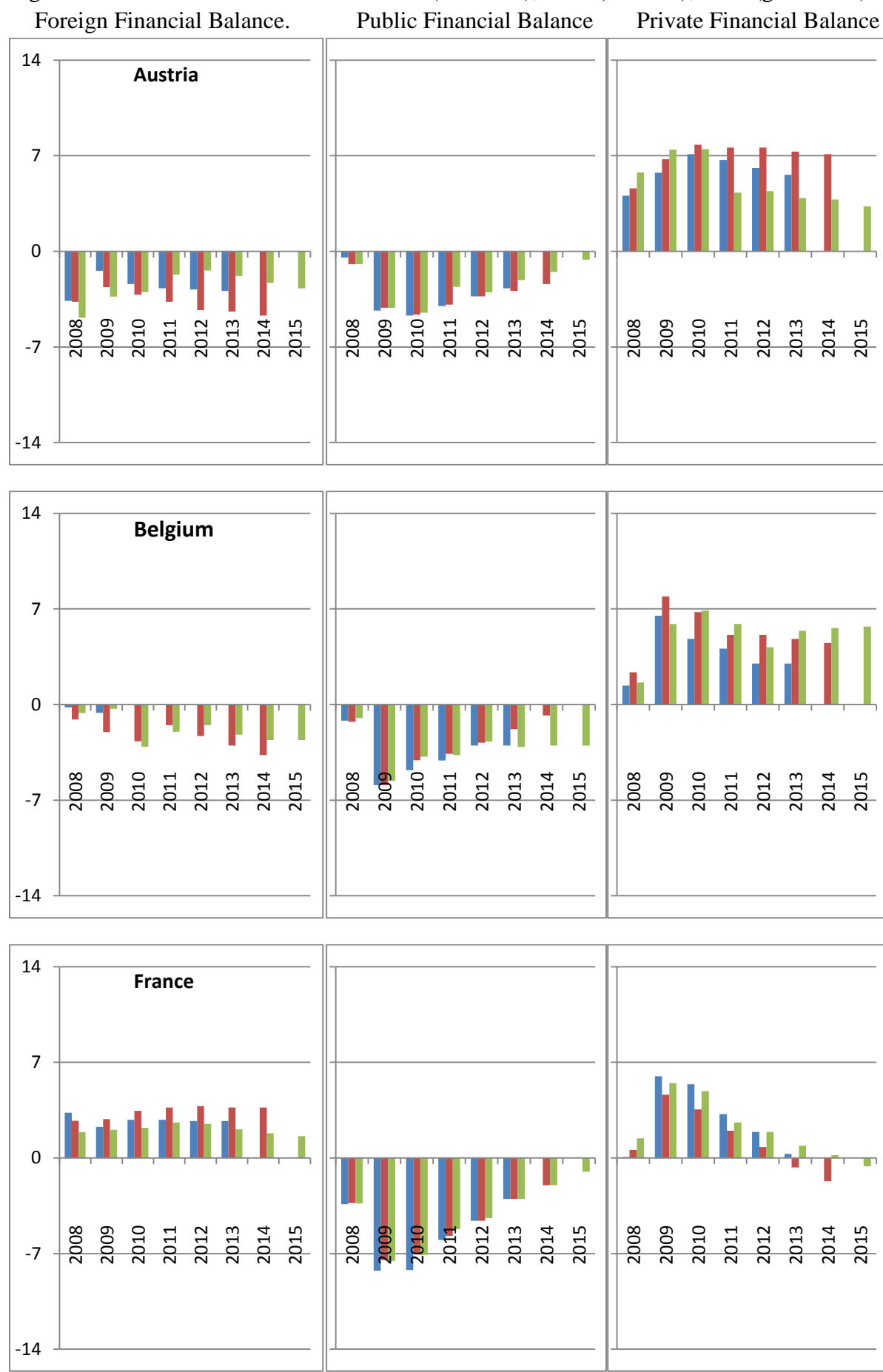


Fig. 3. Financial balances from SPs of 2010 (blue bars), 2011 (red bars), 2012 (green bars).

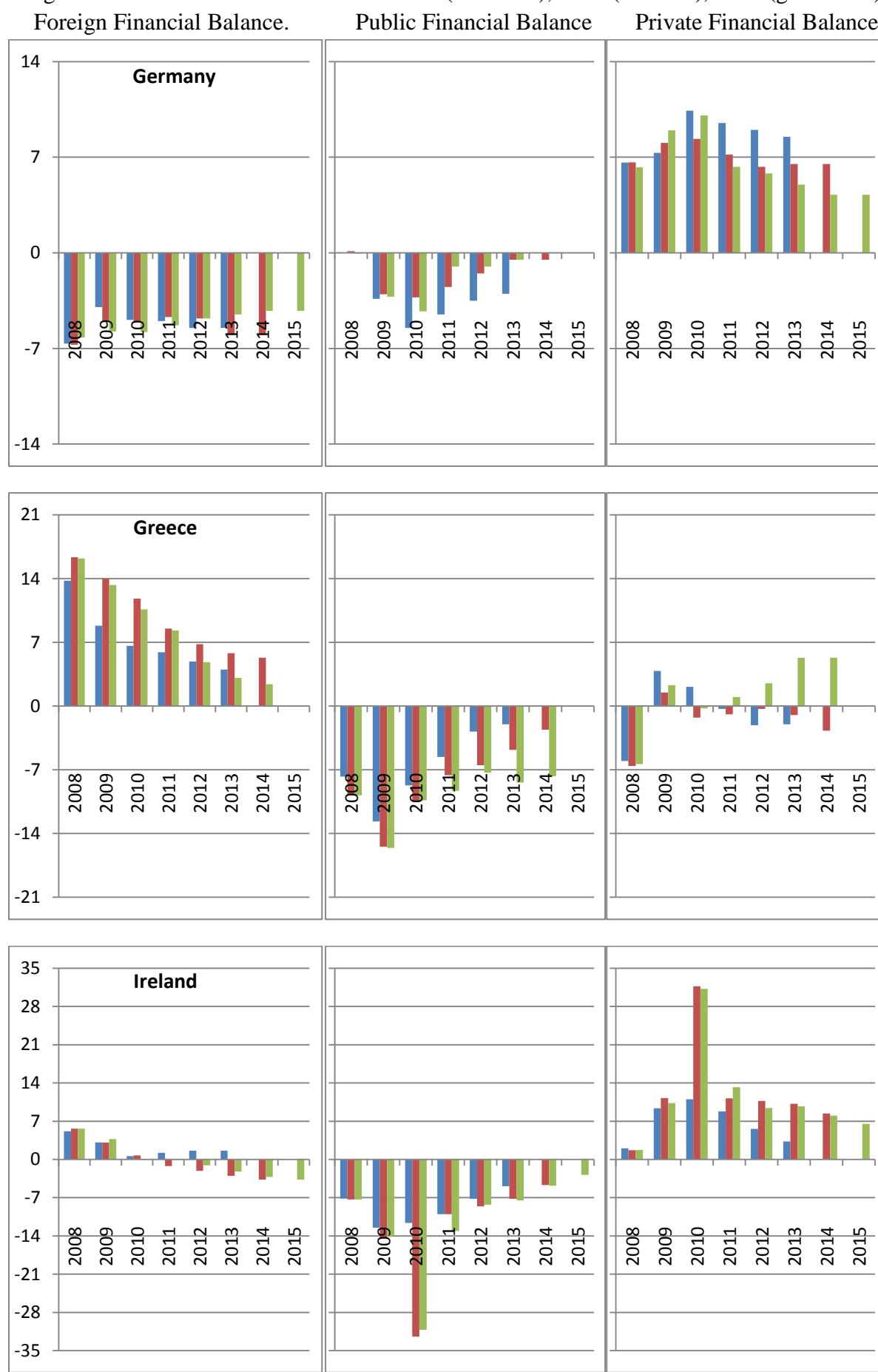


Fig. 3. Financial balances from SPs of 2010 (blue bars), 2011 (red bars), 2012 (green bars).

