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A Reversal in Euro-Area Rebalancing?

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In recent years, regional rebalancing within the euro area has been driven largely by structural adjustments in the periphery. However, since economic recovery has kicked in, countries like Spain and Portugal have seen a modest cyclical deterioration in their current accounts. This may present a medium-term risk.

Large current account deficits in the euro-area periphery were the most visible manifestation of regional imbalances that existed before the global financial crisis. Unsustainable growth financed by foreign flows of capital went from bubble to bust.

During the sovereign-debt crisis, capital inflows dried up and then moved into reverse. Since then, there's been a dramatic improvement in current account positions in the periphery, and a parallel reduction in Germany's large intra-regional surplus.

In our view, this has been one of the most visible indications of the fundamental correction that's taken place in the euro-area periphery (and in the broader region) in recent years. But, this adjustment is not yet complete. More recently, economies like Spain and Portugal have moved into recovery mode, prompting a small cyclical deterioration in their current account positions. So far, this reversal has been modest, but if it continues, it would raise medium-term risks.

A Major Transition

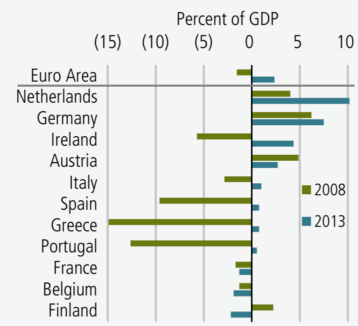
In the aftermath of the global financial crisis, there was a sizeable adjustment in Europe's balance of payments—led by the periphery **(Display 1)**. Since 2008, Spain, Portugal and Greece each turned deficits of between 10% and 15% of gross domestic product (GDP) into small current account surpluses (of 0.5%–1.0% of GDP) in 2013. Ireland moved from a deficit of 6% to a surplus of 4% in the same period.

There have been two components of this transition: First, an intra–euro area adjustment between core and periphery; and second, an extra–euro area adjustment between the region and its external trading partners. **Display 2** shows the change from 2008 to 2013 in the trade balance—the current account's largest component—by intra- and extra-regional contributions.

In the periphery, the intra–euro area adjustment was driven in most cases by a contraction in imports (of manufactured products from core Europe). By contrast,

Display 1
Adjustment in Current Accounts

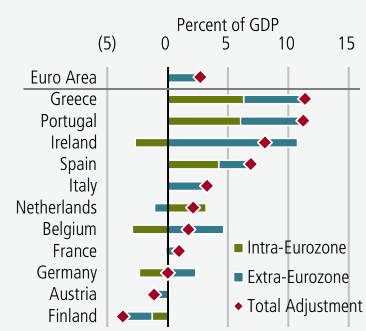
Current Account Balance, 2008 and 2013



As of December 31, 2013
Source: Haver Analytics

Display 2
Intra– vs. Extra–Euro Area Adjustment

Change in Goods and Services Balance
By Contribution, % of GDP



As of December 2013
Source: Eurostat and Haver Analytics

except in Greece, the extra-regional adjustment has been led by an increase in exports, mainly to the developing world.

The mirror image of this can be seen in the reduction in Germany's trade surplus with the rest of the euro area by 2.4% of GDP over the same period. However, Germany's overall trade position has barely changed in recent years as a result of an increase in its surplus with the rest of the world, notably due to higher exports to Asia.

A Structural Adjustment?

Now, the question is whether the adjustment in the periphery was structural, and therefore sustainable, or cyclical, and destined to unwind as economies recover?

In a recent report, the European Commission found that most of the rebalancing in the periphery in recent years was driven by a structural contraction in domestic demand and imports. In other words, Spain's huge current account deficits before the crisis were caused by an unsustainable, credit-fueled boom. Viewed this way, much of the subsequent contraction in domestic demand and imports should be regarded as a correction from inflated pre-crisis levels and therefore permanent (i.e., they are unlikely to return to their former levels—even after the Spanish economy has fully recovered).

But imports are only part of the story. In most cases, exports have also played an important role in the adjustment. For Spain, Portugal and Ireland, exports of goods and services grew by between 18% and 20% cumulatively between 2008 and 2013, putting all three among the region's top performers. In Spain and Portugal, export growth has been diversified across manufactured products, raw materials/fuels, consumer goods and services. In Ireland, it has been led by the country's computer/business services and pharmaceutical export sectors. In all three cases, though, strong export growth has been supported by structural reforms, a reduction in relative unit labor costs and better access to faster growing developing markets. In light of this, the strong export performance of these countries is likely to be sustainable.

A Reversal in the Trajectory

In our view, the evidence suggests that much of the improvement in current-account positions in the periphery has been structural. Yet, there's also a cyclical dimension to consider. Since Spain and Portugal began to recover in mid-2013, their current account balances have deteriorated slightly **(Display 3)**, from a 1% of GDP surplus to a deficit of around 1% of GDP. In our view, this reflects a turnaround in the cyclical components of the balance of payments. So far, the reversal has been modest, but we believe it could continue in the near term.

Notably, a strong cyclical rebound and the impact of past structural reforms have recently allowed both Spain and Portugal to post faster growth rates than many of their main trading partners. This has boosted imports of both capital and consumer goods. Looking ahead, the European Central Bank's (ECB's) plans to support bank lending could provide a further boost to domestic demand in these countries, as could a further easing of fiscal policy in the periphery. So, while most of the current account adjustment has been structural, a further modest cyclical deterioration is probable in the near term, which could raise investor doubts over the sustainability of regional rebalancing.

Medium-Term Outlook

Even a small cyclical deterioration, to a small current account deficit, could be very important for Spain and Portugal. This is because these countries are huge net external debtors **(Display 4)**, and such a development would push their debt stocks further in an unsustainable direction.

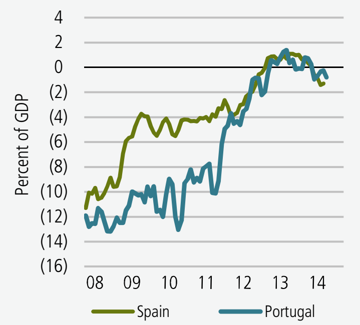
Ultimately, this would raise questions about the need for further action to promote regional rebalancing. With this in mind, an important area of contention is whether or not the region's surplus/creditor nations—primarily Germany but also countries like the Netherlands—have done enough to support this process.

Judging by his recent Jackson Hole speech, ECB president Mario Draghi seems to think the answer to this question is "no." One thing does seem certain, though. Without faster aggregate demand (and import) growth in countries like Germany, the medium-term sustainability of their external positions will continue to hang over the periphery, and could ultimately put a speed limit on their economic growth rates as well. ■

Display 3

A Reversal in the Trajectory

Current Account Balance, Spain and Portugal

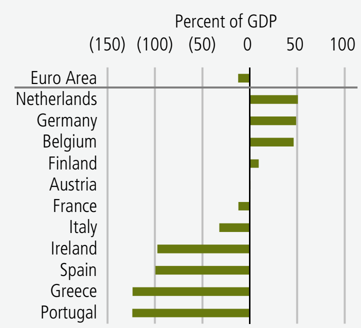


Three-month moving average, % of GDP
As of July 2014 for Portugal; as of June 2014 for Spain
Source: Haver Analytics

Display 4

High External Debt in the Periphery

Net International Investment Position



As of 1Q:2014, except for Ireland and France (which are as of 4Q:2013)
Source: Eurostat and Haver Analytics