SPECIAL REPORT

TD Economics

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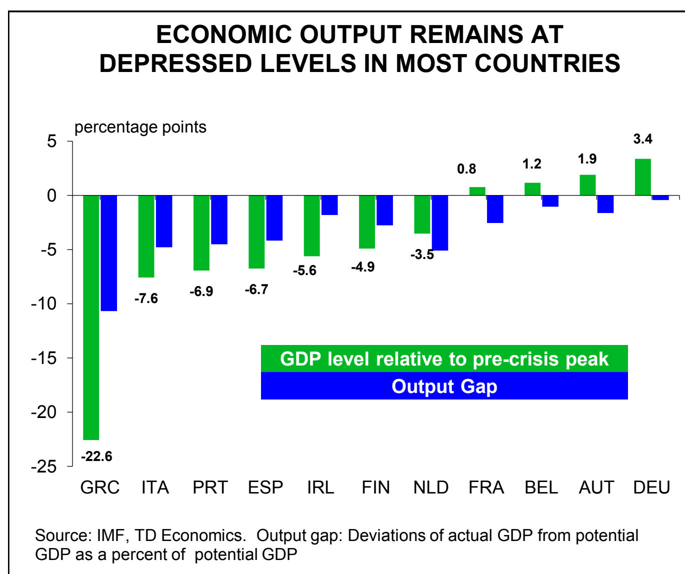
EURO ZONE: FINANCIAL CALM SHOULD NOT DISGUISE OUTSTANDING MACROECONOMIC CHALLENGES

Highlights

- The relative calm in financial market conditions across the euro zone over the last year has resulted not only from the policy actions taken by the ECB, but also from lower external financing needs across the periphery.
- In addition, shrinking private demand for loans, a tougher regulatory environment, and the possibility of using sovereign bonds as collateral for ECB funding has led many euro zone banks to ramp-up their holdings of sovereign debt of their home countries. This has also contributed to narrower sovereign bond spreads.
- This recipe could continue to work for a number of years. However, the combination of weak economic growth, low inflation, large net external liabilities, and still rising government debt might prompt foreign investors to demand higher risk premiums on peripheral euro zone sovereign debt. This becomes a more tangible possibility against the backdrop of higher U.S. Treasury rates.
- Higher interest rates would once again raise concerns about debt sustainability, especially in light of the modest results achieved thus far through fiscal austerity and structural reform.
- Therefore, other more drastic measures, such as debt restructuring, could not be ruled out from the menu of potential policy actions. But before we cross that bridge, we are likely going to see a more resolute response from the ECB.

The euro zone crisis went from an acute to a chronic stage after European Central Bank (ECB) President Mario Draghi vowed to do "whatever it takes" to save the euro in July of 2012. Sovereign bond yields declined and financial market conditions improved, and for much of 2013, remained far more supportive than they had been during the previous three years. News headlines speculating about a potential euro zone break-up are hard to find these days. However, the relative calm in euro zone financial markets was not only the result of actions taken by the ECB during the second half of 2012, but it also stemmed from the waning need for foreign funding experienced by most peripheral countries.

Narrowing current account deficits have resulted both from stronger exports and weaker imports, although the mix differs across countries. However, as encouraging as this new-found competitiveness might be, it has come at the expense of sharp increases in unemployment, which has severely burdened domestic demand. Against this backdrop of significant economic slack, inflation has fallen to historically low levels, and most private forecasters, as well as the European Central Bank



Source: IMF, TD Economics. Output gap: Deviations of actual GDP from potential GDP as a percent of potential GDP