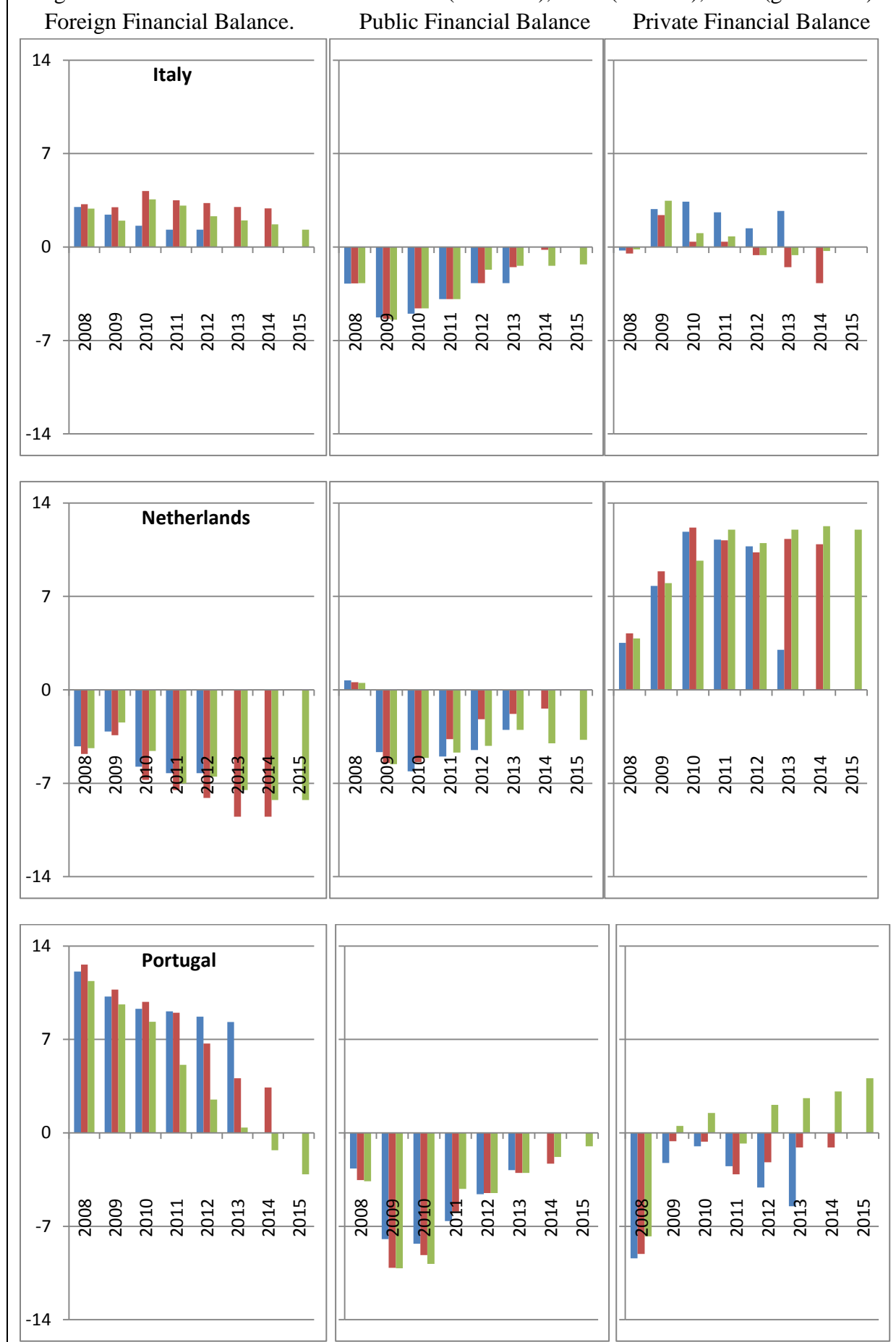
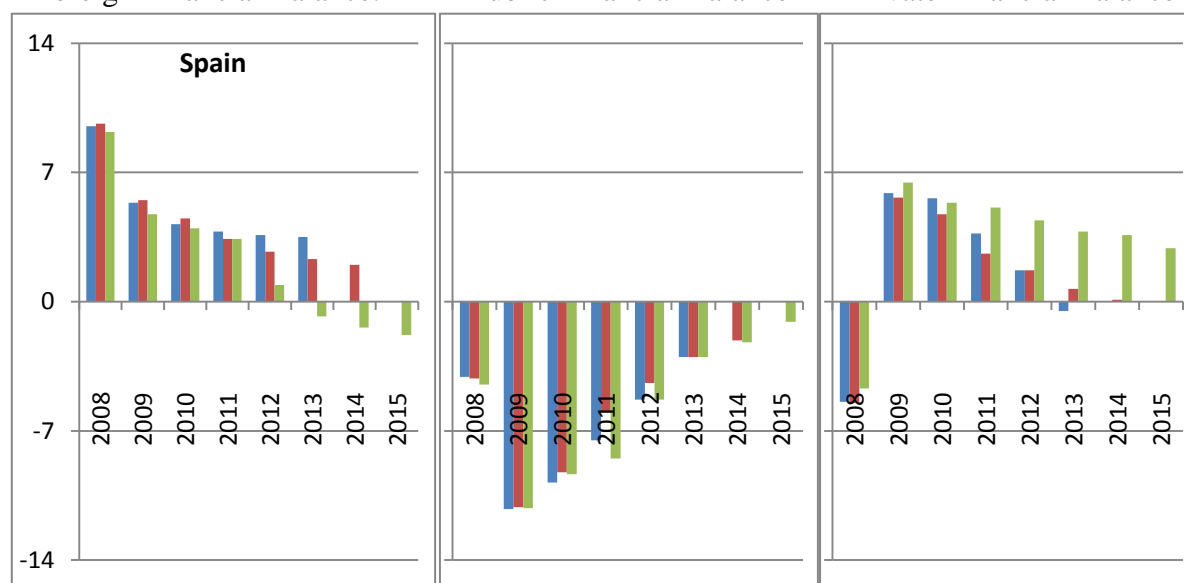


Fig. 3. Financial balances from SPs of 2010 (blue bars), 2011 (red bars), 2012 (green bars).
Foreign Financial Balance. Public Financial Balance Private Financial Balance



Source: AMECO (updates Oct 2009, May 2011, May 2012), SPs from 2010, 2011, 2012, authors calculations. (No foreign financial balance data for Belgium in its 2010 SP.)

Among the negative foreign financial balance countries Austria, Belgium and the Netherlands predict their balance to become steadily more negative in all three versions of their SPs, but at lower levels for the 2012 forecast, reflecting an unanticipated faster rise in imports than exports in the years 2011 and 2012. Germany shows a different prediction pattern. Its first two SP instalments still see its financial balance become more negative over the medium term. But unlike the other CA surplus countries, its balance surpasses expectations. In the newest SP, Germany predicts its financial balance to edge closer to zero and stabilize at -4.25 pc of GDP as opposed to -6 pc in its 2011 SP.⁶

The public financial balance pattern is rather uniform, since each country predicts the balance to reach the -3 pc lower bound stipulated by the SGP. Variation exists merely in that the actual data either outstrips or fails to satisfy the projected public spending consolidation. Germany, Austria but to some extent also France and Belgium actually incur smaller deficits

⁶ It is remarkable how much foreign financial balance historical values of 2008 and 2009 fluctuate from one SP version to the next (Fig. 3). If the 2010 and 2011 will similarly be re-adjusted in the next SP versions, this will influence the values of the remaining two balances: public and private.

in the years 2009, 2010 and 2011 than they predict in the first two SP versions. They update their predictions to see public spending closer to balance in 2012. Conversely, Greece, Ireland and Portugal, revise their deficit predictions downward with each SP period. Netherlands and Spain project a better public balance from 2010 to 2011 but then have to revise it to be more negative in the 2012 SP version. Italy has the most constant prediction pattern.

The private financial balance is calculated as the residual that sums the negative of the financial and the public balances to zero (see Appendix 1). The shrinking public deficits put a downward pressure on the private balance, the improving foreign balance in most countries lets the private balance rise. The two countervailing movements leave the private balance largely steady. Therefore, unlike in previous forecasts, no more large negative private balances are forecasted. Thus, the risk of financial instability implicit in large negative private balances is declining.

