The Importance of Trade and Capital Imbalances in the European Debt Crisis

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Abstract

The European crisis has highlighted the role of intra-European payments imbalances for the survival of the EMU. Payment imbalances between the North and the South have contributed to the accumulation of large stock of foreign debt, while flows of foreign capital ceased to finance productive investments which might have contributed to debt repayments - preferring instead to finance consumption and a housing bubble. The dynamic interplay between current account imbalances and the accumulation of debt reveals that, once the system is driven into disequilibrium by a real exchange rate misalignment, the longer a payments imbalance persists the harder the eventual adjustment will be. Capital reversals, by shifting portfolio balances, lead the system toward instability, sovereign default, and the collapse of the exchange rate regime. Replacing private with public creditors may temporarily help us to stay away from the point where the system breaks down. But this is only a temporary expedient because the underlying imbalances need continued and escalating financing until equilibrium is restored by other means. One permanent solution is the ECB’s official monetary transactions program, if the potential expansions to the central bank’s balance sheet can be tolerated.

Keywords: External debt, trade space, real exchange rate adjustments, official financing, OMT

JEL Classifications: F32, F41, G12, H63

Revised, June 2013

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1. Introduction

In a decade the Economic and Monetary Union has been able to create increased trade space and to deliver both monetary policy credibility and price stability. On the other hand, its functioning has been hampered by serious flaws in institutional design. The asymmetry between the strength of the “monetary” pillar and the weakness of the fiscal and institutional framework has become apparent in the European debt crisis. In particular, the surveillance mechanism based on fiscal rules has failed to provide or enforce virtuous behavior.

Macroeconomic imbalances within the euro area - particularly those related to the external balances - add a further layer of difficulty. For example, introducing the euro allowed interest rates in the South to converge on the lower interest rates of the North, encouraging spending and credit expansion. This then generated an increase in borrowing in both private and public sectors and contributed to investment distortions, with overinvestment recorded in certain sectors such as real estate. Different demand patterns between the North, where there were no interest rate falls, and the South, where there were, created diverging inflation rates and a fast growing competitive advantage in the Northern Euro countries.

The interplay between current account imbalances and the implied accumulation of foreign debt can be described by a dynamic model of current account and portfolio balances. It is shown that if the system gets into disequilibrium, the longer the imbalances persist, the larger and more painful the eventual adjustment will be. This is because an accumulated stock of debt has to be removed, which will take a larger real depreciation in the debtor country than the real exchange rate adjustments needed to eliminate each underlying (flow) imbalance. Such large adjustments in real exchange rates may not be politically feasible if they have to be achieved via an internal devaluation (wage-price deflation) in the debtor countries. But a symmetric adjustment, that is a joint internal devaluation and revaluation by debtors and creditors, would cut the adjustments needed for each player by half.

Public interventions (loans, bailouts, haircuts, forced restructuring, liquidity injections) can also help to force the system away from the point where it breaks down. This is only a temporary expedient however (“kicking the can down the road”) because the imbalances will need continuing and increasing financing until an underlying equilibrium is restored.

It is true that current account deficits have now fallen in a number of countries. But this has been due to falling incomes, and hence lower imports driven by spending cuts and austerity measures, rather than price effects (nominal exchange rates are fixed). Therein lies part of the problem: operating on one side of the trade balance, current account deficits may have come down but not to zero or a surplus – which means (foreign) debt is still accumulating and the crisis continues. To make the point another way, recent work shows that capital reversals, external imbalances and losses in competitiveness are at least as important in explaining the debt crisis as fiscal irresponsibility itself (Alessandrini et al 2012). Hence, to understand

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2 The authors thank without implications William Cline, Joshua Aizenmann, Dong He, Tuan Khai Vu and an anonymous referee for helpful comments and suggestions.

3 See Viscogliosi (2011); also Bergsten and Kirkegaard (2012a and 2012b).

4 South is the following group of countries: Greece, Italy, Spain, Portugal, Ireland, Cyprus.

5 North comprises: Austria, Germany, Belgium, Luxembourg, Netherlands, France, and Finland.
which policy measures could be most useful for resolving the debt crisis, we need to model the interactions between current account and portfolio adjustments explicitly – in a framework that can show the effects of a change in incomes or relative prices.

Finally, the reversal of capital flows from North to South suggests that the self-equilibrating mechanisms which normally characterize an economically integrated area do not operate in the Eurozone. The fact that imbalances have brought about distortions and misallocations, instead of productive investment and growth, suggests that the integration process remains weak and incomplete. In this sense, the “fear of integration” that seems to characterize the underlying political debate in Europe, can be seen as one of the root causes of today’s problem. The European crisis should perhaps be seen as collateral damage from political disagreements over the real purpose of EMU and European integration.

2. Current account imbalances in the Euro-zone

Massive financial flows from North to South in the euro area brought about a buildup in internal imbalances. The debt overhang from the accumulation of debt from those imbalances year after year creates the potential for future financial market distress.

Before the crisis there was the presumption that “good imbalances” were desirable, for their association with a more rational and productive utilization of capital. This view reflected the Blanchard and Giavazzi hypothesis that the fall in the saving-investment correlation recorded before and particularly after the euro could be interpreted as a positive sign of increasing financial integration, with the capital flowing from the more advanced, capital-abundant economies to the less advanced, capital-scarce economies. This perception changed when the definition of “bad imbalances”, resulting from harmful underlying price distortions or capital reversals, turned out to describe the European situation better.

![Figure 1 - Current account imbalances in the euro area countries](source: Gros (2012)).

6 See Blanchard and Giavazzi (2002).
7 For a definition of “good imbalances” and “bad imbalances”; see Eichengreen (2010).
Figure 1 tells us that, following the adoption of the euro, the current account balances of the North and South euro areas started to diverge, with surpluses in the North clearly reflected in deficits in the South. These imbalances are the most striking indicator of the divergent macroeconomic patterns within the euro area, particularly as far as the differences between savings and investment are concerned. In the period between 2004 and 2008 in particular, a trend deterioration is apparent, reflecting the sharp declines in interest rates and the cost of capital which made borrowing and investment easier and brought about significant inflows of capital from abroad. It is also correlated with the diverging pattern of real exchange rates which has characterized the Euro Area since 2000. Indeed, while all member countries experienced a trend of real appreciation since the start, the process has been more pronounced for the Southern countries compared to countries such as Finland, France, and Germany.

Even if the imbalances have tended to reduce in recent years, the stock aspect of the problem (which includes valuation changes) remains a serious concern. Figure 2 shows that, at the end of 2011, the cumulative current account of the North stood at almost 2.3 trillion euro, while the cumulative current accounts of the South amounted to nearly 1.7 trillion euro, of which 1.4 trillion were run up by Greece, Portugal and Spain alone.

Figure 2 - Cumulated current account imbalances for selected euro area countries

![Cumulated current account imbalances for selected euro area countries](image)

This large stock of debt and foreign liabilities is bound to persist for a very long time, even if there is an eventual reduction or disappearance of South’s deficit. It will in any case need to be refinanced on a continuing basis, exposing the Southern countries to financial crises if the markets should refuse to roll over the existing stock of debt. The cumulative current account position can therefore be viewed as a proxy for more sophisticated measures of the fragility of net external debt position of each economy.