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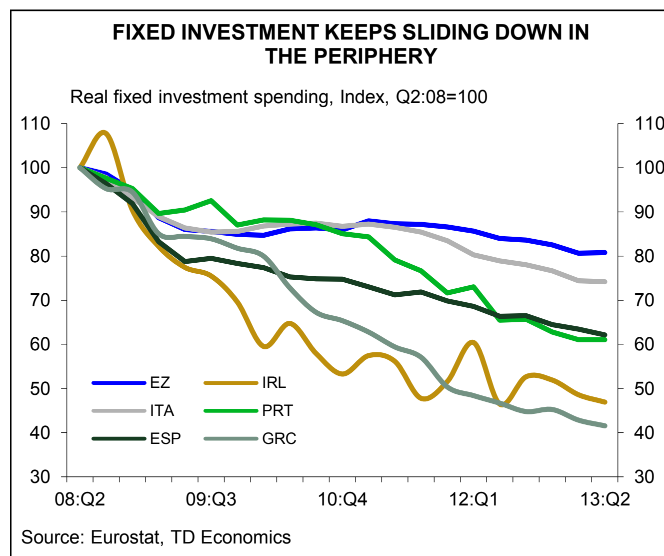
(ECB), expect it will remain low, at least for the next two years. This begs the question whether the euro zone will replicate Japan's deflationary experience. The fact that Southern euro zone countries have accumulated large net foreign liabilities makes it less likely for deflation to prove long-lasting. Given that deflation would eventually prompt foreign investors to demand higher yields on peripheral debt, it would likely make their debt positions unsustainable. Therefore, if there was any indication that deflation could become entrenched, the ECB will react much more forcefully to provide monetary stimulus and avoid that outcome.



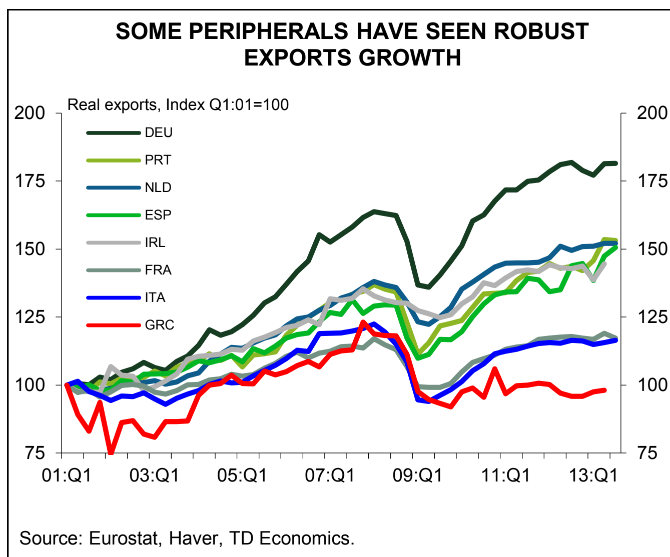
Financial calm masks underlying macroeconomic weaknesses

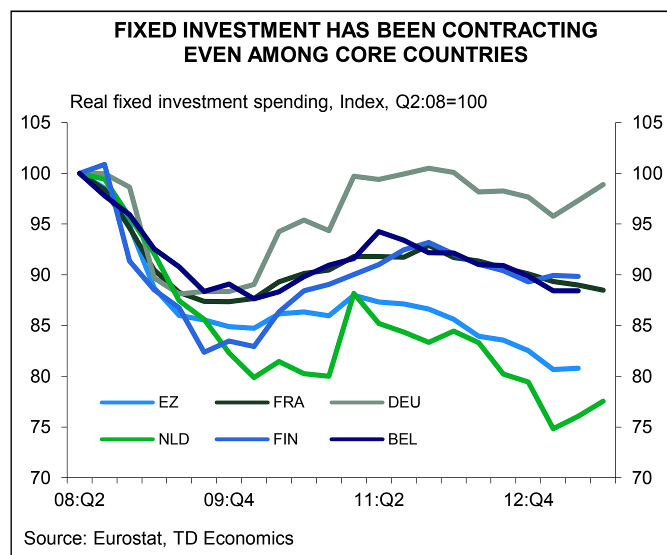
More than five years have passed since the global financial crisis and the euro zone economy is still reeling to regain the ground it lost to the recession. At the end of last year, real GDP for the common currency area remained 1.7% below its 2008 level, with economic output in Ireland, Italy, Spain, and, Portugal is still roughly 7% below their respective pre-recession peaks. Greece remains the outlier, with real GDP having contracted by roughly a quarter since. Granted, a handful of its members have already surpassed their pre-crisis levels of economic output; Germany is ahead of the pack, with an economy 3.4% larger than it was in 2008.