Tying the analysis of growth rates and balances together, if a country has a CA deficits it also has revised its growth rates downwards substantially at least once since 2010. This is only true of some of the CA surplus countries. Also, countries with CA deficits have either just been able to meet their fiscal consolidation plans or have failed to achieve them (with the exception of France). CA surplus countries have often surpassed their consolidation plans. The sign of the CA seems to provide a watershed for whether SP public financial balance projections are realistic or not.

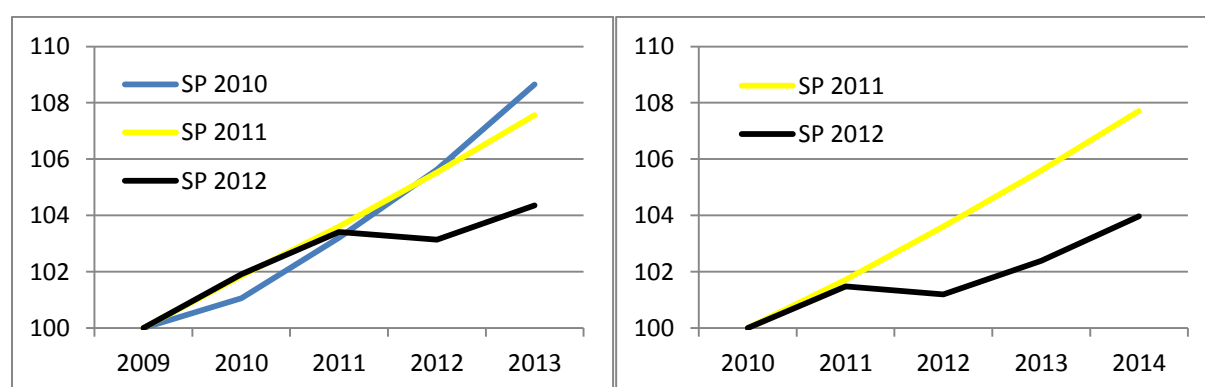
4. 3. Aggregated stability programmes.

By aggregating the SPs' macroeconomic forecasts, we deduce euro area growth and balances. The 2010 SPs forecast a cumulative real GDP growth of 8.7 pc for the Eurozone (excluding Estland) over its prediction period 2010 till 2013 (see Fig. 4). The 2011 SP forecast sees the

Eurozone grow at cumulatively 7.6 pc only over this period. The 2012 forecast, knowing the actual growth rates for 2010 and 2011 revises this number downward further to only 4.4 pc. That is despite the actual growth rate for 2010 being larger than predicted. The 2010 SP medium-term forecast is far more optimistic than in the later SPs, so much so that the cumulative growth is still higher.

The growth forecast 2011-2014 in the 2011er SPs predicts 7.7 pc real GDP growth over the four years at a steady rate of around 1.9 pc per year. The 2012 SPs newly incorporate a slump in 2012 and only predicts 4.1 pc euro area growth over the same four years. Finally, the medium-term growth, that is, the growth rate in each forecast's final year, diminishes from 2.9 over 2.0 to 1.6 pc.

Fig. 4. Euro area real GDP growth rate index forecast, left panel 2009=100, right panel 2010=100.



Source: SPs from 2010, 2011, 2012, authors' calculations.

The steady deterioration of growth forecasts goes hand in hand with a more negative and therefore imbalanced foreign balance forecast for the euro area as a whole. The 2010 SPs predicted a foreign financial balance of -0.5 pc of euro area GDP for 2013. The figures for that year in the 2011 and 2012 SPs are -0.7 and -1.2. The 2011 SPs then predict -0.9 pc for 2014, again smaller than the -1.5 pc predicted in the newest SPs for that year. Even if one takes into account the fact that GDP has shrunk and therefore the balances appear larger, one still arrives at a larger balance figure in euro figures: The 2014 Euro value of the foreign

financial balance predicted in the 2011 SP is Euro -92 billion and in the 2012 SP is Euro -155 billion for that same year. According to the 2012 SPs the balance is to widen further to -1.9 pc of euro area GDP in 2015. In conclusion, despite the forecast rise of the CA the growth prediction in the euro area falters.

4.4. Commission Forecast.

The Commission forecasts till 2013 only. Its growth forecast over this period is very similar to that of the SPs (see also Figure 2). Exceptions are Italy (more positive) and France, Portugal, the Netherlands and Spain (more negative). Spain stands out as the only country for which the EC's real GDP growth forecast in 2013 has the opposite sign from the country's SP forecast. The SP forecasts 0.2 pc real GDP growth in 2013 and then even higher. The Commission expects only -0.3 pc in 2013, their terminal forecast year, and warns of significant downside risks to this figure (EC 2012b. 74).

Spain's public deficit figure also diverges singularly in the forecasts. While the Spanish SP projects that it meets the -3 pc mark in 2013 as stipulated by the SGP, the Commission sees the public balance at -6.3 pc in 2013 – a divergence of 3.3 pc. Box 1 gives an account of the evolution of near-term Spanish public deficit forecasts. The Spring Forecast is more pessimistic about several other countries' public deficits as well. By 2013, the Commission believes France's deficit to stand at -4.2 and not -3 pc of GDP, the Netherlands is projected to stand at -4.6 and not -3 pc of its GDP. In conclusion, while the commission sees growth to proceed like in the SPs, it seems to imply that this growth is only achieved through higher public deficits.

BOX 1: Spanish public deficit revisions.

Spain's frequent budget positions revisions for 2011 and 2012 illustrates the ephemeral character of budget projections in a volatile macroeconomic climate. The following table lists

the instances of revision of the public deficit figures for 2011 and 2012 since the appearance of the Spanish 2010 stability programme.		
New Public Balance 2011 (% of GDP)	New Public Balance 2012 (% of GDP)	Event
-2.5	-3.8	Stability programme, Jan 2010.
-6	-4.4	Stability programme, Apr 2011.
unchanged	-5.3	Government announcement, Mar 2012.
-8.5	unchanged	Stability programme, Apr 2012.
unchanged	-6.4	EC spring forecast, more negative than the Spanish government forecast, May 2012.
-8.9	unchanged	Government announcement, 18 May 2012.
unchanged	exact impact unclear	Bailout of Bank “Bankia” to the tune of up to € 19 billion, end of May 2012.
unchanged	-12 to -15 (estimated)	Larger-scale bank bailout may add 6 to 9 pc to Spain’s deficit, calculates the rating agency Fitch, 7 June 2012 (Reuters 2012).
Moreover, on 10 July the Council decides that Spain may postpone reaching the 3% deficit to 2014 (ECOFIN 2012b).		

The EC foreign financial balance forecasts are similar to those of the SPs. Exceptions are Spain and Greece. For Spain the Commission predicts a balance that is only 0.4 compared to -0.8 pc of GDP in the Spanish SP in 2013. For Greece, it corrects downward its own forecast from the Adjustment Programme, namely 1.6 pc more positive than in the adjustment programme from March 2012. The discrepancy arises mostly from a larger positive capital account balance.

4.5. IMF World Economic Outlook.

The IMF projects growth rates, including in the medium-term (IMF 2012). They are on average slightly more pessimistic than the SP forecasts (Fig. 2). The biggest divergence is visible for France, for which the IMF believes 2013 is still a year of sluggish 1 pc real GDP growth as compared with the 1.75 pc forecast by the French SP. The IMF projects Italy to be

in recession with -0.3 pc GDP reduction, but then to catch up in 2015 relative to the Italy's SP forecast. Germany's and Belgium's medium-term outlook is slightly more subdued.

On public deficits, the IMF has similar findings to the Commission forecasts, expecting far more negative public financial balances throughout 2015 for France, Spain (-4.8 pc of GDP in 2015, thus violating the SGP for three years), and till 2014 for Portugal and 2013 for the Netherlands. However, it forecasts a better budget position for Belgium and – surprisingly – Greece. This is surprising because it vastly diverges from its own forecast for Greece from about the same time: the WEO (April 2012) predicts a public financial balance of -2.1 pc of GDP in 2014 as opposed to -7.7 pc in the adjustment programme (March 2012).

