

From pain to gain on the EU frontier

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The first act of the eurozone debt drama was about whether any European Union member country could ever become insolvent. It ended when the highest EU authority, the European Council, officially recognised in late July that Greece does need a reduction in its debt obligations.

But that acknowledgement of reality does not end the drama. The second act will be about restoring growth prospects for the EU periphery, which will pose an even more difficult challenge.

The key problem is simple: until 2008, these countries enjoyed a long boom based on cheap and plentiful credit, which allowed them to finance large current-account deficits. But any import boom creates a misleading impression of the local economy's productive capacity.

Imagine a country that increases its imports of, say, cars and other consumer goods by 10% of its starting GDP. These goods are sold to local consumers via car dealers and a whole chain of traders and retailers. All of these intermediaries have costs that have to be paid by the local consumer, which flatters the national GDP statistics, because, technically speaking, all of these costs constitute value added in intermediation services. An import boom thus also leads to higher measured GDP growth.

How large is the induced growth in GDP from higher imports? The retail price is often more than twice the wholesale price paid by the importer. The local value added to imports could thus easily equal their value. This implies that an increase in imports of consumer goods equivalent to 10% of GDP could generate an increase in measured GDP of about 10% as well.

But the opposite is also true: when an import boom ends, measured GDP must drop considerably, because much less intermediation is needed. This fall in GDP, although a natural consequence of lower imports of consumption goods, is often mistakenly perceived as something to be avoided, because it seems to imply that output is below its 'potential'.

In a completely flexible economy, this drop in measured GDP (and the concomitant increase in unemployment) could be avoided if the resources formerly employed in selling imported consumer goods could quickly be used to generate exports. But retail shop clerks and car dealers cannot be easily transformed into the specialised and highly skilled workers needed in modern manufacturing. In the case of Greece and Portugal, for example, the tourism industry might absorb some unemployed retailers. But shops and showrooms cannot be transformed into tourist attractions, whose capacity will remain limited until enough time has passed to build new hotels, recreational facilities, etc.

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Given that Greece had a current-account deficit close to 10% of GDP in 2010, a drop in imported consumption goods of that magnitude seems to be needed before the country's external debt can be stabilised. But this would imply a further drop of measured GDP by about the same percentage (and a further substantial increase in unemployment). Even the most flexible economy in the world would take years to switch one-tenth of all of its factors of production from distributing imports to export-oriented activities.

The import boom in the United States was much smaller than that on the EU periphery, but the recent downward revision of US GDP can be seen through the same lens. An import boom creates only the illusion of economic strength.

How long will the adjustment take? Post-unification Germany experienced an import and construction boom that was similar to that of the EU periphery. For a few years, imports surged, and by 1995 a sizeable current-account deficit had developed. It took Germany ten years (until about 2005) of slow growth to reduce capacity in the construction sector and gain market share for its export industry. But Germany had no debt overhang to confront. Financial markets might not give the eurozone periphery that much time.

The three small Baltic EU members provide an alternative model: they had developed current-account deficits of over 20% of GDP during the credit boom, and over the last three years have experienced double-digit GDP contractions. But, because they now run current-account surpluses, they have fully adjusted and can resume growth, albeit naturally at a much slower pace than during the boom.

Could anything be done to accelerate adjustment in the eurozone's periphery? The official recipe is 'structural reform'. But, during a period of weak domestic demand, structural reforms might actually exacerbate short-term problems. Labor-market liberalisation would allow firms in the domestic sector to fire workers more rapidly, but would do little to encourage export-oriented firms to invest more and create more jobs, especially when the domestic banking system is under stress and cannot provide new credit. Moreover, the additional unemployment would lead to more social-welfare spending, thus increasing the need to cut elsewhere or increase taxes.

Governments in the eurozone's periphery, including Spain and Italy, now face a dilemma: they must undertake structural reforms to increase their long-term potential growth, but at the cost of even greater short-term pain. The debt crisis will end only when they have shown that they have understood this and accepted the inevitable sacrifices.