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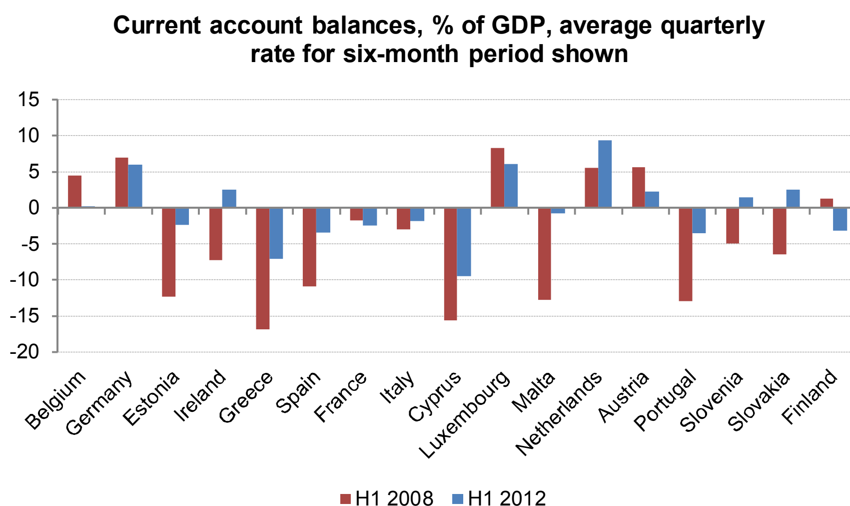
Euro area not out of trouble yet

Persistent imbalances, continued falls in GDP imply crises flare-ups in 2013

Recent EA data is a mixed bag; broadly speaking, they say the economy continues to slow down, with a likely contraction in Q4 after GDP falling by 0.1% in Q3 and further falls in H1 2013. However, the slowdown is perhaps slightly less marked than before.

What about the somewhat longer term? Last month Eurostat published is Macroeconomic Imbalances Procedures Scorecard. The Macroeconomic Imbalances Procedures (MIP) is supposed to show how euro area imbalances are adjusting. Obviously, while there always will be imbalances, it is mainly when they become extreme that they become dangerous. In the case of the euro area some narrowing of imbalances is a necessary, though not sufficient, condition for a successful outcome of the sovereign debt crises. This comment is not going to cover all the MIPs. However, bearing in mind that they were heralded as evidence of the progress the euro area has made, a few words of caution may be advisable.

Although there are eleven MIPS, the key one in terms of illustrating how well the imbalances are narrowing should be the current account balance. This is partly because it was in many ways the large differences between saving and spending which triggered the Great Recession; and because the euro are was very much a world in miniature, divided into excess savers and excess spenders. The evolution of the current account balance is obviously connected with each country's competitiveness, which is therefore a second key component.



Euro area current account balances have indeed narrowed. In Q2 2008, Germany ran a current account surplus of 6.4% of GDP, the Netherlands one of 3.8% and Belgium one of 9%. France ran a 2.8% deficit, Italy a deficit of 1.5%, with Spain -9.9%, Portugal -13.3%, Greece -16.4% and Ireland -5.7% of GDP. By

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Q2 2012, the numbers for the surplus countries were Germany 5.8%, the Netherlands 7.3% and Belgium 4.1%; for the deficit countries they were France -3.1%, Italy -0.2%, Spain -1.1%, Portugal -2.8%, Greece -4.4% and Ireland a surplus of 7.8%. However, this data not being seasonally adjusted, the chart below shows the average for the first half of 2008 and the first half of 2012 for each country. Note that these are each country's total current account, meaning that they also incorporate extra-EA developments. As it happens, the EA current account has over the same period gone from a deficit of 1.7% of GDP to a surplus of 0.5%, meaning that some of the improvement in country balances has come at the expense of non-EA countries. (The EA current account surplus widened further in Q3 to 1.1% of GDP, taking the two-quarter average to 0.9%; but we lack data for the individual countries for the quarter.)

Nevertheless, what stands out from the numbers is that at least some of the narrowing of current account deficits in the crisis-hit countries has come at the expense of deteriorating positions in France and Belgium; and, much more importantly, that the German and Dutch current account surpluses have either narrowed very little (Germany) or widened (the Netherlands). This is bad news for France as doubts about the country's situation are multiplying. It is probably worse for the EA as a whole, as it shows that the key internal imbalance – Germany vs Club Med – is barely shifting. Moreover, at least some of the improvement in the Club Med current accounts is due to the collapse in domestic demand. The effect on the external balance is good; but it begs the question of the sustainability of the improvement if and when growth eventually recovers.