Following the introduction of the euro, investors in the North initially directed excess savings towards the South. Such a situation remained sustainable so long as the deficits, and the corresponding debt positions, could be financed by equivalent flows of capital from North to South. Indeed, in the years preceding the crisis almost all financial account flows, which...
represent the counterpart of current account balances, were intermediated by private markets. The Lehman bankruptcy in September 2008 triggered market’s fears about solvency and liquidity of the banks and, by extension, of the sovereigns which were the bank’s guarantors. The countries of the euro area therefore suffered sudden and large withdrawals of private funds after that point, principally in the South, which left them unable to finance themselves at affordable interest rates.

3. EMU/IMF financial assistance
The sudden reversal of private-cross-border flows to the South, by threatening to increase deficits, trigger sovereign defaults and create contagion effects throughout Europe, made it necessary to counter the effects of a potential default by ad-hoc institutional arrangements – among which the Greek loan facility, the EFSF (European Financial Stability Facility) and the EFSM (European Financial Stability Mechanism) were the most important. These programs involved the collaboration of the European Commission, the IMF, and the European Central Bank to provide funds to cover member countries’ financial needs and tackle the structural, fiscal and financial problems affecting the economies in trouble. Last but not least, the Euro-system provided liquidity to the banking sectors hit by the crisis. This helped offset the outflows of private funding originated by the financial turmoil in the United States in early 2008 and allowed the continued financing of trade flows within the euro area. That therefore prevented a sharp slowdown in intra-European trade. This liquidity assistance was channeled through the Target2 payments system.

Prior to the crisis, the net Target2 balances of the national central banks were relatively small because the import-related payments were mostly financed by foreign private investors. But, with the withdrawal of private funds after 2008, Target2 balances rose dramatically. By the end of 2011 Germany the Netherlands and Finland had accumulated credits of about euro 700 billion. As a counterpart, broad net liability positions were recorded for Greece, Ireland and Portugal, and to a smaller extent in France and Spain.

Figure 3 shows that a significant share of the net foreign liability positions of the program countries is represented by net liabilities of the respective monetary authorities and official, program-related borrowing by governments. Target2 shares are very broad in Ireland, Greece, and Portugal, while private and public debt continued to be largely financed by the market in Italy and Spain until 2012.

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8 European Commission (2012).
9 European Central Bank (2012). Put differently, the possibility of capital reversals or sudden financing stops means that private risk is easily transformed into sovereign risk (Alessandri et al 2012).
10 The Trans-European Automated Real-time Gross Settlement Express Transfer System, or Target2, is a recording, clearing and settlement system used by public and private market participants and operated by the ECB. While the net balances of other members are settled daily, Eurozone NCBs can build up gross and net claims or liabilities over time, and without limit. In other words, Eurozone NCBs can borrow from or lend to other Eurozone NCBs at will through Target2. See Buiter, Rahbari, and Michels (2011), Whelan (2011).
11 The issue of the interpretation of Target2 positions is contentious; see Buiter, Rahbari, and Michels (2011). These authors suggest that the Target2 net balances of national central banks must be interpreted with caution in that they do not automatically reflect current account deficits in those countries.
The application of loans under the EU and the IMF assistance programs together with the operations conducted by the Euro system to provide liquidity have helped to prevent a disorderly adjustment in current account imbalances. Consumption and investment in certain member states have been kept at levels which would not otherwise be sustainable.

**Figure 3 - Net foreign asset position: breakdown by type of funding.**
(to end-Q3 2011, in per cent of GDP)

Nevertheless the situation remains unstable. Sustainable external debt requires the external accounts to be rebalanced. There is wide consensus that this should be achieved with the help of structural reforms, and particularly via real depreciations as specified in the conditions of the existing programs of official financial assistance. In the absence of such measures, macroeconomic imbalances can be expected to persist and play an increasingly damaging role.

### 4. North and South in a model of current account and portfolio adjustment

A model of the interactions between current account imbalances and foreign liabilities (debt) can easily be adapted from the trade-portfolio balance model in Hughes Hallett and Martinez Oliva (2012). This section and the appendix contain a truncated version of that model.\(^{12}\)

We assume a two-country world: South and North. Southern investors distribute their wealth, \(W\), between home \((X)\) and foreign \((X^*)\) assets, putting a share \(\alpha\) in home securities and \(1-\alpha\) in foreign assets. Likewise \(\alpha^*\) and \(1-\alpha^*\) are the shares of Northern wealth, \(W^*\), held in domestic and external assets. We assume that \(\alpha\) is increasing in the relative rates of return, on South’s

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\(^{12}\) Others have modeled parts of this interaction process (Annicchiarico et al 2013 for example; or Theofilkou and Stournaras, 2012), but none have attempted a systemic or general equilibrium analysis. The paper closest to the aims of our study focuses on the Caribbean economies: Greenidge et al (2010).
assets, $R^e$ [defined formally in the appendix]; and increasing in $s$, defined as a preference for domestic assets including any home bias or safe haven effects. Symmetrically, $\alpha^*$ decreases in those two factors. If home biases dominate the asset market, as we might expect in bad times, then $\alpha + \alpha^* > 1$.

Equilibrium in the market for South’s assets, and hence North’s assets, can now be written as:

$$X = \alpha W + (1 - \alpha^*)W^*/E = \alpha(X - F) + (1 - \alpha^*)(X^*/E + F)$$  \hspace{1cm} (1)

This expression is non-linear: its slope is a quadratic function of the real exchange rate $E$,

$$\frac{dE}{dF} = -\frac{\alpha + \alpha^*_1}{(1 - \alpha^*)X^*/E} < 0,$$  \hspace{1cm} (2)

Hence (1) is downward sloping iff $\alpha + \alpha^* > 1$, but decreasingly so as $E$ falls.

Meanwhile, the South’s current account balance is given by:

$$F_{t+1} = (1 + r) F + (1 - \alpha)(1 + r)(1 - 1/R^e)(X - F) + D_{t+1}$$  \hspace{1cm} (3)

This is a current account balance relationship since $CA_{t+1} = D_{t+1} - rF$. Notice that the term in the middle of (3) reflects the changing evaluations of home owned foreign assets due to varying relative rates of return $R^e$ (including risk premia). Notice also that (3) contains the current account balance, but also the cumulative effect of future trade balances. Thus policymakers have little control over $F$ except through future trade balances and growth. However they can change the composition of $F$ by providing liquidity or loans in the face of sudden stops in capital flows or financing flows, even when $F$ is constant.

The slope of the current account balance relation in $E$-$F$ space, in the current period, is then:

$$\frac{dE}{dF} = -\frac{E_{t+1}}{(1 - \alpha)(1 + r^e)(X - F)} < 0$$  \hspace{1cm} (4)

with $F = F_{t+1}$ imposed to ensure balance. This implies:

$$0 = rF + \theta E + z$$  \hspace{1cm} (5)

where $\theta = [r(1 - \alpha)(1 + r^e)(X - F)]/E_{t+1}$ is a state dependent coefficient defined by the underlying relationship’s slope, (11). Notice that $\theta > 0$ if $X > F$; but decreasingly so as $F$ increases. So even if (5) looks like a linear approximation, it is in fact quite different. Instead it provides a state dependent representation of the original equation, and a global representation of (3).

