Grant Proposal to the Coleman Fung Center

Current Account Imbalances as Asymmetric Competitiveness Shocks and Euro Zone Stability

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Nontechnical Summary

After the launch of the euro on January 1, 1999, large current account imbalances opened up among members of the new currency union. Greece likewise ran much larger deficits after its entry in 2001. European policymakers, however, took the position that these national surpluses and deficits were irrelevant, just as individual states’ deficits are of no significance (and not even knowable) in the United States currency union. The macroeconomic tests for admission to the euro, as spelled out in the 1991 Maastricht Treaty, covered government fiscal variables, exchange rates, and inflation, but not national current account deficits.

This perspective changed after the financial crisis of 2007-09, with the European Commission adopting a new “six pack” of surveillance criteria including current account balances. Yet the precise rationale for this intellectual shift, even in light of the ongoing euro zone crisis, remains unclear. Growing current account dispersion within Europe preceded the euro zone crisis, but does temporal precedence imply that euro zone national imbalances were an independent cause of subsequent financial turmoil?

In this proposal I will quantify the sense in which a pattern of large current account imbalances necessarily creates an adjustment problem within a currency union when wages and prices lack downward flexibility. The emergence of a large national deficit, say, is accompanied by relatively high domestic inflation, which lowers the domestic real interest rate, spurring spending and widening the deficit further. Ultimately,
however, the *real exchange rate* must fall below its initial level to enable the country to service, through net exports, a higher ultimate level of net external debt. But if the country uses the euro, the needed real depreciation requires domestic deflation (relative to trade partners), and hence in all likelihood a recession. This is the competitiveness problem euro zone peripheral countries now face. My project will explore the magnitude of the adjustment within calibrated dynamic models of euro zone economies, and assess quantitatively the degree of internal deflation required for long-term adjustment.