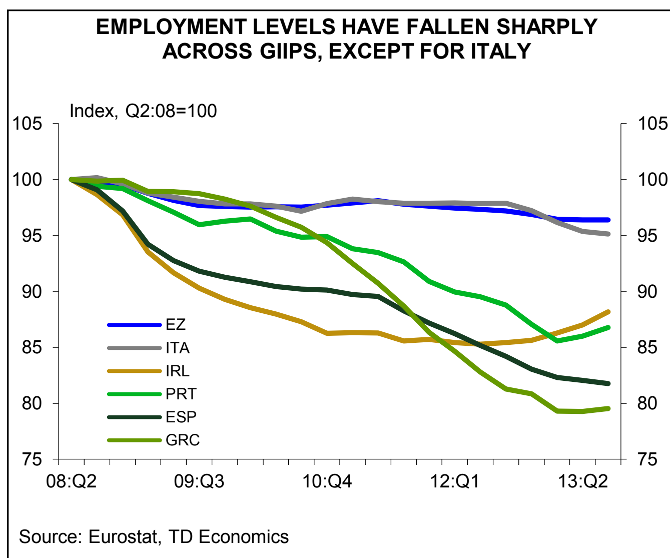
In turn, significant idle capacity and the prospect of a prolonged period of subdued demand have led to a sharp decline in fixed investments' spending. Even in Germany, gross capital formation remains roughly 3% below its pre-crisis level, with spending in machinery and equipment surprisingly weak at more than 12% below its 2008 peak. This is striking considering the country has virtually closed its output gap, it is operating near full-employment and real exports are 11% higher than their pre-crisis peak. Naturally, the contraction in fixed investment spending has been much more pronounced in the Southern countries. Fixed investment spending in machinery and equipment in Italy, Portugal, and Spain is below their 2007 peaks by 26%, 25%, and 22%, respectively.

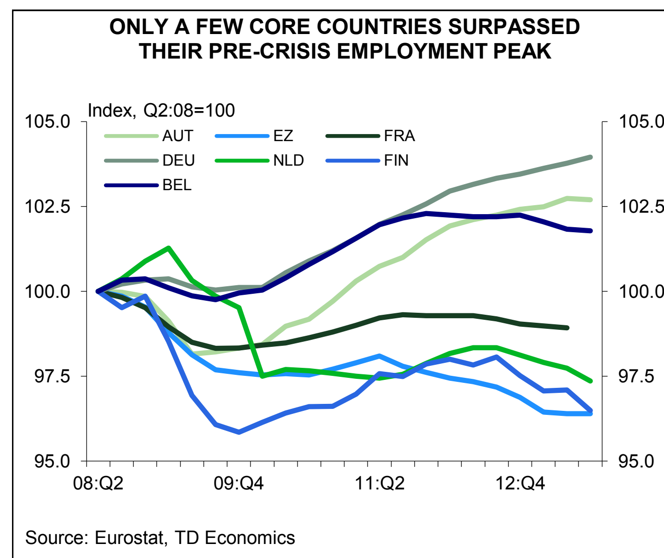
The labor market has not been spared of this malaise.

Employment remains at depressed levels in most countries, especially among Southern countries. In Greece, the number of people employed is 21% below its pre-crisis peak; in Spain it is 19% lower, Ireland and Portugal are 13% lower,