We now rearrange the terms in (1) and (5), we get the complete system:

$$E = \frac{X^*(1 - \alpha^*)}{(1 - \alpha)X - (1 - \alpha - \alpha^*)F}$$  \hspace{1cm} (6); \hspace{1cm} and

$$E = -\frac{r}{\theta}F - \frac{z}{\theta}$$  \hspace{1cm} (7)

where the slope of (6) is given by (2); and $z$, if positive, is any shock that increases the trade deficit $D$. Thus, falling income levels originating outside the foreign trade–portfolio balance bloc (imposed, say, by an austerity program of spending cuts and tax increases) would appear
in this model as a negative trade shock: \( z < 0 \). Moreover, the slope of (7) is negative and increasingly so as \( F \) expands.

Equilibrium in the market for South’s assets (and hence North’s assets) is represented by a portfolio balance line (“\( PB=0 \)”) in \( E-F \) space; a relationship between the bilateral real exchange rate, \( E \), and the net foreign liabilities, \( F \), which leaves the overall market for assets in equilibrium. This relation is downward sloping if \( \alpha + \alpha^* > 1 \), but decreasingly so as \( E \) falls.

Similarly, the current account balance relation (“\( CA=0 \)”), including an evaluation of home’s foreign assets as rates of return change with risk premia or safe haven/home biases, is also downward sloping – and increasingly so as South’s net liabilities to the North expand. These two relationships, (6) and (7) are drawn in \( E-F \) space in Figure 4.

**Figure 4 - Stability of the system and multiple equilibria**

*Stability Analysis*: Figure 4 demonstrates that our two-country economy has two equilibrium points: A and B. But only A is stable. Point B is unstable and may place the system on an explosive path if there is an adverse shock. For example, to the right of B a rise in external debt \( F \) raises interest payments and thus increases the current account deficit just created. With the passage of time, that will force a decline in South’s real exchange rate to improve the trade balance and current account deficit. But in the short term, to the right of B new interest payments will exceed any trade balance improvements and lead to an increase in the South’s current account deficit and hence to an increase in \( F \). This process of falls in the real exchange rate and then increases in net debt would then continue without limit.

Left of B, the adjustments go the other way. A decrease in \( F \) contributes to an improvement in the current account deficit by reducing interest payments. That allows some deterioration in the trade deficit and a limited rise in the exchange rate without destabilizing the system. In short, the debt reduction now outweighs the currency effect, and we move off towards a stable equilibrium at A.
At A, the dynamics reverse themselves: movements to the right improve the current account, movements to the left worsen it. In that sense, A represents the optimal position; and the real exchange rate value $E_0$ may be viewed as the equilibrium real exchange rate. By contrast, the significance of B is that it shows the debt level at which South’s economy collapses – where debt escalates and prices collapse, leading to an eventual default. Thus the distance AB is a measure of safe “trade space”, akin to the IMF’s concept of fiscal space. Policy needs to be directed to keeping net foreign debt within an interval around A where trade and portfolio balances are self-stabilizing; but away from point B where shocks, and information or policy errors, can easily drive an economy into default and financial breakdown.

Adjustment outcomes: What happens now if South’s current account balance turns negative? This could be the result of a real exchange rate appreciation following price/wage increases which are faster in the South than the North; or if productivity growth is slower in the South than in the North; or if, as part of an austerity drive, direct or indirect tax hikes are (partly) compensated by wage increases; or if the social security contributions by employers increase. Any of these changes increase relative prices or production costs in the South. The real exchange rate would then move from its equilibrium $E_0$, to a new position $E_1$ in figure 5.

Figure 5 - Effect of South’s real exchange rate overvaluation

Point A3 reflects this situation: South’s current account is in deficit and its net foreign debt is therefore increasing. The $PB=0$ line will therefore shift right and continue to do so for as long as the real exchange rate remains overvalued. Clearly such a situation is not sustainable in the long run as South’s foreign debt would increase without limit. That cannot continue forever. When the level of debt can no longer be serviced, default (whether expected or realized) will force South to accept a real depreciation, either through deflation or by abandoning the fixed

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peg/currency union regime. When that happens, the economy will adjust down the \(PB=0\) dotted line until we reach point C, where, due to the now higher debt level, a lower (more depreciated) real exchange rate is necessary to sustain an equilibrium. Hence the longer the current account imbalances persist, the further the \(PB=0\) line will have shifted to the right and the greater the increase in debt and currency depreciation needed to restore equilibrium. The result is a larger financial crisis and a greater potential for a currency collapse.

When the markets realize that a possible default or currency collapse is in prospect, a reversal of capital flows between North and South will occur. This translates into an increase in home bias \(\alpha^*\) as private investors in North repatriate their funds from South to the domestic market. Using the same logic as above, the portfolio balance line will shift left again since, from (6), \(dE/d\alpha^* = -F/X^*\). Figure 6 shows this by restoring the \(PB=0\) line to its original position.

**Figure 6 - Effect of public funding of net foreign asset position**

![Diagram](image)

**Official financing and Liquidity Support:** To restore a new equilibrium position such as A depends on a number of conditions, the most important being a sufficient adjustment in real exchange rates. Should that fail, current account deficits will continue to accumulate without being financed by private capital flows. The eventual outcome in this case is national default, unless some other source of financing intervenes. In practice this new source of finance has been, and has had to be, official finance. In the case of the Euro system, new financing has been introduced through the official rescue vehicle EFSF (ESM from July 2012), and by the backdoor through Target2 payments, both of which have the capacity to replace the private financing assumed in figure 5. In specific episodes, it has also come though liquidity support provided to the national banking systems, or implicitly via haircuts imposed on creditors, or via asset purchases by the ECB to lower the cost of borrowing by distressed governments (the ECB’s latest weapon for defending banks or governments in difficulties in the Euro system: see section 5).
Liquidity support to the banking sector is a result of the Target2 payments mechanism, in which the national central banks are empowered to provide credit support to national banks under pressure if they are short of funds — funds that have drained away through capital flows or bad loans. This creates extra liquidity at home and increases the value of the stock of home assets. That in turn reduces the net foreign liability position, pushing the PB=0 line back to the left as shown in figure 6. Cash injections from ESM, or asset purchases by the ECB, do the same thing. Cheap loans from the ECB to the South’s banks under the LTRO program also achieve the same effect. But it is important to note that, in each case, the restoration of the old PB=0 line is just a temporary reprieve. The new position at A2 is only a temporary equilibrium unless the real exchange rate either falls, or is forced to fall, from E₁ to E₀. There is no mechanism in official financing that would force such a depreciation; and there is no likelihood that a depreciation will happen of its own accord since relative prices adjust slowly and there is no nominal exchange rate to help out. By the time such adjustments do come about, external deficits will have become larger and the PB=0 line will have shifted right again. Official financing on this scale is therefore necessarily an emergency measure and one that needs to be applied repeatedly for at least as long as it takes the real exchange to fall by enough to allow us to settle at position A. Since the required real exchange rate adjustment is likely be a protracted process, taking 5-10 years, the necessary liquidity support is going to be very large, bordering on infinite. It is not clear if the ESM and ECB would be able or allowed to provide the necessary resources. By definition distressed governments in the South cannot.