The IMF does not forecast net lending of the rest of the world but instead the CA. The divergence from the SPs' CAs (which most also project) is often considerable. While the IMF believes France to run a CA deficit of only -0.8 pc of GDP as opposed to the French SP's -1.6 pc in 2015, it forecasts that Belgium has a 1.5 pcp lower CA in 2015, Spain 2 pcp, Netherlands 3 pcp, Portugal even 5 pcp. Thus, unlike in their SPs, Portugal and Spain never become CA surplus countries in the IMF forecast. On average (unweighted), the IMF forecasts the CA to be 1.1 pcp lower than the SPs. In conclusion, the EC spring forecast doubts that the euro area countries can achieve their deficit targets, given the growth projections and the IMF seconds that. The IMF moreover doubts the CA improvement.

4.6. Conclusions from comparing forecasts.

The examination of SPs and other forecasts through the financial balance lens highlights two things. First, the structural macroeconomic situation since 2010 is largely unchanged: euro area countries continue to be divided into CA surplus and deficit countries. Any imbalancing effects this can have has thus not been resolved, especially with surplus countries (Austria,

Belgium, Germany, Netherlands) leaving their positions essentially unchanged since 2010. Meanwhile, the rest of the world is experiencing only sluggish recovery since 2010, leaving the world economy in a state not markedly different from two years ago in terms of growth rates (IMF 2012).

Second, SP projections are most of the times revised downwards as new data becomes available. The cautious forecasts of IMF and EC and the revisions in their own forecasts only months apart indicate that the current SPs might yet again project overly optimistic growth. Finally, with the first conclusion about the macroeconomic situation not being markedly different from when the previous SPs were written, this allows to conjecture that these years' SPs projections will again have to be revised downwards, since they also continue to prescribe the same policies as before: austerity and fiscal deficit reduction instead of trying to address the other structural imbalances, e.g. the CA imbalances.

5. Past financial balances analyses – borne out by the evidence?

Before moving on examining the current SPs in depth, we briefly contemplate how the past two such analyses (Brecht et al. 2010 and Semieniuk et al. 2011) have held up against subsequent actual developments.

Brecht et al. concluded that the optimistic growth projections of the 2010 SPs combined with fiscal consolidation implied a private demand boom that coincided with entrenched CA imbalances. The financial balances showed that according to the projections private sector would be forced to accept low and negative savings rates in CA deficit countries, threatening renewed financial instability. Moreover, failure to achieve the upward shift of the euro area CA, which was optimistically predicted in the SPs of 2010, would even further hinder the achievement of growth rates and fiscal consolidation in the euro area. Focusing on Germany,

Brecht et al. suggested that continued growth would be ensured only by acceptance of larger public deficits, since the private demand boom projected in Germany for the period 2010-2013 and driving its growth seemed unrealistic and unprecedented in recent German history. German growth has previously been driven by exports.

A year on, new data and SPs showed that while fiscal consolidation was more or less done according to plan, the growth rates could not be maintained. Some CA deficit countries – Ireland, Portugal, Spain – had lowered their projections of GDP growth and thereby also of their CA deficits. Those CA deficit countries still projecting high growth - France and Italy – had corrected the CAs downward and implicitly their private financial balances, forecasting instability. On the flipside, surplus countries continued to run large surpluses. Hence, for the CA-deficit reducing countries the argument that growth would falter in the face of asymmetric balancing was borne out by the evidence. German growth data was very high in 2010 – while the medium-term forecast was corrected slightly downward.

In the next analysis instalment with new evidence at hand, Semieniuk et al. argued that there was a shift perceptible towards France and Italy becoming the new high CA deficit, low private savings countries. They would need to rely on unlikely private demand booms in the future to sustain growth, unless these countries, too, would change their forecasts. France, Italy and the CA surplus countries retained growth prospects and fiscal consolidation targets. The rebalanced forecast in Ireland, Portugal and Spain had been “bought” at the cost of lower growth: lower domestic income vis-à-vis the rest of the world improves the trade balance other things equal. Semieniuk et al. also maintained that the growth rates over the medium-term in Germany would be too optimistic, absent more fiscal activity in an attempt at symmetric rebalancing of external imbalances. This argument rested on the assumption that the deteriorating climate in CA deficit countries, which struggle with rebalancing on their own would eventually also depress economic activity in Germany, which ships some 40 pc of

its exports to euro area countries. Finally, they warned of too optimistic forecasts of euro area CA improvement without which the balances would be even more destabilizing.

Another year on, the newest data shows that all deficit countries in the absence of public demand and with tepid private demand have reduced their growth forecasts. This is the price of fiscal rebalancing or austerity, while fiscal targets are not achieved (see Box 1 above for Spain's case). Surplus countries save Austria and Germany have also revised their growth rates downwards. France and Italy are now also forecasting their CA to improve. As a result asymmetric rebalancing of CAs takes place. All this is in line with Semieniuk et al. predictions. However, the euro area CA did improve significantly as the SPs projected. Strikingly, also, Germany still enjoys high growth rates, including strong domestic demand, whose growth contribution even surpasses previous forecasts; it is unclear, of course, whether this persists into the medium-term.

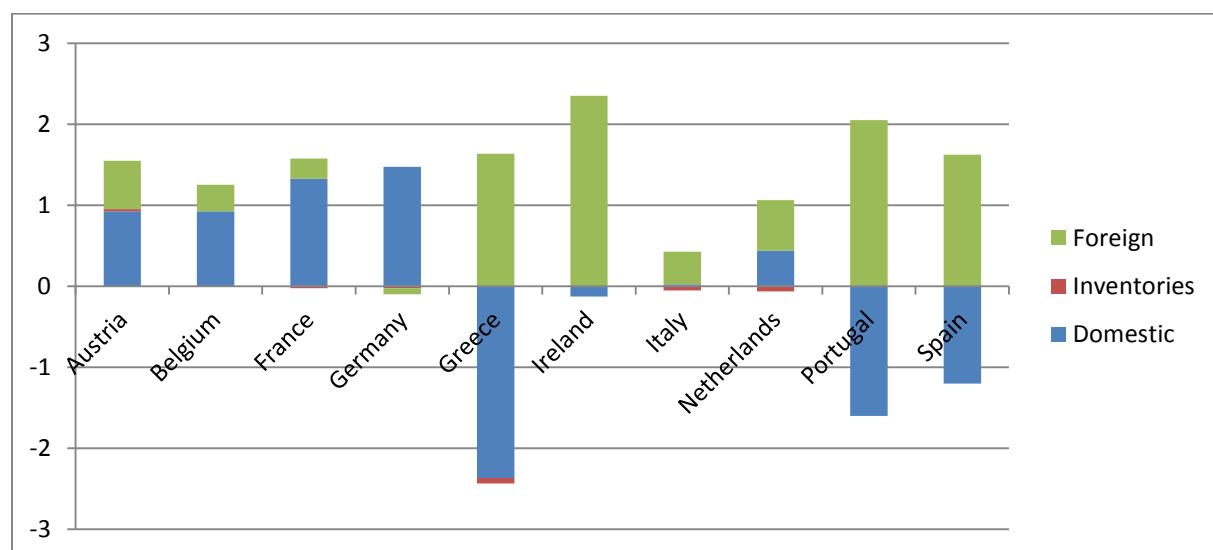
In conclusion, the previous analyses provide a good explanation of how three financial balances are important for the evolution of each of them. This illustrates why a focus on the fiscal balance alone is insufficient, as the euro area countries economic developments are linked through the common currency, which is reflected in the CA imbalances; and as private balances are an important determinant for whether balanced public spending is not merely the flipside of an unstable private demand boom. They also provide a good explanation why overall euro area recovery is unlikely with only little additional theory (namely that the pressure for asymmetric rebalancing of CAs ultimately results in low growth, see Appendix 1 on desired and actual balances). However, they are less accurate in making statements about particular countries. This is due to the large number of degrees of freedom in the accounting identities system of equations, and the lack of including more specific economic conditions in different countries. The present analysis will heed this by making only statements about the euro zone or the groupings of CA deficit surplus of deficit countries.