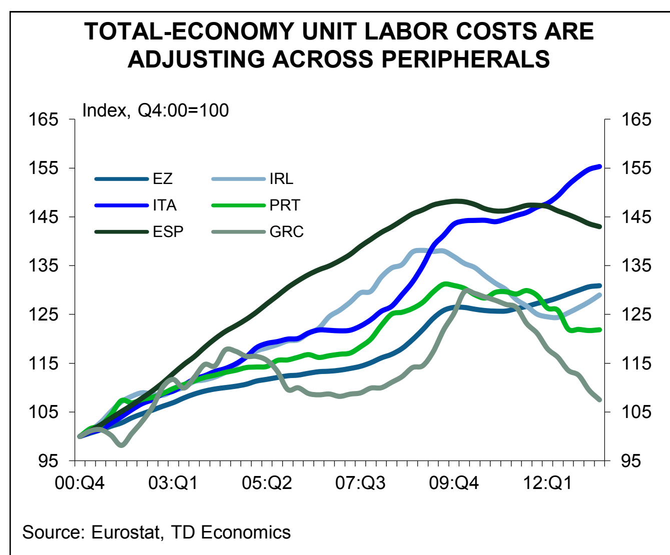






while Italian employment is 5% below its 2008 level. For the euro zone as a whole, employment levels are still 3.6% below the pre-crisis peak. This has negatively affected wages and salaries. Total employee compensation – adjusted for inflation – has dropped by 40% in Greece, 22% in Spain, 18% in Ireland, 17% in Portugal and 10% in Italy. Real disposable income has naturally declined in tandem, and, with it, the ability of households in these countries to both spend and pay down debt.

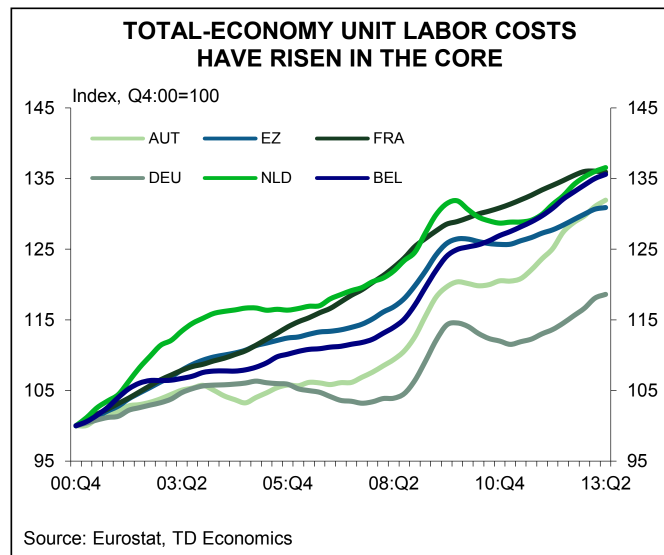
There is, nonetheless, a positive side effect to the weakness observed in the job market. Because the declines in employment compensation mentioned above have exceeded those registered by GDP, it follows that unit labor costs (ULC) have also declined, particularly in tradable sectors such as manufacturing. This has yielded gains in competitiveness in most stressed countries.