5. Outright Monetary Transactions (OMT)

The most recent, and probably most highly regarded of the measures designed to combat the debt crisis, is the new Outright Monetary Transactions program in which the ECB has undertaken (under certain strict conditions) to intervene without limit in the markets for debt to reduce national borrowing costs.

This is important because it recognizes interest rates play a role in the adjustment process. As it can be seen from equation (7) a rise in the interest rate \( r \) will make the (negative) slope of the current account balance curve steeper. Conversely, lower \( r \) will make the slope of the current account balance line flatter. More important for our purposes, lower interest rates at given or pre-existing values of \( F \) will also shift the current account line up (as shown in figure 7). To see this, take the easy case first. If the effects of an OMT operation is to reduce the South’s interest rates, but with a negligible effect on the value of \( \alpha \), then from (7)

\[
\frac{\partial E}{\partial r} = \frac{-F}{\theta} + \frac{rF}{\theta^2} \frac{\partial \theta}{\partial r} + \frac{z}{\theta^2} \frac{\partial \theta}{\partial r}
\]  

(8)

Inserting \( \frac{\partial \theta}{\partial r} = \frac{\theta}{r} \) from the definition of \( \theta \), we have

\[
\frac{\partial E}{\partial r} = \frac{1}{\theta} \frac{z}{r}
\]  

(9)^{14}

^14 (9) assumes the real exchange rate, \( E \), is not expected to change due to sticky relative prices and common inflation rates across the currency union – as we have seen in practice under the EU austerity programs.
which is unambiguously negative since \( X-F>0 \) implies \( \theta>0 \) if \( z<0 \) (as it has been throughout the EU’s austerity adjustment process: see section 3 above). The rationale for this result is that, with exchange rates fixed, lower interest rates mean smaller net interest payments than before. So current account balance can be achieved with a larger trade deficit or a higher real exchange rate: the available trade space has increased.

**Figure 7 - Effect of ECB’s OMT on current account equilibrium**

The more complicated case, where \( a \) may vary with domestic interest rates, produces the same result. Indeed given (7), and recognizing that a reduction in \( r \) will reduce the relative rate of return on domestic assets and hence \( a \) [see appendix A2], we can extend (8) to get

\[
\frac{\partial E}{\partial r} = \frac{-F}{\theta} + \frac{rF \partial \theta}{\theta^2} + \frac{z \partial \theta}{\partial r} + \frac{\theta E \partial \theta \partial a}{\partial r} + \frac{\theta^2 \partial^2 \theta \partial a}{\partial r^2}
\]

\[
= \frac{z}{\theta r} - \frac{(rF + z)(1 + r^*) (X - F) \partial a}{\theta^2 E_{+1}} \frac{\partial E}{\partial r}
\]

(10)

which is unambiguously negative when \( z<0 \), since \( \partial a / \partial r > 0 \) follows from equation (A.6) in Appendix A. Hence this more realistic case just produces a larger upward shift than (9) did.

Perhaps the most valuable gain from OMT interventions, even if an unintended consequence, is the increase in “trade space” evident in figure 7. This allows the crisis countries more room to run with poor competitiveness, current account deficits or excess debt before the financing difficulties or default of the “bad equilibrium” set in. That in difficult circumstances may be a significant gain, especially if it takes time to organize a rescue. But it may delay the incentive to undertake the reforms necessary to improve competitiveness or reduce debt.
Second, the gains for individual countries will depend on where they are located in figure 7. They will not all be the same. A country currently north-west of the original good equilibrium (point A) will find the adjustments to the new equilibrium at A2 are easier than at point A itself, at least in the short term, in that the real exchange rate needs to adjust by less to regain equilibrium at $E_2$ rather than at $E_0$. The required competitiveness reforms will therefore be smaller. Likewise, the amount of additional debt that that a country would need to accept during the transition would be smaller ($F_2$ instead of $F_0$). This is the situation in the stronger economies of Europe’s south (such as Italy or Ireland); they have trade deficits, excess real exchange rates, and high or expanding but easily financed debt. For these countries, OMT provides an easier set of reforms or adjustments, and more room for errors or slippage, for as long as interest rates can be held low on the way to the good equilibrium.

An interesting, but again probably unintended contrast emerges with the strong economies in Europe’s north. These countries have trade/current account surpluses, low real exchange rates compared to the South, and declining or negative net foreign debt. This places them south or south-west of the good equilibrium (point A). For these countries, OMT actually makes it more difficult to reach the new temporary equilibrium (A2): an internal revaluation, smaller trade/current account surpluses with their partners, having to accept more foreign assets than required at A. To the extent the reforms needed to reach the new equilibrium are now larger, the incentives to make the required adjustments also need to be larger. If the OMT system does indeed increase the pressure on the north to adjust, then it would have created a long awaited “symmetric adjustment” mechanism for the Eurozone – and with it a natural increase in the degree of integration. Sadly, there seems to have been little appetite to help by making symmetric adjustments, and hence by implication no real taste for greater integration.

The third group of countries contains those with excess or escalating debt, though not all of it acquired through fiscal irresponsibility: trade deficits and lower but uncompetitive real exchange rates may still play a role (Spain, Portugal, Ireland in 2011-12). These countries are characterized by higher debt to trade deficits, or smaller current account deficits and lower real exchange rates than elsewhere. They therefore lie north or north-west of the bad equilibrium B, and have the potential to improve their trade position through competitiveness and income reforms if the debt interest rate burden can be reduced. OMT makes this process easier, by lowering interest payments and reducing current account deficits so less foreign debt is accumulated. This shifts those counties upward from B in fig.4. The downside is the upward shift in the $CA=0$ line makes it clear that there is a larger competitiveness adjustment to be made than without OMT, but the debt reductions will be smaller. The enthusiasm for reform may therefore be reduced.

Lastly, countries south-west of the bad equilibrium point, B, have high and escalating debt, and large trade/current account deficits despite relatively low real exchange rates (Greece?). OMT can probably do little to arrest their unstable path from B, unless the shift in $CA=0$ is large enough to convert their current account deficit into a surplus. If that can be done, these countries will join the third group but with lower real exchange rates, and have a good (if slow) chance of eventual recovery. As in the other cases, it is a matter of size. Can the OMT interest rate reductions be made large enough to set in train current account reductions, debt
reductions and eventual recovery? If not, OMT offers only temporary relief before direct action to reduce relative prices, or default and financial collapse, intervene.

All these gains remain temporary however unless action is taken each period to keep $r$ below market clearing levels. Repeated, and ultimately unlimited, interventions in the bond markets may be necessary to maintain lower interest rates in the long term. But that is the point of the OMT interventions: they are supposed to be unlimited under strict conditions, in contrast to the official financing schemes noted above which were unconditional but limited. By keeping interest rates lower than market rates as necessary, OMT helps reduce the distance and ease the transition between actual real exchange rates or debt in the South, and the levels necessary to restore a temporary equilibrium. That may stabilize the economy, but it cannot replace a full equilibrium where macroeconomic variables reach their long-term equilibrium values: essentially, quantitative easing calculated to offset the effects of private deleveraging.