6. Analysis of the 2012 stability programme forecasts.

6.1. Inspection of the stability programmes taken together.

This year's SPs provide prognoses of macroeconomic variables for the years 2012 through 2015. As has already been discussed in section 4. 1. the growth rate forecasts in these programmes are very subdued (black lines in Fig. 2). The euro area is predicted to undergo a mild recession in 2012 and to grow at 1.5 and 1.6 pc in 2014 and 2015, the medium-term forecast. This medium-term growth forecast is much lower than in previous programmes, by 0.4 and 1.3 pc vis-à-vis the 2011 and 2010 programmes. Austria, Belgium, France and Germany mostly project to grow via domestic demand (Fig. 5). The Netherlands has growth contributions evenly split between domestic and foreign sector. Ireland, Greece, Portugal and Spain predict growth exclusively via net exports and suffer from a domestic contraction of 1.5 to 2 pc of GDP.⁷

Figure 5: Average contributions to growth of foreign and domestic sectors 2012-2015.



Source: SPs of 2012. Data for Greece only until 2014.

⁷ Refer to footnote 4 for the focus only on a subset of euro area countries.

The financial balances' movement has already been discussed in section 4.2. Table 1 and Table 2 show the balances cross sections for 2011 and 2015. An additional remark on each balance is in order. The foreign financial balance in the leftmost column shows that in terms of actual volumes, Germany and Netherlands make up the bulk of CA surplus, whereas France, Italy and Spain divide up the deficit amongst themselves in 2011 (Table 1). Four years later (Table 2), Germany and Netherlands as a whole have reduced their surplus by only roughly 4 billion euros, whereas the deficit countries have improved their CA deficit by about 100 billion euros. This is asymmetric rebalancing. Thus the eurozone financial balance moves from -0.31 pc of eurozone GDP to -1.62 pc. The subsequent simulation will adumbrate how a lack of improvement would impact balances.

Second, unlike in the previous SPs the private financial balances do not move far into negative territory in the medium term. That is a consequence of all countries projecting a reduction of net foreign borrowing, the flipside of the private financial balance given the rigid fiscal balance trajectories.

Third, there is a bifurcation into countries that forecast a public balance of no more than one percent in 2014, Austria, France, Germany, Portugal, Spain, and those that merely meet the three per cent criterion: Belgium, Netherlands, Ireland. Italy is in between. Greece is still in deep deficit.

Table 1. Financial balances 2011. In billions, as pc of national GDP, as pc of euro area GDP.

2011	Balances (bill. €)			Balances (pc of GDP)			Bal. (pc of eurozone. GDP)			GDP
	Public	Foreign	Private	Public	Foreign	Private	Public	Foreign	Private	
Austria	-7.8	-5.1	12.9	-2.6	-1.7	4.3	-0.1	-0.1	0.1	301.1
Belgium	-13.7	-7.4	21.0	-3.7	-2.0	5.7	-0.1	-0.1	0.2	369.3
Cyprus	-1.1	1.8	-0.7	-6.3	10.4	-4.1	0.0	0.0	0.0	17.8
Estonia	0.2	-1.1	0.9	1.0	-7.0	6.0	0.0	0.0	0.0	15.6
Finland	-1.0	0.6	0.4	-0.5	0.3	0.2	0.0	0.0	0.0	191.4
France	-	51.9	51.9	-5.2	2.6	2.6	-1.1	0.6	0.6	1996.6
Germany	-25.7	-136.3	162.0	-1.0	-5.3	6.3	-0.3	-1.4	1.7	2570.9
Greece	-20.0	17.9	2.2	-9.3	8.3	1.0	-0.2	0.2	0.0	215.3
Ireland	-20.5	-0.2	20.7	-13.1	-0.1	13.2	-0.2	0.0	0.2	156.5
Italy	-61.5	48.9	12.6	-3.9	3.1	0.8	-0.7	0.5	0.1	1576.5
Luxemb.	-0.3	-2.9	3.2	-0.6	-6.8	7.4	0.0	0.0	0.0	42.8
Malta	-0.2	0.1	0.0	-2.7	2.3	0.4	0.0	0.0	0.0	6.4
Netherlands	-28.4	-42.3	70.6	-4.7	-7.0	11.7	-0.3	-0.4	0.8	603.7
Portugal	-7.2	8.7	-1.5	-4.2	5.1	-0.9	-0.1	0.1	0.0	171.1
Slovakia	-3.3	-0.9	4.2	-4.8	-1.3	6.1	0.0	0.0	0.0	69.0
Slovenia	-2.3	0.2	2.1	-6.4	0.6	5.8	0.0	0.0	0.0	35.6
Spain	-91.2	36.5	54.7	-8.5	3.4	5.1	-1.0	0.4	0.6	1073.4
Sum	-21.5	-1.6	23.2				-4.1	-0.31	4.4	9412.9

Source: SPs of 2012. AMECO (May 2012) data for Luxembourg's and Slovenia's foreign financial balance.

We have already mentioned in section 4 that the 2012 data set might fail to match the projections so that the next SP batch would again have to revise downwards its forecasts.

Now we point out three potential inconsistencies in the current SP macroeconomic forecasts

Table 2. Financial balances 2015. In billions, as pc of national GDP, as pc of euro area GDP.

2015	Balances (bill. €)			Balances (pc of GDP)			Bal. (pc of eurozone. GDP)			GDP
	Public	Foreign	Private	Public	Foreign	Private	Public	Foreign	Private	
Austria	-2.0	-9.2	11.2	-0.6	-2.7	3.3	0.0	-0.1	0.1	339.5
Belgium	-12.6	-10.9	23.5	-3.0	-2.6	5.6	-0.1	-0.1	0.2	419.6
Cyprus	0.0	1.0	-1.0	0.0	5.0	-5.0	0.0	0.0	0.0	19.9
Estonia	0.1	0.2	-0.2	0.5	0.8	-1.3	0.0	0.0	0.0	19.1
Finland	0.0	-0.4	0.4	0.0	-0.2	0.2	0.0	0.0	0.0	223.9
France	-22.7	36.4	-13.6	-1.0	1.6	-0.6	-0.2	0.3	-0.1	2274.4
Germany	0.0	-121.3	121.3	0.0	-4.3	4.3	0.0	-1.2	1.2	2854.4
Greece	-16.4	7.0	9.4	-7.7	3.3	4.4	-0.2	0.1	0.1	213.1
Ireland	-5.0	-6.6	11.6	-2.8	-3.7	6.5	0.0	-0.1	0.1	178.6
Italy	-22.0	22.0	0.0	-1.3	1.3	0.0	-0.2	0.2	0.0	1692.7
Luxembourg	-0.9	-3.3	4.3	-1.8	-6.5	8.3	0.0	0.0	0.0	51.4
Malta	0.0	0.0	0.0	-0.3	-0.2	0.5	0.0	0.0	0.0	7.6
Netherlands	-24.9	-54.8	79.8	-3.8	-8.3	12.0	-0.2	-0.5	0.8	664.7
Portugal	-1.8	-5.7	7.5	-1.0	-3.1	4.1	0.0	-0.1	0.1	183.8
Slovakia	-1.4	-1.9	3.3	-1.7	-2.3	4.0	0.0	0.0	0.0	83.7
Slovenia	-0.2	-0.4	0.6	-0.4	-1.1	1.5	0.0	0.0	0.0	39.6
Spain	-12.7	-20.8	33.5	-1.1	-1.8	2.9	-0.1	-0.2	0.3	1156.8
Sum	-6.8	-9.4	16.2				-1.2	-1.62	2.8	10422.8

Source: SPs of 2012. SP value of 2014 used for Greek public & foreign financial balance and IMF value used for the foreign financial balances, Luxembourg and Slovenia.

as seen through the financial balances lens that might be responsible for why they won't be matched by the actual 2012 data.