For that sustainability it is helpful to look at changes in competitiveness. The MIPs includes inflation-based real effective e exchange rates and nominal labour costs. Here we will instead look at the ECB's real harmonised competitiveness indicator, based on unit labour cost. Again, the news is mixed. This indicator is set at an index of 100 for Q1 1999. However, while most EA countries joined the single currency at that stage, some did not. Greece joined in 2001, Slovenia in 2007, Cyprus and Malta in 2008, Slovakia in 2009 and Estonia in 2011. Because the two last-named have been members for such a short period, they are excluded from the chart. The chart compares the harmonised competitiveness indicator at the time of joining the euro; at its peak and the latest available number.

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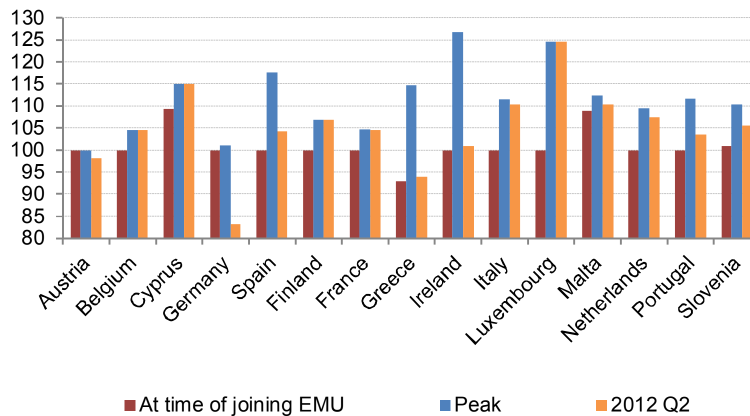
ECB harmonised competitiveness indicator, based on real ULC



In most countries (Austria and Germany partly excepted) competitiveness deteriorated when the country joined the euro. Again, in most countries, the competitiveness indicator fell back again (ie, competitiveness improved) after peaking in the 2000s – although with some significant exceptions, notably and worryingly France and Italy. The Club Med countries and Ireland have certainly seen substantial falls in their real ULC-based exchange rate, which is excellent news. But, what is less good is that in none of these has competitiveness improved beyond the point where it was when the country joined EMU. In Ireland, it is almost back where it was.

Unfortunately, it is not enough to get back to where you were. Bearing in mind the task facing these countries, with austerity and deleveraging in all domestic sectors, they have to improve their competitiveness beyond where it was ten years or so ago, not least because the hope of export-led salvation from slump is not exclusive to euro area members. And what is perhaps most disconcerting from an intra-EA perspective is that Germany's competitiveness has improved far beyond where it was in 1999. This is bad news for the Club Med countries – and ultimately for Germany as well if it means that the recovery of the crises-hit periphery is postponed.

What all of this means, is that although the ECB managed to stem the EA's seemingly endless crises by its promise to "do whatever it takes" and by holding out the promise of unlimited Outright Monetary Transactions, the fundamental problems afflicting the single currency zone remain. Chief among these is the lack of growth and the lack of growth potential, not only in parts of the periphery, but also in France.

EA fixed income has done reasonably well of late. Obviously, if you believe that the EA has turned a corner and that the crises will now begin to subside, periphery debt should be an attractive investment. However, the persisting imbalances outlined here, combined with the outlook for continued falls in GDP in 2013, rather point to the risk that targets will be missed and crises will flare up again – with rising bond yields as both a cause and an effect.

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And there is another instability factor which suddenly (re-)appeared over the weekend. This is the political risk, the danger of some event unnerving markets, causing government bond spreads to widen again and weakening fiscal positions and confidence. With excellent timing, the decision of Silvio Berlusconi to announce that he will return to politics and lead his party in the forthcoming Italian elections – brought forward by Mr Berlusconi's removing his support from Prime Minister Monti – perfectly fits the bill. It is difficult to conceive of any event more calculated to destroy confidence in Italy than the possibility that it will once again be led by Mr Berlusconi (unless it were a Beppe Grillo premiership, unlikely though either probably are). This is not the only political risk that can (will) throw EA plans – but it is a good example.

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