OMT can therefore be seen as a helpful device to alleviate the market pressure on member states while they reestablish a sustainable equilibrium. Three qualifiers: given the zero lower bound, there is no guarantee that interest rate reductions large enough can be found to achieve a stabilizing position on the way to the new equilibrium. Second, our analysis has been conducted on the assumption that the $PA=\theta$ does not shift with $r$. To a first approximation this is correct since the only mechanism would be via changes in $\alpha$ and $\alpha^*$. However appendix C shows that allowing $\alpha$ and $\alpha^*$ to change would also shift $PB=0$ down by a small amount. That just has the effect of reinforcing the logic and results of this section.

Third OMT, although widely discussed, has not been used in practice. At the time of writing, this is because the legality, under current rules, of expanding the ECB’s balance sheet without limit is under challenge in the German constitutional court. If that challenge succeeds, OMT will remain a technical possibility beyond the policymakers’ reach. However the key point is that it is not always necessary to implement OMT; a credible announcement that the ECB will implement OMT in full may be enough. That is the story of the original announcement made in 2012, and conforms closely to the theory of policy announcements (Hughes Hallett et al, 2012). Thus, unless the German constitutional court strikes down the credibility of the announcement, OMT remains the only effective mechanism for giving indebted governments the space to reestablish a new sustainable equilibrium.


For the purposes of numerical simulation, we will make use of calibrated values for $r$ (interest rates in the South), $X$, $X^*$, $\theta$ (responsiveness of demand for Southern assets to relative prices, real exchange rate changes), and $z$ to establish a metric for assessing the stability of the Euro system. In our baseline, the situation at the start of the euro, we use the following. For $r$, we use the interest rate on the total interest-bearing debt plus the inflation rate prevailing at the time, around 7 per cent. Based on a ratio for financial assets to GDP of around 2 we get €6.6 trillion for $X$ and €8.16 trillion for $X^*$. The range of elasticity estimates in the literature is quite broad; we set $\theta$ equal to the mid-range estimate of 0.7$^{15}$. Finally, given these parameter

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$^{15}$ Blanchard, Giavazzi, Sa (2005). This assumption is consistent with the results found in a survey conducted by Chinn (2002). See also Cline (2005) for a similar figure.
values, we chose $z$ to be -1.6; a figure that is needed to set the baseline at a real exchange rate of unity at the start of the euro regime. This is the natural normalization. We then track the changes from there. This setup implies $F$ is roughly zero at the start; the official accounts of member countries are in balance and no creditor or debtor positions are outstanding. Finally, we set $\alpha$ and $\alpha^*$ to be equal to 0.8 and 0.7 – a case in which home/safe haven biases apply. Portfolio balances and current account positions under this scenario are shown in figure 8.

**Figure 8: Baseline simulation of North and South at the start of the Monetary Union**

Suppose now that, following a sustained loss of competitiveness in South, the portfolio balance line shifts to the right as a result of the current account deficits thus created. Foreign liabilities in the South, $F$, reach 1 trillion euros (Figure 9). That is not a problem in itself since equilibrium can evidently be reestablished with a real depreciation of 10% in the South.

**Figure 9: Simulation of an increase in Southern net liabilities of 1 trillion**
However, whereas in a world with flexible exchange rates a real exchange rate depreciation of 10% could be achieved by a nominal depreciation of the same amount, this is impossible in the euro area since nominal adjustments cannot be made. Accordingly, if we recognize that adjusting relative prices is normally a slow and politically very damaging process, financing foreign debt via the private sector was a natural solution. When this became impossible in 2010, with foreign creditors fearing potential insolvencies in the South’s financial institutions or governments, private financing flows dried up causing a credit stop, a liquidity crisis and capital reversals. In the short term, public funding (loans, bail-outs, Target2 payments) of the net foreign asset position were then the only solutions left.

A more durable solution for the long term would be an internal devaluation: that is, a real exchange rate depreciation via a reduction of prices, wages or non-wage costs, coupled with productivity increases to enhance competitiveness in the South. An internal revaluation at the same time in the North would achieve a more effective distribution of the burden of the necessary adjustments. If the real exchange rate depreciation is to be achieved by South alone it would have to be larger, and hence less likely (politically and socially) to be achieved since labor cost reductions cannot be imposed by decree and will take time to take effect. It took Germany 12 years to achieve a 17% reduction in relative prices and unit labor costs since 1999, and efforts by Portugal Ireland and Italy in the current crisis are proceeding no faster.

Our simulations above confirm this view: the shift in portfolio balances needed to redress the existing 1 trillion imbalance in foreign assets between North and South would require a 10% reduction in the baseline real exchange rate value (Figure 9 vs. Figure 8). But this is not the end of the story since the real exchange rate was already misaligned before the current imbalances were created; indeed that was part of the process by which the accumulation of debt came about. To restore equilibrium between North and South and remove the net debts which past misalignments had caused, the 10% real exchange rate depreciation needs to be added to past misalignments. That means real depreciations of 10% to 30%, depending on the indicator used for the past misalignments. Taking a mid-range value, the South’s real appreciation since 1999 was 20% of the baseline, which, together with the 10% depreciation to remove current imbalances, means a total depreciation of 30% between North and South to restore equilibrium between North and South. Put differently, this is the depreciation needed to bring the South’s real exchange rate back to the German level (not just the status quo ante) so as to remove the misalignments between them. This is shown in table 1, where we use four different calculations to come up with the same 30% depreciation.

Clearly, a 30% real depreciation is too large a figure to be realistic, or politically feasible in a short period of time. Hence the authorities will inevitably resort to official financing to push the PB=0 line inwards in the interim, and sit out the real exchange rate adjustments needed.

These calculations refer to the countries in the South as a group, of course. Depreciations of the necessary size might still be feasible in some individual cases. The last column of Table 1 contains calculations of what each country would have needed to do to restore equilibrium in

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16 See the ECB’s harmonized competitiveness indicators since 1999 [ECB statistical warehouse data].
17 For a broad range of estimates based on alternative indicators, see Bayoumi, Harnsens, and Turuken (2011).
18 Note that PB=0 means “no further changes in net foreign held debt”, not “zero net debt”.
Table 1: Real Exchange Rate Adjustments in 2011 relative to Germany, 1999=100.