Inconsistency 1: First, over the last three SP periods we have seen repeated downward corrections of growth forecasts in an environment of fiscal austerity in several CA deficit

countries. At the same time, reaching the public deficit target has officially been postponed (Greece, Spain) or might still be postponed, e.g. in France or Netherlands. The EC and IMF forecasts confirm that the current growth forecasts can only be achieved with larger public deficits, and the IMF openly criticizes this “frontloaded” fiscal consolidation approach (IMF 2012. 55). But if public deficit reduction is attempted at all costs, as has hitherto been done, growth falters and ultimately leads to failure to achieve the initially planned public deficit anyway. The stark reduction of growth rate forecasts over the three SP batches with simultaneous deterioration of public balances testifies to this failed strategy of “austerity”. As the SPs stand now, they prescribe more austerity, which is likely to lead to even less growth (recession) and yet no fiscal consolidation. The self-reinforcing nature of this process might lead to a spiral of spending cuts and ever shrinking GDP, a depression, in the whole euro area. In this situation, the fiscal compact would only exacerbate the process by toughening the demands on public deficits, regardless of assurances from EC officials that the compact is flexible and tailored to countries’ needs (Buti 2012, Rehn 2012).

Inconsistency 2: Second, the forecast of growth and fiscal consolidation rests on the assumption of well-performing export markets and a rising euro area CA. If the warnings about a slowdown in the global economy at the time of writing are true, the euro area CA might not perform as hoped for, which is already indicated in the WEO forecast. In that case, to achieve the growth and fiscal consolidation projected in the SPs, the domestic private sector would have to be vibrant enough to replace the demand for products which the rest of the world lacks. But the euro area economies are themselves teetering on the edge of recession and an uptick in the domestic private demand seems unlikely (compare again the negative or zero domestic contribution to growth in several countries in Fig. 5). Our very simple simulation below illustrates this. It calculates required average private domestic contribution to growth, if foreign demand is less than projected over the next four years.

Inconsistency 3: There is now a lack of confidence in the single currency and open debate about its breakup. The political and economic “downside risks” of such a “shock” are not factored into the SP forecasts. In the event that the currency breaks apart or, say, a mismanaged rescue of Spanish overindebted banks brings down the financial system, the SPs’ forecasts can be discarded. For musings about breakup consequences, see for instance Cliffe (2011), Wolf (2012) or Rodrik (2012).

While we continue with our simulation, we comment in Box 2 on the whether the European institutions have a different take on the macroeconomic imbalances than the SPs.

Box 2: European Institutions: addressing stability programme inconsistencies?

In this box we assess whether the European institutions are more aware of the interlinkages of the financial balances and take them into account when suggesting policies for member states and reviewing their SPs. For that purpose we review first the new report of Macroeconomic Imbalance Procedure (MIP) by the EC, and second the EC’s working paper for the eurozone countries (EC 2012e) and the Council recommendations for member states policies based on the EC’s assessment of the SPs (ECOFIN 2012j).

1) The Macroeconomic Imbalance Procedure.

The Macroeconomic Imbalance Procedure (MIP) promises to widen the scope of relevant variables for policy making. It compiles ten indicators of imbalances in a scoreboard. Five are external indicators: CA balance, net international investment position, real effective exchange rate, export market share, unit labor costs. And five are internal indicators: house price index, private sector debt, private sector credit flows, general government debt, and the unemployment rate. Thresholds for maximal levels or yearly changes in these variables are imposed (EC 2011a). If a country breaches too many thresholds, the EC identifies imbalances in its annual report by using the scoreboard. Subsequently it conducts an in-depth review in that country.

The new indicators establish a broader fundament on which to assess the economic situation, just as we aim to do in our analysis. Except for the growth rate, the scoreboard includes the additional economic magnitudes omitted in the SPs, that we are chiefly concerned with in our analysis (foreign and private financial balances). Moreover, inclusion of the net international investment position and private sector debt are useful additions to assess the overall debt position of a country. As unit labor costs largely determine the real exchange rate behavior within Europe due to little fluctuation in the nominal exchange rate (EC 2012b. 37), their inclusion might yield an explanation of some CA developments.

It remains to be seen whether this fundament is also interpreted in a way that makes use of the additional information. The first MIP report (EC 2012a) from February casts doubt on this. It finds imbalances only in eurozone countries that have CA deficits in 2011: Belgium, Cyprus, Finland, France, Italy, Slovenia, Spain (according to the Balance of Payments statistics, Belgium had a negative CA balance in 2011⁸). Greece, Ireland and Portugal are not reviewed because they are already monitored by means of their adjustment programmes. The in-depth recommendations for the countries in which imbalances were identified, expressed in separate documents published in May, almost uniformly recommend wage moderation and reducing of taxes on labour and capital, in order to increase competitiveness (EC 2012g). Efforts to consolidate the public balance are frequently mentioned. This is supposed to boost net exports according to panel data estimates (EC 2009, 29). Taken together, these measures threaten to eclipse demand and thereby growth in these economies. But this might in turn frustrate the consolidation and reform efforts as we argue in “Inconsistency 1” above.

Nowhere is symmetric rebalancing addressed. Germany and the Netherlands escape the imbalance in-depth review thanks to a generously high threshold for positive CAs at 6 pc of GDP. In fact, the only external threshold breached by both countries is the “change in export market share”. This indicates that Germany and Netherlands should aim at boosting their exports so as reduce the share loss.⁹ Sweden, the only European (but non-eurozone) CA surplus country reviewed in depth has a CA of above 7 pc, but the EC concludes this is not a considerable imbalance, perhaps justified outside a monetary union. Yet, if this is any indication of how the EC treats CA surpluses in its MIP, it has to be concluded from all of the above that the MIP will not add any momentum to tackling the eurozone external imbalance problems with concerted, symmetric action.

So the MIP hardly identifies the three potential inconsistencies that we list in section 5.1. Inconsistency one arises from considering foreign and fiscal balances together with growth rates. But the scoreboard only looks at foreign balance and hence is not alerted to the fall in growth going hand in hand with the consolidation efforts. Nor is the fall of aggregate demand due to wage constraints and fiscal consolidation a concern. The second (unrealistic CA evolution) and third (future policy failure) inconsistencies cannot be identified because the scoreboard is a backward-looking mechanism, not taking into account expectations.

Apart from that, it is remarkable that the EC announces the in-depth reviews to be the main analytical tools for imbalance evaluation (EC 2012a, 1). But these country-level exercises once again avert their gaze from euro area-wide developments, making the imbalance procedure further susceptible to overlook the cause for symmetric policies.

⁸ For further discussion of the discrepancies between Balance of Payments and National Accounts statistics of the CA due to different compilation methods see EC (2012a: 7) and references therein.

⁹ It appears the „export market share“, which measures a country’s exports as a share of world exports, is an unhelpful indicator in this context, due to denominator effects: If trade increased due to regional trade treaties elsewhere, this would increase the volume of world trade within that region without the eurozone countries’ participation. Also, if countries elsewhere grew much faster than in Europe, it would be expected that their export volume grows faster than in Europe. An indicator that measures export share change relative to change in GDP or with respect to other European countries might be more indicative of actual imbalances, focusing attention on changes in the numerator, i.e. on the actual change in exports of the country under consideration.

2) Working papers and Council recommendations.

The EC working paper for the euro area as a whole has a separate section on imbalances (EC 2012e. 12-23). It and the unprecedented section on imbalances in the EC spring forecast 2012 may be said to be an indirect positive effect of the MIP institution by generally bringing imbalances to attention. But unlike the MIP, the working paper actually addresses the current account surplus and the ability of some sovereigns to forfeit fiscal consolidation for boosting growth in the near-term.

The encouraging passages first regard the fiscal consolidation. Countries which are not in danger of seeing their borrowing costs surge are argued to “fully let their automatic stabilizers play along the structural adjustment path” (ibid. 10). The paper further recommends growth-enhancing expenditure for solvent governments, e.g. productive investment promoting policies (ibid). This is a marked difference from the analogous document from the previous year, which solely identified needs for further fiscal tightening measures (EC 2011b. 5).

On external deficits, while the working paper does not speak of active symmetric rebalancing, it does mention that in the case of Germany, the high CA surplus could be the mirror-image of “lower than necessary [domestic] living standards” (ibid. 18). Moreover, it adumbrates the need for symmetric rebalancing in a passage that warns that “the euro area as a whole faces a double challenge of rebalancing and strengthening growth in the medium and long term” (ibid. 19).

