The Economist

Adjustment in the euro zone

More and more and not enough

Europe's peripheral economies have already undergone a lot of restructuring. But without action by the rest of the euro zone, it risks being in vain

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THE port of Barcelona, Spain's third-busiest, used to handle more imports than exports. This has now turned around, says Santiago Garcia-Milà, the port's deputy general manager; among many other things, ships are now for the first time taking cars off to China. The European Commission believes that this year exports of goods and services from Spain will be 22% greater, in real terms, than they were in 2009, as will exports from Portugal. Irish exports are expected to have grown by 15% over the same period, and if the rate is a little slower the growth matters even more; Irish exports are worth about 100% of GDP, whereas in Spain the share is about 30%.

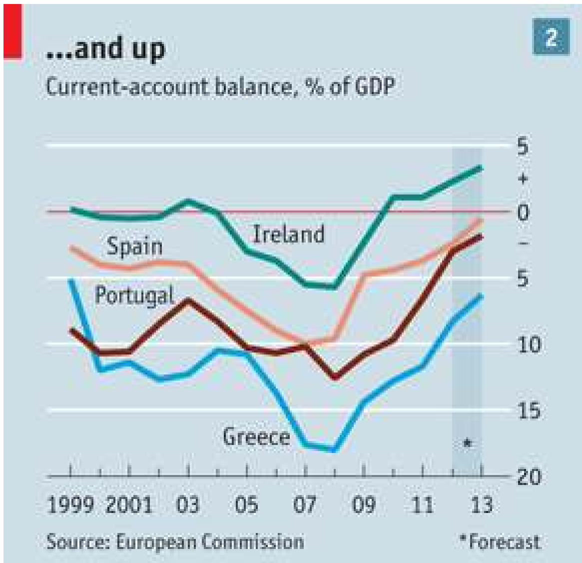
Growth in exports, and with them strongly reduced current-account deficits, are one sign of change on Europe's periphery. Budget deficits have also been dropping. So have labour costs, increasing competitiveness. One measure of the scope of the efforts under way is the wave of industrial protest against them on November 14th, which included a general strike in both Spain and Portugal and smaller protests in Greece and Italy.

There remains much for these countries to do by way of "structural reform"—shake-ups of product and labour markets that will cause more pain and unrest. And little of the limited good news spreads as far as Greece, where exports are barely rising and which remains, in effect, insolvent. But the amount of both fiscal and economic progress in Spain, Ireland and Portugal, and to some extent Italy, is both underappreciated and heartening. The south is more than half way through the adjustment that is needed, says Julian Callow of Barclays, a bank, and still going in the right direction.

Even if such efforts are continued and strengthened, though, they cannot in themselves be enough. If the euro crisis is ever to be resolved, the divide that opened up in the first decade of the single currency between creditor countries in the northern core of the 17-strong euro zone and debtor nations in the south must be closed. That will require concerted action from the core countries of the north, as well.

There has been some helpful action at the level of the euro zone as a whole. Tensions in financial markets have eased since Mario Draghi, head of the European Central Bank (ECB), said in July he would do “whatever it takes” to save the euro. The ensuing commitment by the ECB to buy short-term sovereign bonds of beleaguered countries without limit (under strict conditions) is a treatment for the symptoms of the crisis rather than its causes. But the relief it has brought by reducing bond yields is still welcome. The effect was most obvious in Spain, which was on the brink of requiring a bail-out for its public finances on top of the one earlier provided to its banks. But yields dropped elsewhere, too—in Portugal ten-year-bond yields fell from 11.1% to 8.8%, in Italy from 6.5% to 4.9%. In part as a result, Ireland has been tapping financial markets for the first time in two years.

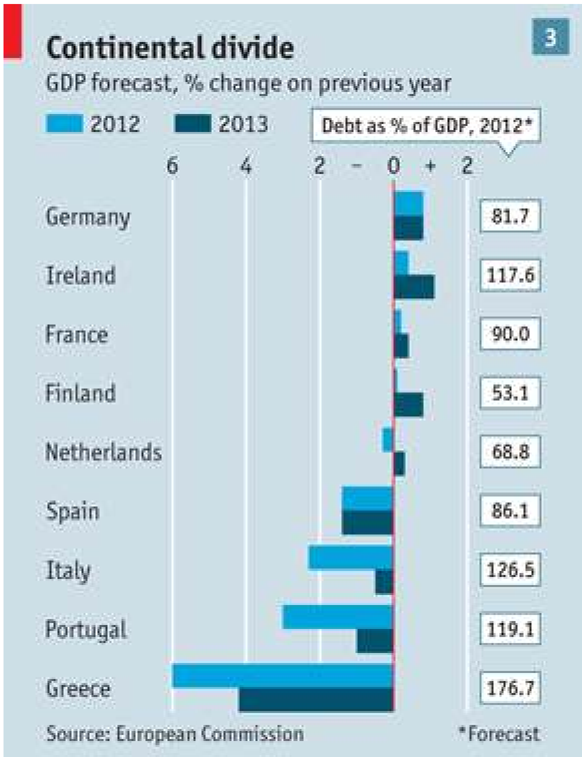
This improvement may owe much to Mr Draghi, but it also reflects real change in the south, where yawning budget deficits have been cut back. A crucial measure is the primary budget balance (ie, before interest), which needs to swing into surplus in order to prevent debt from spiralling out of control. The size of the necessary surplus depends on growth rates, interest rates and the stock of debt. Since 2009 primary deficits have narrowed a lot in southern countries (see chart 1), and Italy’s has returned to surplus.