<table>
<thead>
<tr>
<th>Country</th>
<th>RER index; GDP deflator</th>
<th>RER index; ULC figures</th>
<th>Deflator over Germany (%)</th>
<th>ULCs over Germany (%)</th>
<th>% RER (real) depreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Greece</td>
<td>108.97</td>
<td>106.50</td>
<td>28.8</td>
<td>29.3</td>
<td>28.25</td>
</tr>
<tr>
<td>Portugal</td>
<td>104.69</td>
<td>106.92</td>
<td>23.7</td>
<td>29.8</td>
<td>23.15</td>
</tr>
<tr>
<td>Ireland</td>
<td>102.24</td>
<td>109.93</td>
<td>20.8</td>
<td>33.5</td>
<td>20.25</td>
</tr>
<tr>
<td>Italy</td>
<td>105.34</td>
<td>110.02</td>
<td>24.5</td>
<td>33.6</td>
<td>23.95</td>
</tr>
<tr>
<td>Spain</td>
<td>117.59</td>
<td>105.74</td>
<td>39.0</td>
<td>28.4</td>
<td>38.45</td>
</tr>
<tr>
<td>Cyprus</td>
<td>111.88</td>
<td>111.35</td>
<td>32.2</td>
<td>35.2</td>
<td>31.67</td>
</tr>
<tr>
<td>Germany</td>
<td>84.61</td>
<td>82.37</td>
<td>--</td>
<td>--</td>
<td>--</td>
</tr>
</tbody>
</table>


Notes: RER = real exchange rate; ULC = unit labor costs. The GDP-weighted average of depreciations needed by country is 29.45% by GDP deflators; 31.38% by unit labor costs; 38.99% using German Ministry of Finance figures quoted in Sinn (2010); and 30.78% using 2008 figures quoted in Carlin (2012).

their own economies by 2011. They range from a real depreciation of 20% in Ireland, to 38% in Spain. The latter is hardly more feasible than the 30% group figure. On this basis, if a 5% real depreciation is the maximum that one can reasonably expect to achieve in any one year, Ireland would take at least 4 years to regain equilibrium; and Spain 7-8 years.

More sophisticated calculations are not possible because they need a full specification of the underlying trade and portfolio relationships, their dynamics and price elasticities inclusive of J-curve effects, portfolio evaluation effects, home biases and expected exchange rates. We do not have the means to estimate these factors. Nonetheless, three points stand out:

a) The amount of adjustment called for varies by country. Spain is in the worst position, then come Cyprus and Greece;
b) The debt problem for the Eurozone will not be solved until the large players (Spain, Italy) restore their competitiveness;
c) The difference between columns 1 and 2 in Table 1, shows a distinction between those whose unit labor costs have grown faster than output prices (Portugal, Ireland, Italy) – implying TFP productivity is growing faster than labor costs – and those in a more difficult position (Greece, Spain, Germany) where labor costs have risen slower than prices, implying that productivity is lagging or inefficiencies or monopoly power exist in the markets. If the problem is to be solved by austerity and wage restraint, then Portugal, Ireland and Italy have the scope to start a recovery. But Greece and Spain do not. Germany, ironically perhaps, may be on the verge of starting to help by becoming less competitive.

7. Policy conclusions:
The European debt crisis has highlighted the role of intra-European payments imbalances for

\footnote{These figures have been computed by taking GDP weighted averages of the GDP deflator measure of the real exchange rate appreciations relative to Germany, adjusting that average to 30%, and then calculating the individual country deviation by GDP deflator real exchange rate from Germany.}
the survival of EMU. Imbalances between the North and the South have contributed to a large stock of debt in the South; while flows of foreign capital have ceased to finance productive investment that might have contributed to debt repayment. The lessons to be learned are:

a) Competitiveness and real exchange rate realignments, and the structural reforms that those realignments imply, are unavoidable if equilibrium is to be restored and maintained.

b) The necessary adjustments are likely to take several years. So early economic restructuring is more important than debt restructuring, or official financing to alleviate the crisis.

c) The longer the correction of imbalances is delayed the larger and more painful the eventual adjustment – because the accumulated debt is a stock, implying that a larger real depreciation is needed to remove the effects of past, in addition to current, misalignments.

d) Replacing private with public creditors may keep the system away from the point where the system breaks down. But this is only a temporary expedient; the imbalances will need continuing and increasing financing until equilibrium is restored by other means.

e) OMT is the only effective long-term mechanism for providing indebted governments with “financing space” needed for the necessary restructuring reforms.

f) If adjustment needs to be rapid and achieved by internal devaluations in debtor countries, it may not be politically or economically feasible. Symmetric adjustment, spreading the burden across debtor and creditors by internal devaluation and revaluations, would have had a better chance of success by reducing the fiscal and social cost to any one economy.

g) The incentives to restructure are not equally shared. Those above the good equilibrium in figures 4 or 7 would find it relatively easy to adjust; but the stronger economies on the good (low) side more difficult – which explains the “fear of further integration” effect so evident in the latter. Similarly those whose fundamentals put them on the good side (above) of the bad equilibrium have the scope to reform themselves; but those on the bad side do not.

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APPENDICES

A Model of Current Account and Portfolio Balances

Since current accounts and portfolio balances both affect exchange rates and rates of return, and are affected by them, they need to be modeled jointly. This is usually done by assuming perfectly substitutable assets and instantaneous but complete market adjustments. Uncovered interest rate parity can then be applied. However, given that we are dealing with a problem where a country’s net debt could become excessive, and may have to be limited, it is not clear that such a model would be suitable in a world of imbalances and market distortions caused by sticky prices, fixed exchange rates, sudden stops, and a revealed preference for holding foreign reserves or foreign assets.

A more general approach is provided by Blanchard, Giavazzi and Sa (2005), who model current account and portfolio balances directly. Such a model allows us to consider imperfect asset substitutability and hence different asset preferences. This allows us to examine the stability of the adjustment process in assets/debt under a common currency, sticky relative prices, and sudden stops in inter-economy financing, and the valuation changes caused by exchange rate and interest rate movements.

A.1 Perfectly Substitutable Assets

To start, consider two countries: home and foreign. In each country, the foreign sector is determined by two relationships. First uncovered interest parity,

\[ (1 + r) = (1 + r^*) \frac{E}{E^*_{t+1}} \]  

(A.1)

where \( r \) and \( r^* \) are home and foreign rates of interest respectively ("*" denotes foreign variables throughout); \( E \) is the real exchange rate (defined as the price of home goods relative to that of foreign goods), and \( E^*_{t+1} \) is the real exchange rate expected next period. Thus

\[ E = P (eP^*) \]  

(A.2)

where \( e \) is the nominal exchange rate of domestic currency: dollars per euro say. Hence a fall in \( e \), and a rise in \( E \), indicates a strengthening domestic real exchange rate. However, while we are in the Eurozone, \( e = 1 \) by definition and we are only interested in changes in internal real exchange rates \( E \). In that case, Spain might be “home” and Germany “foreign”.

Second, the net foreign liabilities or debt accumulated by the home country are:

\[ F_{t+1} = (1 + r) F + D(E^*_{t+1}, z_{z+1}) \]  

(A.3)

where \( F \) is net debt of the home country denominated in the home currency (the amount of domestic currency needed to pay them off\(^20\)). \( D(E, z) \) is the trade deficit, defined to increase with the real exchange rate. Thus \( D > 0 \) implies a deficit; and an appreciating real exchange rate will make that deficit larger (the first derivative is positive, \( D_E > 0 \)). Equation (A.3) says that net liabilities next period are equal to net debt this period, plus net interest payments due, plus the current trade deficit.

Finally, \( z \) is a shift variable describing the impact of a trade shock, a change in preference for home goods, or other changes in the pattern of spending on those goods (including austerity measures or other income shocks). It is defined so that an increase in \( z \) worsens the trade balance: \( D_z > 0 \).