The Council recommendation for the euro area reflects these concerns. It emphasizes growth-enhancing expenditure to contain the fiscal consolidation’s negative growth impact (ECOFIN 2012d. 4). The Council explicitly recommends symmetric rebalancing: “surplus countries can contribute to rebalancing by removing unnecessary regulatory and other constraints on domestic demand, non-tradable activities and investment opportunities” (ibid. 5).

Given these perspicacious analyses and recommendations at the eurozone level, it comes as a disappointment that the country-level EC working papers and the drafts for the Council country-level recommendations, based on the working papers, do not dovetail with the Council’s euro area recommendations. The Council’s recommendation for Germany and Austria, the countries that might be best placed to make growth expanding expenditure, only emphasize further fiscal consolidation. The recommendation to emphasize growth enhancing measures exhausts itself in additional spending on education and research (ECOFIN 2012e. 10). The recommendations for Austria actually only discuss additional expenditure cuts (ECOFIN 2012f. 6). The recommendations for the Netherlands come closer to what is proposed at euro area level, but still remain far off: the Netherlands are advised to slash expenditure only in areas where growth is least hurt (ECOFIN 2012c. 10), and to foster private (sic!) investment in R&D (ibid. 11).

Mentioning of symmetric rebalancing, so clear in the euro area recommendation, is completely absent at country level. Here the Council falls back on the asymmetric stance of spurring CA deficit countries to improve their competitiveness. Examples include Italy (ECOFIN 2012g. 8), Spain (ECOFIN 2012h. 10) and Portugal (ECOFIN 2012i. 9).

6.2. Simulation of euro area current account constraint.

We conduct a very simple simulation to grapple with potential consequences of the second potential inconsistency: too much reliance on imports by the rest of the world. We calculate what the domestic private sector demand growth contribution would have to be in eurozone countries over the period 2012-15 on average, if the eurozone collectively failed to improve its CA in that period, *but growth rates and public financial balances were still to achieve SP projections*. Our simulation is very simple because we assume that a drop in the CA – entirely caused by the trade balance – is offset by a drop of similar size in the private financial balance, and all other things remain unchanged. By deflating the resulting change in net exports and by calculating the public growth contribution from deflating the growth of government spending, we deduce the private growth contribution as the residual (see appendix 2 for a mathematical formulation of the simulation setup).

We compute two scenarios. Both constrain the euro area foreign financial balance to -0.31 pc of its GDP, its value in 2011, for each year till 2015. This is in contrast to the SP forecasts, where it improves to -1.62 pc. We spread the adjustment over the CA surplus countries in the first scenario, and over the CA deficit countries in the second scenario. Surplus countries are Austria, Belgium, Germany, Luxembourg and the Netherlands. Deficit countries are France, Greece, Italy, Portugal and Spain. The adjustment weight of each country is proportional to the size of its foreign financial balance in 2011. The results are shown in Table 3.

In the surplus country adjustment scenario, the five countries adjust their financial balances downwards. Accordingly, their average growth contribution from net exports falls, but since the planned growth rate is achieved and the fiscal consolidation goes ahead, their average private contribution surges to compensate for the growth gap. The Netherlands' CA drops 4.5 pc over four years, average private growth contribution jumps 1.1 pc to 2.7 pc of GDP. Germany's CA balance drops 3.4 pc, its average private growth contribution rises 0.8 pc to

2.8 pc of GDP. Historically private growth contributions have been below 1 pc, also in the Netherlands (see Fig. 1). This suggests that a more active government could help bolster growth in the absence of strong private demand. While the Netherlands is struggling to meet its SGP target and the Council calls the Netherlands projections optimistic (ECOFIN 2012c. 5), Germany is not prevented by any EU rules to increase its spending. In fact, the EC just recommended Germany's excessive deficit procedure be terminated (EC 2012d).

The surplus adjustment scenario can also be examined for the consequences of symmetric CA rebalancing, where surplus country CAs would drop similarly. If surplus countries were willing take action to encourage reduction of their CA surpluses (e.g. by higher wages as suggested by the German finance minister), growth could be upheld by higher fiscal deficits in the near future. Moreover, if the current account is not constrained, the symmetric rebalancing should be even less painful for surplus countries.

The deficit country adjustment scenario sees the re-emergence of large CA imbalances. The deficit countries would need to muster elevated private demand (by between 0.5 and 1.8 pc more growth contribution) each year to grow at the rate they forecast. If this fails to materialize, their fiscal consolidation plans would be jeopardized or else growth would falter, leading automatically to larger fiscal deficits, too, since the denominator of the deficit (net government lending *per* GDP) expenditure would shrink. Clearly, this would destabilize the already fragile eurozone further, since no private demand on the required scale can realistically be expected. This simulation disregards more complicated interlinkages of the CA balance with other economic variables and the specific trade relationships. Yet, if no symmetric rebalancing is attempted and the external economic climate does not improve as forecast, the deficit adjustment scenario looks not entirely unrealistic. Hence, the assumption that the currency union's external balance improves is a crucial one in the forecasts' assumptions.

Table 3: Simulation Results: Adjusted financial balances in 2015 and sectoral growth contributions averaged over 2012-2015.

	Surplus Countries Adjust (light grey)						Deficit Countries Adjust (dark grey)					
	Balances in 2015			Growth Contrib. Avg 2012-15			Balances in 2015			Growth Contrib. Avg 2012-15		
	Public	Private	Foreign	Public	Private	Foreign	Public	Private	Foreign	Public	Private	Foreign
Austria	-0.6	2.2	-1.6	-0.8	2.3	0.0	-0.6	3.3	-2.7	-0.8	2.0	0.3
Belgium	-3	4.3	-1.3	-0.9	2.2	-0.1	-3	5.6	-2.6	-0.9	1.9	0.2
Cyprus	0	-5.0	5.0	-1.6	1.0	1.2	0	-5.0	5.0	-1.6	1.0	1.2
Estonia	0.5	-1.3	0.8	-1.3	6.0	-1.8	0.5	-1.3	0.8	-1.3	6.0	-1.8
Finland	0	0.2	-0.2	-1.2	2.7	0.1	0	0.2	-0.2	-1.2	2.7	0.1
France	-1	-0.6	1.6	-1.0	2.4	0.2	-1	-2.5	3.5	-1.0	2.9	-0.3
Germany	0	0.8	-0.8	-0.4	2.8	-1.0	0	4.3	-4.3	-0.4	2.0	-0.2
Greece	-7.7	5.3	2.4	-1.0	-0.5	1.5	-7.7	-1.8	9.5	-1.0	1.3	-0.3
Ireland	-2.8	6.5	-3.7	-0.9	2.2	0.9	-2.8	6.5	-3.7	-0.9	2.2	0.9
Italy	-1.3	0.0	1.3	-1.0	0.5	0.4	-1.3	-2.4	3.7	-1.0	1.1	-0.2
Luxemb.	-1.8	4.3	-2.5	-0.5	4.1	-0.9	-1.8	8.3	-6.5	-0.5	3.0	0.1
Malta	-0.3	0.5	-0.2	-1.1	2.5	0.6	-0.3	0.5	-0.2	-1.1	2.5	0.6
Netherl.	-3.75	7.5	-3.7	-1.2	2.7	-0.8	-3.75	12.0	-8.3	-1.2	1.6	0.4
Portugal	-1	4.1	-3.1	-1.1	-0.4	2.0	-1	0.1	0.9	-1.1	0.6	1.0
Slovakia	-1.7	4.0	-2.3	-1.2	3.7	0.3	-1.7	4.0	-2.3	-1.2	3.7	0.3
Slovenia	-0.4	1.5	-1.1	-0.9	1.7	0.4	-0.4	1.5	-1.1	-0.9	1.7	0.4
Spain	-1.1	2.9	-1.8	-1.5	0.7	1.3	-1.1	0.2	0.9	-1.5	1.3	0.6
Eurozone	-1.2	1.5	-0.3				-1.2	1.5	-0.3			
Source: Underlying values from SPs of 2012 and AMECO for public sector growth contributions; authors' simulation (see appendix 2 for method).												