Current-account deficits are also improving. The room for improvement, admittedly, was vast. The deficits in Greece and Portugal peaked in 2008 at 18% of GDP and 12.6% of GDP, respectively. Spain’s peaked at 10% the year before. Deficits throughout the periphery have shrunk notably since then (see chart 2). Ireland, where the deficit peaked at 5.7% of GDP in 2008, has been running a current-account surplus since 2010. Portugal and even Greece have been running surpluses in recent months, though this may not last. The European Commission's projections show both countries running a deficit in 2013, with Greece's still worryingly high at 6.3%. Italy's deficit, meanwhile, shrank from 3.5% in 2010 to 1.2% this year.

Indicators of underlying competitiveness like unit labour costs have also turned in the right direction in most of the countries in trouble, though Italy's are still rising. Ireland has done the best, with a 14% improvement since 2008. And there has been progress on the structural reforms needed to allow southern economies to cope with the rigours of the single currency in the longer term. How much progress is hard to say, because the reforms cover such a wide range of regulations affecting businesses and workers. Mr Draghi said on November 8th that the peripheral economies had moved far faster in this area in the past year than they had before. But as Mr Callow notes, progress on structural reforms lags behind the improvement on external adjustment.

The missing ingredient



All the progress, though, needs to be judged in the harsh light of the periphery's lack of growth. Although the improvement in the south's balance of payments is welcome in as much as its exports are finding markets, much of it is due to the fact that demand for imports has fallen in its recession-stricken economies. As far as GDP and unemployment are concerned, the economic divide between the periphery and the core is continuing to widen (see chart 3). Next year the European Commission expects the euro area to grow by just 0.1% (following a decline of 0.4% this year). But whereas GDP in Germany will rise by 0.8%, the same as this year, it will fall in Spain by 1.4%, and in Portugal by 1% (after a 3% fall in 2012). Italy's GDP will decline by 0.5%, after a 2.3% decline in 2012. The Greek collapse will continue for a sixth year, with output shrinking by 4.2%. The divergence will be just as marked for unemployment, predicted to be 5.6% in Germany compared with 26.6% in Spain.

This lack of growth is the heart of the problem: the south is being subjected to self-defeating austerity, which drives economies down, makes it harder to close deficits and raises debt. The bigger the debt burden—which exceeds 100% of GDP in Greece, Italy, Ireland and Portugal—the more important the gap between interest rates and growth becomes, and that gap widens when economies are shrinking. In such circumstances the growth in the stock of debt can accelerate even if deficits are shrinking. The main reason why the Greek debt burden is expected to get worse despite serious deficit reduction is that its economy has continued to nosedive.

Further structural reform could help provide the needed growth. One way to see the scope for improvement is in the World Bank's "ease of doing business" measurement, derived from factors such as the time it takes to start a business, register a property and enforce contracts. Figures released this October show that Greece, Portugal and Spain have all significantly narrowed the gap that divides them from the best European countries in which to do business by reforming things like construction permits and procedures for insolvency. But though the gap has been narrowed, it is still present. And in the case of Italy it has narrowed very little.

But the rest of the euro zone also has a role to play in delivering the growth that the south needs. The country with the most to offer is Germany. Although its surplus with the euro area has fallen a lot, it still amounted to 2.3% of GDP in 2011. Germany resists structural reforms in its underdeveloped services sector that would generate more domestic demand in the longer term. And its citizens remain hostile to the idea of inflating away some part of their competitiveness in order to make things easier on their cousins in the south.

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A narrowing fiscal and economic divide between north and south is a necessary condition for ending the euro crisis, but it is not a sufficient one. The crisis has led to a deep gulf between financial conditions in the north and south. In the north, businesses and households can borrow at cheap rates. In the south, they have to pay much more, and often banks just don't want to lend at all. Despite emergency measures by the ECB—including the provision of €1 trillion ($1.3 trillion) three-year central-bank funding to European banks last winter, most of which went to the periphery—this divide persists.

This reflects the third dimension of the euro crisis: that it involves not just collapsing public finances and huge trade imbalances but fragile financial systems, which are susceptible to investor panics. Weak government finances left banks with lots of dodgy government debt; in Ireland and Spain, which experienced epic housing boom-and-busts, self-inflicted wounds by the banks weakened the governments. The pernicious link between banks and governments stymies progress.

Putting this right requires a return of confidence on the part of private investors outside the south, which would ease financing pressures. But although yields have fallen, private investors are still leery of investing in the south. Its banks remain heavily reliant on ECB funding. The "Target2" imbalances between central banks—liabilities chalked up in the south by, for example, the Bank of

Spain and claims accumulated in the north, especially by the German Bundesbank—have recently fallen a little but remain extraordinarily high, which indicates the extent to which central banks have been financing capital flight from the south.

Say not the struggle naught availeth

Breaking the vicious circle between weak banks and weak sovereigns requires a big leap forward in economic integration: a euro-area banking union (see article (http://www.economist.com/news/finance-and-economics/21566643-euro-zone-needs-banking-union-isnt-it-made-brussels)). Although European leaders recognised the necessity of this reform over the summer, they have since been backtracking on making it a swift and meaningful reality. In particular, hopes of introducing euro-wide deposit insurance are dwindling.

That is characteristic of the way the euro crisis has been mishandled. Whenever the ECB has countered market fears, its reaction has taken the pressure off European politicians and they have dragged their feet. Spain is a prime example. Mariano Rajoy continues to hesitate over seeking a bail-out which could trigger the ECB's bond-buying policy, even though that may mean that he eventually has to ask for one from a position of weakness rather than strength. Despite all the adjustments, the euro area remains vulnerable to economic setbacks and political upsets, especially in the south (and above all in Greece). And the progress has been bought at a price. How much more will electorates be prepared to suffer without seeing more convincing and rewarding results?

From the print edition: Briefing