A.2 Imperfect substitutability and portfolio balances

To allow for imperfect substitutability between national assets, let \( W \) be the total wealth of home investors, \( X \) the total stock of home’s assets, and \( F \) the net debt of the home economy. Thus:

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\(^{20}\) We do not distinguish home’s foreign and domestic held debt since no Eurozone country can use monetary policy to inflate its debt away. Given that the ECB cannot do that either, all debt is “foreign”.

\[ W = X - F \quad \text{where } F \geq 0 \text{ implies a net debt position.} \quad (A.4) \]

The wealth of foreign investors, in home’s currency, is therefore
\[ W* / E = X* / E + F. \quad (A.5) \]
So the expected real rate of return from holding home’s assets relative to foreign assets, is
\[ R^e = [(1 + r) / (1 + r^e)] \frac{E_{t+1}}{E}. \quad (A.6) \]

Home investors distribute their wealth between home and foreign assets, putting a share, \( \alpha \), in home securities and \( 1 - \alpha \) in foreign assets; \( \alpha^* \) and \( 1 - \alpha^* \) are the shares of foreign’s wealth held in domestic and external assets. We assume that \( \alpha \) is increasing in the relative rates of return on home assets \( R^e \); and in \( s \), defined as the preference for holding domestic assets including any home bias and/or safe haven or flight to quality effects. Symmetrically, \( \alpha^* \) is decreasing in those two factors. If home biases dominate, then \( \alpha + \alpha^* > 1 \).

Equilibrium in the market for home’s assets, and hence foreign’s assets, is now given by
\[ X = \alpha W + (1 - \alpha^*)W* / E = \alpha(X - F) + (1 - \alpha^*)(X* / E + F) \quad (A.7) \]
This is the portfolio balance equation. Unlike under perfect substitutability, the distribution of wealth between home and foreign is independent of shifts in the trade or current account balances (i.e. \( z \)). Instead the exchange rate \( E \), relative rates of return \( R^e \), and asset preferences \( s \), all of which affect \( \alpha \), determine and are determined by the distribution of wealth holdings. Nevertheless, trade and current account balances do lead to changes in \( F \) and in the exchange rate:
\[ \frac{dE}{dF} = -\frac{\alpha + \alpha^* - 1}{(1 - \alpha^*)X* / E^2} < 0 \quad \text{iff } \alpha + \alpha^* > 1. \quad (A.8)^{21} \]
Notice that: (i) the portfolio balance relation is, by definition, nonlinear in \( E - F \) space and will be downward sloping as long as home biases persist \( \alpha + \alpha^* > 1 \); (ii) under these conditions, higher debt at home requires a lower exchange rate (because the demand for home assets has fallen, a larger trade surplus is needed to meet interest payments); (iii) real exchange rates respond rather little to current account imbalances; rather more to changes in portfolio preferences and the distribution of wealth.

**A.3 Current account balances under imperfect substitutability**

If the trade balance \( D \) behaves as in (A.3), then home’s net debt in the next period will be:
\[ \Delta F_{t+1} = (1 - \alpha^*)(1 + r)W* / E - (1 - \alpha)(1 + r^e)W.E / E_{t+1} + D(E_{t+1}, z_{t+1}) \quad (A.9); \]
That is the foreign ownership of home assets (plus interest), less the value of home owned foreign assets (plus interest), plus the next trade deficit. Rewriting with (A.4), (A.5) and (A.6):
\[ F_{t+1} = (1 + r)F + (1 - \alpha)(1 + r^e)(1 - 1 / R^e)(X - F) + D_{t+1} \quad (A.10). \]
This is the current account balance relation since \( CA_{t+1} = D_{t+1} - rF \). Notice the term in the middle reflects the changing evaluations of home owned foreign assets due to differing rates of return (including risk premia). Thus (A.10) implies policymakers can affect \( F \) through future trade, growth and relative rates of return.

The slope of this current account balance relation in \( E - F \) space, in the current period, is:
\[ \frac{dE}{dF} = \frac{-E_{t+1}}{(1 - \alpha)(1 + r^e)(X - F)} < 0 \quad (A.11) \]

---

21 Both (A.8) and (A.11) are derived assuming that variations in \( \alpha \) and \( \alpha^* \) are small and may be ignored. This is correct up to a first order approximation. Moreover \( \alpha + \alpha^* > 1 \) is a natural condition given transaction costs, foreign risks, and that \( \alpha = \alpha^* = \frac{1}{2} \) implies indifference between \( X \) and \( X^* \) as assets.
where the slope depends on the size of the domestic asset base: a large asset base, \( X > F \), means a shallow slope, a small asset base a steep slope. This is the normal state of affairs since, if \( F \) rises, it requires \( E \) to fall to create a move towards a trade surplus at home in order to generate sufficient extra revenues to pay for the higher net debt – the more so the smaller is the asset base relative to foreign ownership of domestic assets. That implies (A.11) will have to be negative.

**B. Current Account and Portfolio Adjustments: Stability and Dynamics**

**B.1 Zones of stability and instability**

Do these economies offer a stable financial system? Figure 1 implies that they are stable so long as the portfolio balance line has a steeper downward slope than the current account balance line. In that case, a stable steady state will be achieved at the intersection of the two.

To see this, Figure B1 (linearized around the equilibrium point for exposition) divides \( E-F \) space into 8 zones. It has been drawn with a steady state point where both asset holdings and the current account are in balance at the same time, to reflect a FEER exchange rate value (which leaves the current account at zero) and \( F = 0 \). But that is done for convenience: the economies may achieve equilibrium at other values for \( E \) and \( F \) – for example where \( E \) generates a trade surplus sufficient to service home’s net debt. So, trade will be balanced \( (D = 0) \) where \( F=0 \) lies on the current account line. There is then a trade surplus \( (D < 0) \) to the right of that point on the \( CA=0 \) line, but a trade deficit to the left, as a consequence of the real depreciations or appreciations involved. Similarly \( F \) switches along the horizontal, from home having net assets \( (F<0) \) to home having net liabilities \( (F>0) \).

![Figure B1: Stable and Unstable Adjustments to Equilibrium](image)

Following this logic, going to the right of \( F = 0 \), the value of \( F > 0 \) becomes larger which means larger trade surpluses are needed to pay the interest on the larger net debt if the current account is to remain in balance. To generate those surpluses \( E \) has to fall until the current account deficit reaches the \( CA=0 \) line. Likewise, to the left, \( F < 0 \) which means larger deficits are possible with the same current account and \( E \) rises to create those deficits. Thus, above \( CA=0 \), trade deficits are larger
(surpluses smaller) than at points vertically below. Conversely, trade deficits are smaller/surpluses larger below that line than at points vertically above. On the \( CA=0 \) line, home’s net debt doesn’t change since the current account is balanced: \( \dot{F} = 0 \). But above it, \( CA<0 \) and \( \dot{F} > 0 \); and below it, \( CA>0 \) with \( \dot{F} < 0 \).