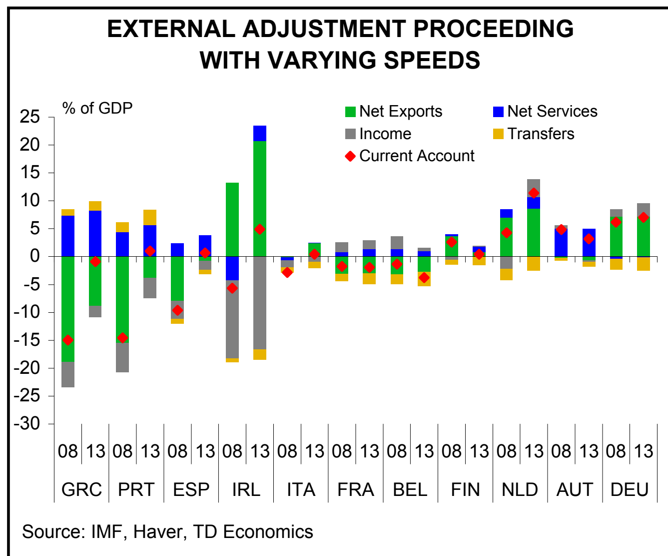


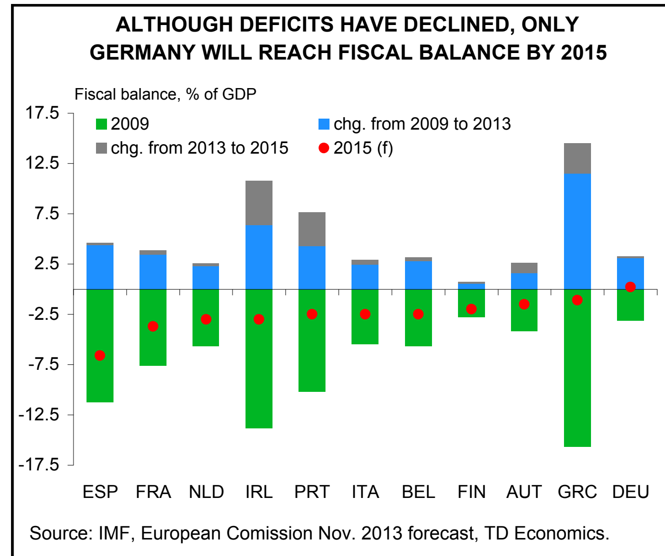
External gaps narrow as competitiveness improves

Falling labor costs have boosted real exports, which have outpaced overall economic activity by wide margins while real imports have remained depressed. Both Spain and Portugal have seen their real exports surpass their pre-crisis peak by roughly 12%; Irish exports have done so by 7%. On the other hand, their real imports remain 19.5%, 13.4%, and 11.7% below their pre-crisis peak, respectively. As a result, Portugal has reverted from a current account deficit of 14.5% (measured as a share of GDP) in 2008 to a projected 1% surplus in 2013. In turn, Spain and Ireland have seen their external balances go from deficits of 9.6% and 5.6% to surpluses of 0.7% and 4.9% last year, respectively.

Greece has also reduced its current account deficit from 15% of GDP in 2008 to a projected 1% deficit last year, but







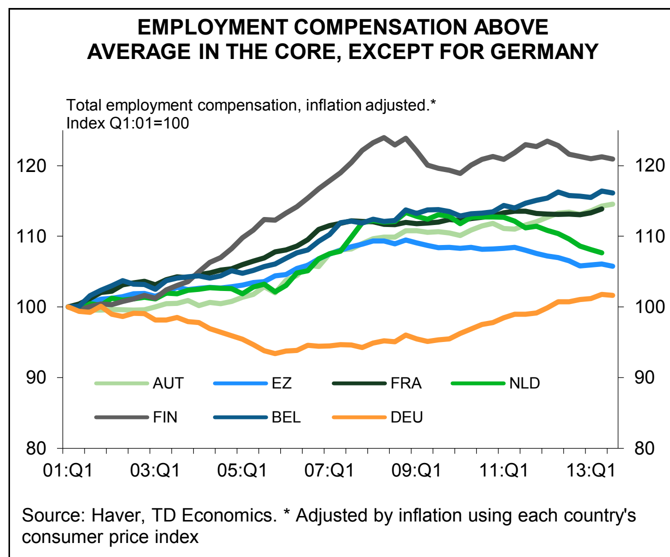
this has mainly resulted from a precipitous 50% decline in real imports since 2008. Real exports have declined by a less dramatic 20%. Italy has experienced a similar performance, with imports underperforming more than exports, albeit by smaller margins.

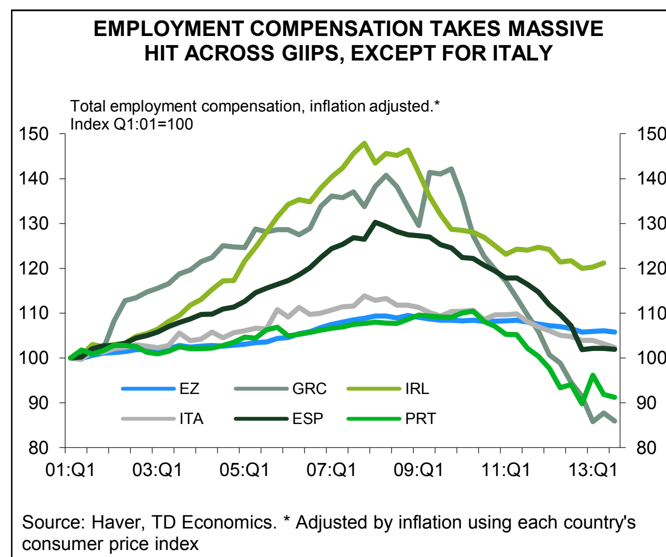
Progress in addressing fiscal imbalances has been less encouraging