7. Discussion.

Based on the simple accounting identity of the financial balances in an economy, we have examined whether there is evidence in the national accounting data of the past few years and the projections of the SPS, that the focus on fiscal deficits to the exclusion of other economic magnitudes risks further deterioration of the euro area economy. First we have analyzed SPs from 2010 to 2012 and compared them to IMF and EC forecasts as well as the real data that has emerged since. Second we have scrutinized the current SPs and suggested what might be inconsistencies in them that are the reason for overly optimistic forecasts. We have found that the macroeconomic situation is largely similar to that in 2010 and that under the policy prescription of fiscal austerity to reach the 3 pc public deficit target the growth rate forecasts have usually been revised downwards over the past two years. Meanwhile asymmetric rebalancing of the CA is taking place and in CA deficit countries fiscal consolidation is postponed further into the future. Due to the similar macroeconomic situation, we conjecture that this year's SPs are likely to forecast too high GDP growth again. This also implies a failure to achieve fiscal balance targets since they are measured relative to GDP, and a further downward revision of forecasts in next year's SPs. Moreover, if our conjecture from Appendix 1 about the negative effect on growth of a mismatch in desired balances is correct, then the ex post balancing of the accounting identity through asymmetric, undesired CA rebalancing shrinks growth in CA deficit countries. Finally, our simple simulation reveals that symmetric CA rebalancing efforts might be more easily accommodated than asymmetric rebalancing, if such symmetry can be coordinated by appropriate policies.

Additionally, our analysis in Box 2 finds that the EU institutions have an ambiguous stance on the SPs focus on fiscal rebalancing. The new macroeconomic imbalance procedure does not yet convincingly identify potential inconsistencies in fiscal plans stemming from external balances. However, it does direct attention to the external imbalances. The Council

recommends symmetric rebalancing and growth enhancing investment in its euro area-wide recommendations, but does not carry these recommendations to country-level comments.

Our overall conclusion is that a financial balance-based analysis finds that the current austerity measures, which are the mainstay of returning to “stability” are the wrong medicine for the eurozone crisis. We use no elaborate economic theory to arrive at policy conclusions, omit financial instability and country-specific economic factors. Thus we cannot make sharp predictions, which might not prove too reliable in the insecure environment anyway. But our analysis permits the qualitative argument that if governments want to escape recession and prolonged stagnation, they should consider all financial balances in lieu of focusing only on fiscal deficits. While reform policies in individual countries are of course an important ingredient for achieving the monetary union stability through economic homogeneity, these reforms should be accompanied by symmetric action on reducing external imbalances, where different countries pursue different policies according to their economic situation.

Encouragingly, the European Union institutions this year make some of the same recommendations in their euro area wide documents.

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Appendix 1: Financial balances.

Our analysis rests on two accounting identities:

$$(1) \text{Public sector financial balance} + \text{private sector fin. bal.} + \text{foreign sector fin. bal.} \equiv 0.$$

$$(2) \sum_i \text{foreign sector fin. bal.} \equiv 0, i \in \text{the set of national economies.}$$

(1) means, any of the three sectors in an economy can only run a deficit if at least one other sector runs a surplus. According to (2), one country can only run a foreign surplus if at least one other country runs a foreign deficit. The public financial balance is equal to tax revenues minus government spending. It is frequently negative and we will often refer to it as the public deficit. The private financial balance is the net lending of the households and firms combined and is positive if lending is greater than borrowing. The foreign financial balance is equal to minus CA balance minus capital transactions ($CA = -(FFBal + Cap. Acc.)$). In the International Monetary Fund (IMF) terminology, it is equal to the financial account of the balance of payments (IMF 2009: 216).

It is important to distinguish between desired and actual balances. While desired balances can sum to any number, actual balances will – by some adjustment mechanism which can be conjectured about with economic theories – eventually always sum to zero. Our conjecture about adjustment runs as follows: balances ultimately balance through a GDP adjustment. An example illustrates: In a hypothetical country A, the government might wish to reach a 3 per cent deficit target under the SGP. The private sector may wish to accumulate savings to the tune of 5 per cent of GDP due to an uncertain economic environment. This can only be fulfilled if the foreign sector acquiesces into borrowing fund equal to two per cent of the country's GDP. In other words, the country, which has a small capital account and insignificant net foreign incomes and transfers, must achieve strong export relative to other countries and have a CA surplus close to two per cent of GDP.

The actual balances may of course work out to exactly these numbers. But suppose foreign borrows less perhaps because its imports were weak in the mentioned uncertain economic climate and the CA just balances. Then either government needs to expand its deficit or the private sector is forced to save less or both to meet somewhere between three and five per cent. One way to achieve this would be for

growth to be less than forecast and therefore households and firms having less income to deposit in savings. Most likely, government's deficit would surge as well, however, due to automatic stabilizers whose size grows in a slower growth environment. Thus the actual balances would sum to zero.

Appendix 2: Mathematical simulation setup.

The simulation is a very simple comparative statics exercise. The exogenous variables are growth rates and public balance of the seventeen eurozone countries and the euro area foreign financial balance.

The latter is also the one, whose value we change to obtain comparative statics. Each country's foreign financial balance is an endogenous variable. Since the private financial balance is the residual, it changes also.

In mathematical terms we have for each country:

$$(1) \quad PuB_{2015}^i + FB_{2015}^i = -PrB_{2015}^i, i = 1, \dots, 17.$$

PuB_{2015}^i is the public financial balance of the i^{th} country in 2015, FB is the foreign balance, PrB is the private balance. The sum of the foreign financial balances add up to the euro area (ea) foreign financial balance.

$$(2) \quad FB_{2015}^1 + FB_{2015}^2 + \dots + FB_{2015}^{17} = FB_{2015}^{ea}$$

If we change FB_{2015}^{ea} , then FB_{2015}^i have to change. We restrict the change to a subset of the seven countries, either surplus or deficit countries and thus create our two scenarios. The adjustment weights are proportional to the size of the balance (in Euros) of the adjusting countries.

In addition, we deduce the sectoral growth contributions, using forecasts about government spending and price developments from the SPs. We calculate the arithmetic average of public sector contribution to growth, Pug^i , over the forecast period based on projected growth of general government expenditure.

$$(3) \quad Pug^i = \frac{1}{4} \sum_{t=2012}^{2015} \frac{G_t^i - G_{t-1}^i}{GDP_{t-1}^i},$$

where government expenditure, G_{2011}^i , is retrieved from AMECO, and GDP_t^i is the real gross domestic product whose price index is 100 in the year 2011. The change in prices is taken from the SP forecasts. We calculate the change in expenditure using the SPs' forecast growth rate of government consumption only, since there is no forecast for total government expenditure available.

We calculate the arithmetic average of net export contribution to growth, Fg^i , over the forecast period based on changes in the foreign financial balance. Hence we assume that all changes in the balance are attributable to changes in exports. While this is not always the case (notably in Ireland), for most countries it is a good approximation and it allows us to determine the approximate growth contribution directly from the balances.

$$(4) \quad Fg^i = \frac{1}{4} \sum_{t=2012}^{2015} \frac{FB_t^i/P_t^i - FB_{t-1}^i/P_t^i}{GDP_{t-1}^i},$$

where P_t^i is the price index by which also the real GDP is deflated (2011=100). Since both GDP and the balance thus start with nominal equal to real magnitudes in 2011 the deflation is consistent. We do not use export/import deflators, since we cannot determine from the change in the balance, which part is due to a change in exports and which is due to one in imports.

Then, with the growth rate, g_t^i , given, we calculate the average private growth contribution, $Pr g^i$ as the residual of the other sectors:

$$(5) \quad Pr g^i = \frac{1}{4} \left(\sum_{t=2012}^{2015} g_t^i - \frac{G_t^i - G_{t-1}^i}{GDP_{t-1}^i} - \frac{FB_t^i/P_t^i - FB_{t-1}^i/P_t^i}{GDP_{t-1}^i} \right).$$

Thus, by changing FB_{2015}^{ea} in (2) and determining the adjustment weights, we can solve for all balances and sectoral growth contributions.

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