

European Trade Balances: Measuring the Contribution of Expenditure Volume and Expenditure Switch

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My Main Message: The Unit Labor Cost Divergence Is a Red Herring

- ▶ Mario Buti argues: Relative wage adjustment will achieve healthy rebalancing:

*“Looking forward, **competitiveness** will play a key role in redressing external imbalances on a sustainable basis. For the rebalancing process to be durable, it cannot be linked to **expenditure reduction** only, but also to a **switch of expenditure** away from imports and towards domestic production. ... The role of **relative wages and prices** is key” (Buti and Turrini, 2012).*

- ▶ I argue: Low-wage policy in Germany mainly induced expenditure reduction, and very little expenditure switch; low-wage policy in the periphery will induce expenditure reduction, and very little expenditure switch

Two Roads Lead to an External Surplus

- ▶ Harry G. Johnson (1958) introduced the distinction between expenditure-switching and expenditure-reducing policies

$$\text{TradeBal.} \equiv \underset{B}{\text{Exports}} - \underset{M}{\text{Imports}} \equiv \underset{Y}{\text{Output}} - \underset{E}{\text{Expenditure}}$$

- ▶ Given expenditure volume, **expenditure switch** refers to the reallocation of expenditure between domestic output and foreign output
- ▶ The **high road** leads via boosting output/exports
- ▶ The **low road** leads via dampening expenditure/imports

Trade Ratio \equiv Terms of trade \times Expenditure switch \times Relative expenditure volume

- ▶ DE denotes **domestic expenditure** (equal to absorption or domestic demand)
- ▶ Write **aggregate imports** as $M \equiv M/DE \times DE$
- ▶ $m \equiv M/DE$ is the **import propensity** of domestic expenditure
- ▶ Imports \equiv Import propensity \times Domestic expenditure:

$$M \equiv m \times DE$$

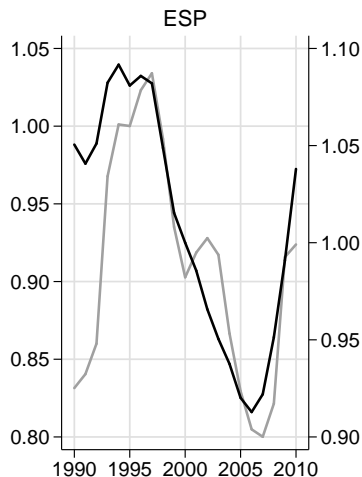
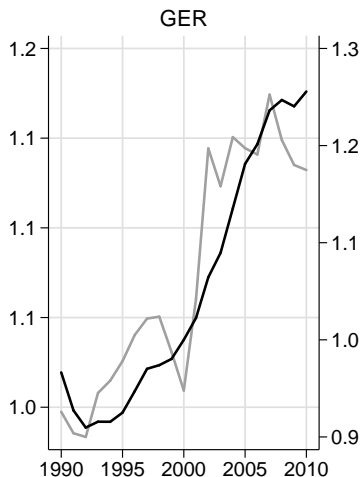
- ▶ Exports \equiv Foreign import propensity \times Foreign expenditure:

$$X \equiv m_f \times FE$$

- ▶ Putting everything together, write the trade ratio (exports over imports) as

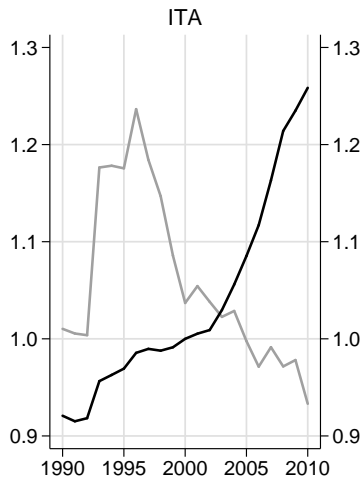
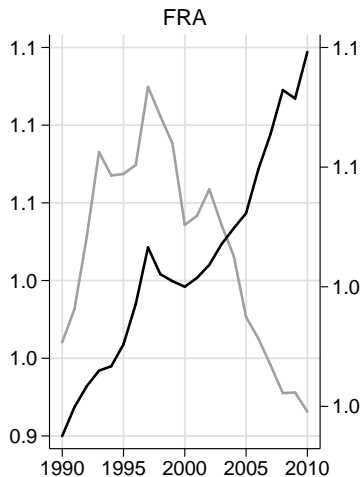
$$\frac{TRV}{\frac{P_X \cdot X}{P_M \cdot M}} \equiv \frac{TOT \times ES \times EV}{\frac{P_X}{P_M} \times \frac{m_f}{m} \times \frac{FE}{DE}}$$

Germany and Spain: Aggregate Expenditure Made the Difference



- Trade ratio = Exports / Imports (values)
- Relative expenditure = Foreign exp. / Domestic exp. (right axis)