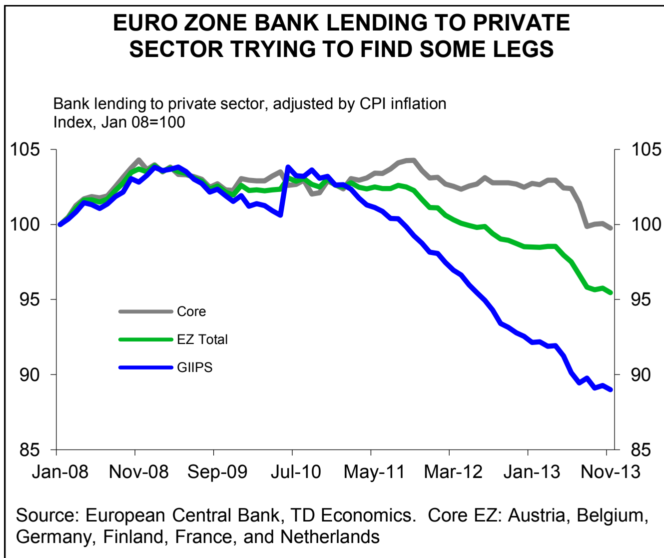
Weak economic growth has limited the effectiveness of ongoing fiscal consolidation efforts. In its latest Economic Outlook released in November 2013, the European Commission projected Spain would register a fiscal deficit equivalent to 6.8% of GDP last year, which would decline marginally to 6.6% of GDP by 2015. The fiscal accounts of Ireland, Portugal, and Italy are also expected to be in the red two years from now, with deficits in the range of 2.5% to 3% of GDP. As a result, sovereign debt-to-GDP ratios will keep rising, despite continued fiscal restraint. The European Commission foresees Spanish sovereign debt reaching 104% of GDP by 2015, 119% in the case of Ireland, 126% for Portugal, and 133% for Italy. Although already in a downward trajectory, Greek sovereign debt will remain at a shockingly high 171%-of-GDP by 2015.

Private deleveraging weighs on credit creation

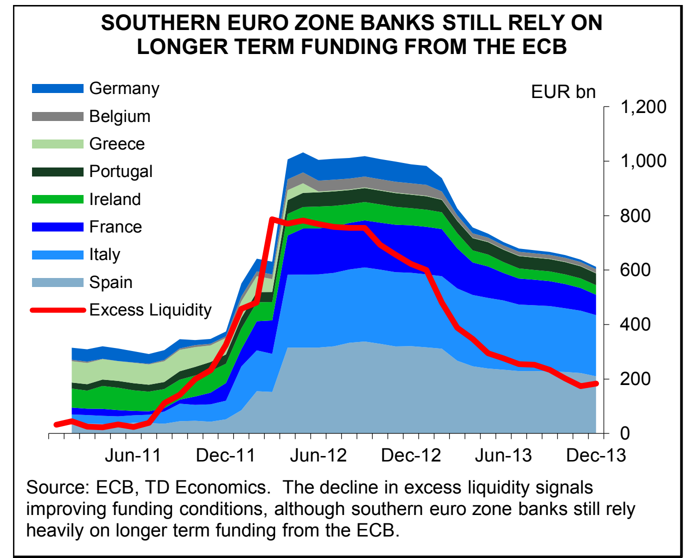
Similarly to its impact on fiscal consolidation, low employment levels and declining labor compensation have hampered households' capacity to reduce their debts. Nonfinancial corporations have also struggled to bring down liabilities amidst falling business activity. As a result, the







Source: European Central Bank, TD Economics. Core EZ: Austria, Belgium, Germany, Finland, France, and Netherlands