Since the points above the \( CA=0 \) line all have \( \dot{F} > 0 \), if we arrive at any of these points the portfolio balance line will shift to the right at any given exchange rate. Similarly, the points below \( CA=0 \) all have \( \dot{F} < 0 \), which means the portfolio line moves to the left. In other words, the current account line depicts a set of unstable points in the sense that, once off it, portfolios start to adjust and the portfolio balance positions all shift. The portfolio line, by contrast, does not. Once off it, exchange rates need to adjust to rebalance both trade and the asset distribution. Thus, we arrive at the inequalities, shifts and dynamic adjustments displayed in figure B1.

**B.2 The stability of adjustment**

Suppose now that we have arrived at a position on the upper side between the two balance lines. This could happen after a rise in home’s real exchange rate (rising costs); or because of a change of policy (home runs a trade deficit); or because of a shift in relative prices or preferences for home goods.

How do the economies now adjust? Home’s trade deficit outweighs her net investment earnings. This implies a current account deficit and a decrease in home’s net assets or an increase in her net debt. In a world of flexible relative prices, this would lead to two effects: an increase in foreign’s holdings of home’s assets; and a depreciating real exchange rate to reduce the trade deficit. The two economies therefore move down a saddle path in a south-easterly direction between the two lines until we come to the equilibrium point where \( PB=0 \) and \( CA=0 \) cross (Figure 4, point A, of the main text).

But there is more. Stability not only requires movements to the south-east; the increased interest payments on home’s (now higher) debt must also match the decreases in her trade deficit if those movements are to stop. This happens automatically at the intersection point. But whether we actually get to that point depends on whether the elasticity of the trade responses match the speed of portfolio adjustments. If the exchange rate is sticky or fixed, the adjustment may come about through a path that moves more east than south and therefore hits the portfolio balance line before the intersection point. Early adjustments will then take place through net debt accumulations, and later ones through relative price movements caused by portfolio adjustments in response to valuation changes as the expected real rates of return on home assets fall (see (6), and then (10)). Then, once we reach the \( PB=0 \) line we slide down it. Conversely, if relative prices are flexible, the adjustments are mostly south (not east) as foreign dumps her surplus currency reserves or Target2 promissory notes till the \( CA=0 \) line is reached. Then we slide down the \( CA=0 \) line. Either way, the process is stable and depends heavily (but not exclusively) on relative prices and on valuation effects.

We can tell the same story in reverse if we start between the lines on the lower side in Figure B1. But starting from any other position, stability is not assured. It depends on the real exchange rate being more flexible than the net debt accumulation process. This is not guaranteed. In fact, it appears to have been a lost cause in most Euro-zone economies.

**B.3 Necessary and sufficient conditions for stability**

To ensure stability in both the trade and capital markets, we need the slope of the portfolio balance line to exceed that of the current account line. Using (A.8) and (A.11), this amounts to:

\[
\frac{(1 - \alpha)(1 - \alpha^*)}{\alpha + \alpha^* - 1} > \frac{E_4 E^2}{(1 + r^*)X^*(X - F)}
\]  

(B.1)
It is easy to satisfy (B.1), and thus guarantee financial and debt stability, if:

- \( X >> F \) or \( F < 0 \). This represents an economy with a large domestic asset base or net assets.
- But it is more difficult to satisfy (B.1) if \( X - F \) is small: that is, an economy dependent on foreign debt for funding.
- If \( E \) is low and expected to remain low; or \( X^* \) is large. This is generally a matter of policy stance; as in Germany in the Euro zone, or China outside.
- If \( \alpha + \alpha^* \approx 1 \) but \( \alpha \alpha^* \) is large, i.e. if assets are largely substitutable.

It becomes impossible to satisfy this stability condition if \( \alpha \) and \( \alpha^* \) are such that \( \alpha + \alpha^* < 1 \); and difficult if \( X \approx F \). This may be the case in smaller Euro-zone economies who need to rely on foreign assets for risk sharing and diversification: for example, in Greece, Portugal and Ireland whose assets are widely held by other Euro zone countries. Italy, by contrast, whose assets are predominantly held at home may be relatively safe because \( \alpha^* \) will be large, even if \( \alpha^* \approx \frac{1}{2} \) in the rest of the Euro zone.

Thus, \( E \) needs to be free to adjust as much as required. Since \( E \) is a real exchange rate, this has strong implications for economies with different rates of cost inflation, or that have sticky wages and prices.

**B.4 What happens if real exchange rates fail to adjust?**

Figure B2 shows the implications of having an inflexible real exchange rate. This is figure B1 with a fixed real exchange rate \( \bar{E} \) imposed. For simplicity, we treat this as a binding constraint – as indeed it has been in the indebted Euro-zone economies for most of the crisis period.

**Figure B2: Adjustments to Equilibrium with Fixed Exchange Rates**

At a point A, with a fixed real exchange rate, home’s current account is in deficit and her net foreign debt rising. So the \( PB=0 \) line will shift right, and will continue to do so as long as the fixed exchange rate value remains in place; and that means for as long as (relative) prices remain sticky. The process of adjustment is that described for figure B1, where the early stage movements involve adjustments in the net debt position before the valuation and exchange rate effects cause us to slide down the \( PB=0 \) line; but with the difference that we will never get all the way to \( A'' \) if no real exchange rate depreciations are possible. This is because the \( PB=0 \) line moves out, and the additions to \( F \) chase after it (horizontally to the right) without ever fully catching up. That cannot be sustained indefinitely;
default will break the real exchange rate when the debt level can no longer be serviced. The economy then goes into recession and prices fall. When that happens, the economy adjusts down the $PB=0$ line till we reach C. But the longer the real exchange rate is maintained, the further the $PB=0$ line moves out, the greater the debt burden, and the bigger the eventual default.

In order to avoid those outcomes, home or foreign will have to allow a sudden financing stop and provide liquidity support; or they must adjust their real exchange rates; or foreign must accept an ever increasing accumulation of claims on home (that is, unused foreign reserves or Target2 notes). Thus, debt is the equilibrator but only until we are forced to adjust real exchange rates and competitiveness.

**C. Effect of OMT Interest Rate Reductions on the Portfolio Balance Line**

Starting from (6), the portfolio balance, and differentiating under the same conditions as (8)-(10):

$$\frac{\partial E}{\partial r} = \frac{-X^* \frac{\partial \alpha^*}{\partial r}}{(1-\alpha)-(1-\alpha-\alpha^*)F} - \frac{X^*(1-\alpha^*)[(1-1)\frac{\partial \alpha}{\partial r} + F\frac{\partial \alpha^*}{\partial r}]}{[(1-\alpha)-(1-\alpha-\alpha^*)F]^2} \quad (C.1)$$

$$= \frac{[(1-\alpha)-(1-\alpha-\alpha^*)F + (1-\alpha^*)]X^* \frac{\partial \alpha}{\partial r}}{[(1-\alpha)-(1-\alpha-\alpha^*)F]^2} \quad (C.2)$$

where we have used the fact that the domestic preference for holding domestic bonds and the foreign preference for holding domestic bonds change by equal and opposite amounts when domestic interest rates fall: $\frac{\partial \alpha}{\partial r} = -\frac{\partial \alpha^*}{\partial r}$. The expression in (C.2) is clearly positive since $\frac{\partial \alpha}{\partial r} = 0$ follows from (A.6). The $PB=0$ line shifts down as $r$ is reduced.