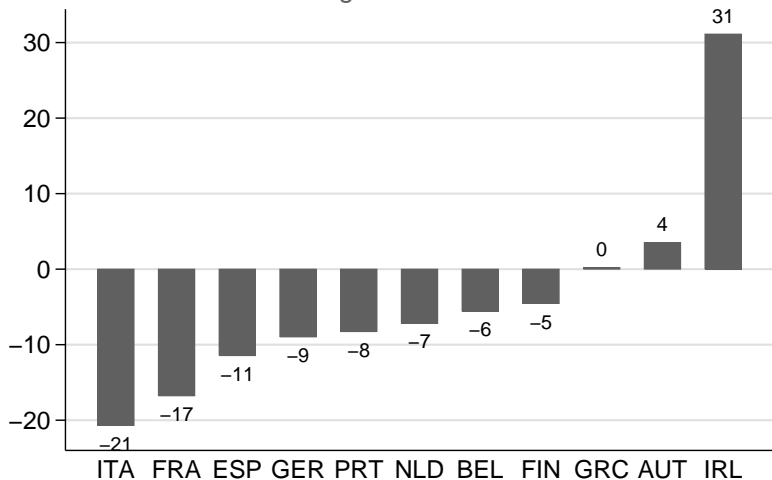
France and Italy: Unfavorable Expenditure Switch Indicates Competitiveness Problems



- Trade ratio = Exports / Imports (values)
- Relative expenditure = Foreign exp. / Domestic exp. (right axis)

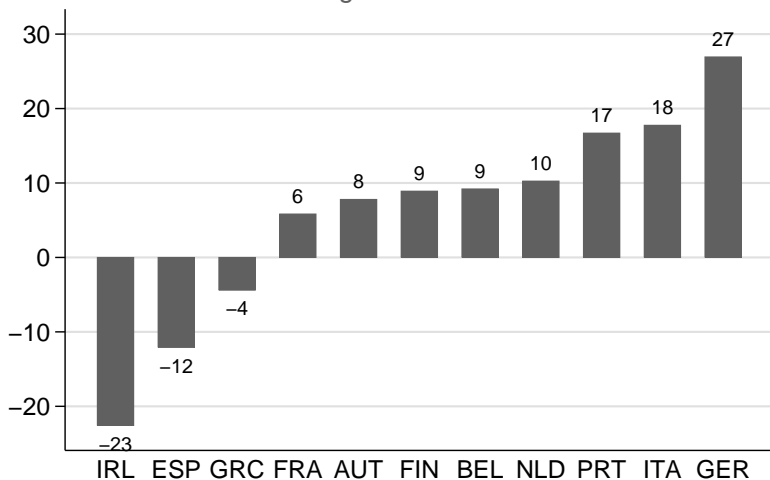
Italy and France Are the Competitiveness Laggards

Expenditure switch (relative import propensity)
Cumulative change 1999–2007 measured in %

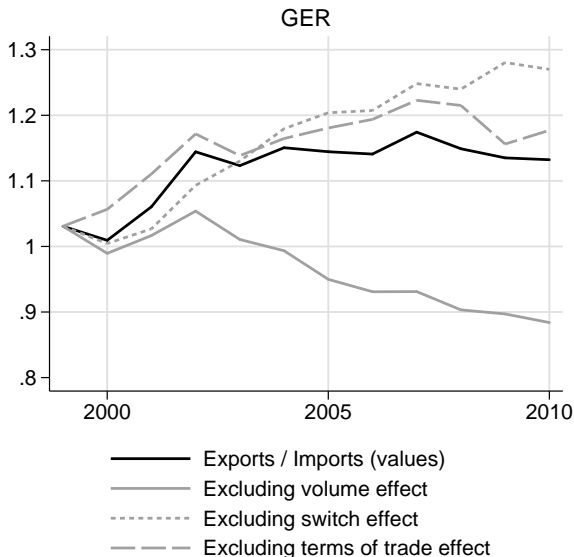


Germany's Expenditure Restraint Stands Out

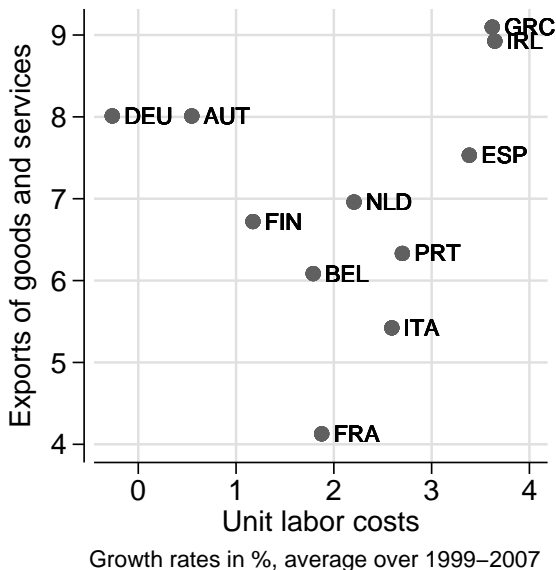
Foreign over domestic expenditure (relative expenditure)
Cumulative change 1999–2007 measured in %



If German Expenditure Had Grown as Fast as Trading Partner Expenditure, We'd Observe a Trade Deficit



ULC Growth Does Not Seem to Hurt Export Performance



Wrapping Up

- ▶ Unfavorable expenditure switch in nearly all European countries, most severe in France and Italy; Germany and Spain share same pattern of expenditure switch (while ULC diverged)
- ▶ **Volume** effect larger than switch effect (except in France, Italy, Ireland)
- ▶ Germany has taken the **low road** to external surpluses – a model for Europe?
- ▶ Tinkering with relative prices – low-wage policy in the periphery – is **expenditure-reducing** policy
- ▶ Address debt overhang, raise expenditure in Germany+, and develop industrial policy