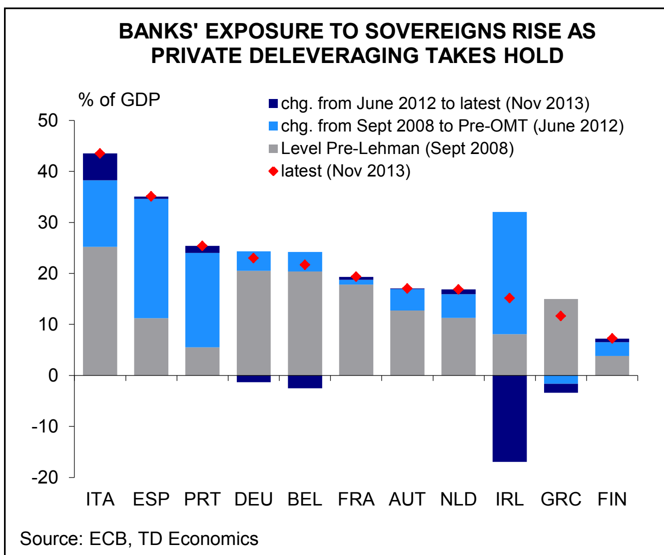
Source: ECB, TD Economics. The decline in excess liquidity signals improving funding conditions, although southern euro zone banks still rely heavily on longer term funding from the ECB.

sum of households and non-financial corporations' debt in both Spain and Portugal exceeds 200% of GDP, while in Ireland it remains more than three times the size of the economy. This is why it is not surprising to observe bank lending perform so poorly despite the ultra-low interest rate policy pursued by the ECB.

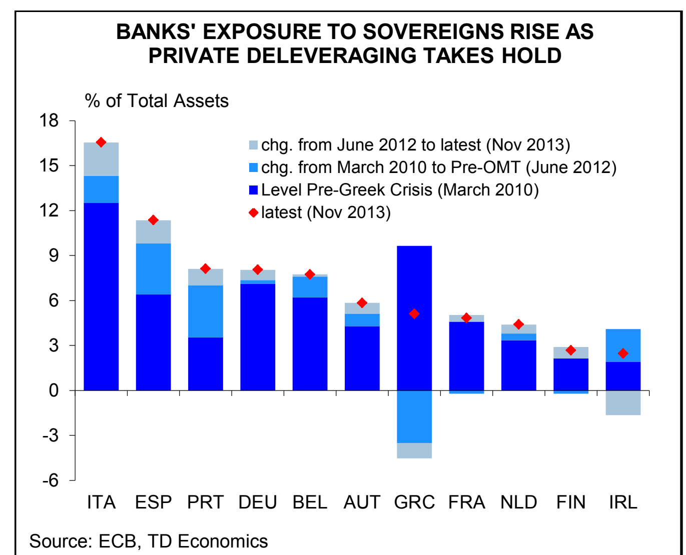
However, credit in Southern euro zone has not only declined due to weak demand. Banks are also dealing with deteriorating assets' quality and tougher regulatory requirements. In this environment, funding fiscal deficits has turned increasingly attractive for euro zone banks. The sovereign bonds they buy can be posted as collateral with the ECB in exchange for additional liquidity, or used to enhance their capital ratios. As a result, many of them have increased their holdings of their home country's sovereign debt. This is apparent in the case of Italy, Spain, and – to a lesser extent – Portugal, where ECB liquidity support for their domestic banks has coincided with an increase of banks' holdings of national sovereign bonds.

ECB is eager to force banks to clean-up their books

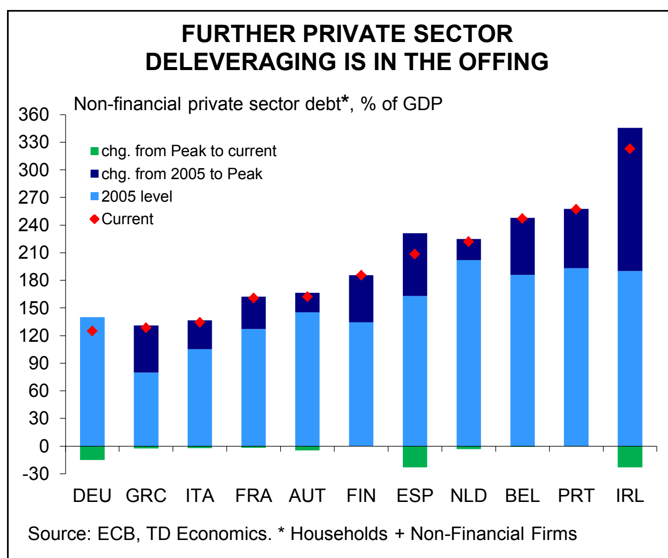
Attentive to these developments and the challenges they pose to the transmission of its lax monetary policies to the real economy, the ECB is trying to accelerate the clean-up of euro zone banks' balance sheets. To achieve that goal, it launched in October 2013 an Asset Quality Review (AQR) and this year it will conduct a stress test exercise in conjunction with the European Banking Authority (EBA). By increasing transparency around banks' financial health, these exercises have the potential to reduce financial frag-

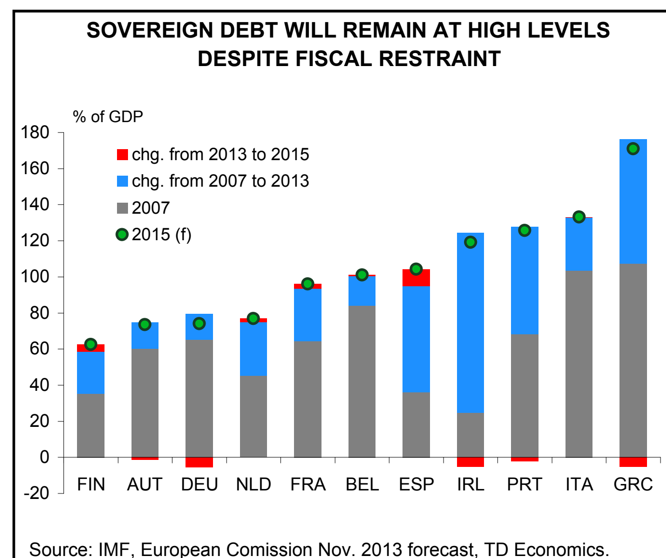


Source: ECB, TD Economics



Source: ECB, TD Economics





mentation and, consequently, improve credit supply across the euro zone. However, in the short-term, they are likely to lead to a further tightening in credit conditions, as banks reduce exposure to riskier assets and seek to raise capital to meet higher regulatory standards.[1] Ironically, this runs counter to the ultimate goal of the ECB, as this response will limit the scope to which bank credit could support economic activity. Therefore, if both bank lending and inflation continue to underperform, it is very likely that the ECB will try alternative ways to stimulate credit growth, such as outright asset purchases.

Will the euro zone mimic Japan's lost decades?

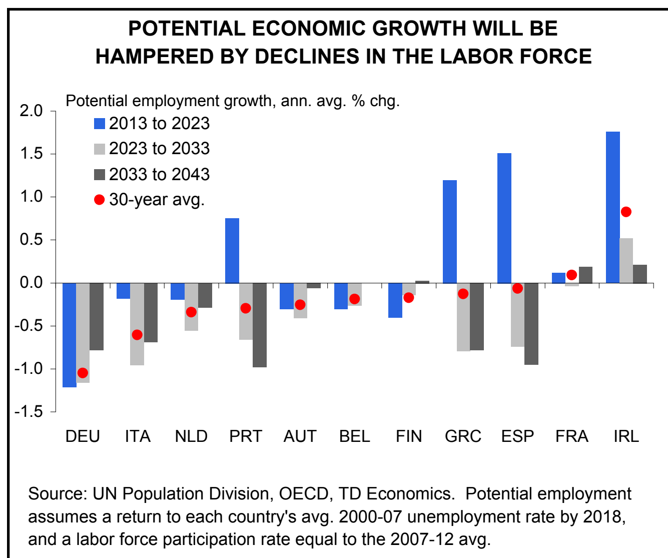
As you may have already guessed from the deluge of economic challenges cited above, the economic recovery in the euro zone will proceed at a very slow pace. As we highlighted in our latest Quarterly Economic Forecast, by the end of 2015, the economies of Greece, Ireland, Italy, Portugal, and Spain will still remain below their pre-crisis peaks. All in all, we project economic growth of 1% in 2014 for the euro zone and a slightly stronger 1.3% in 2015.

Protracted economic weakness and the prospect of low inflation naturally beg the question of whether the euro zone is posed to repeat Japan's lost decades. The short answer is no, but to understand why, it is necessary to illustrate what economic factors converged to yield Japan's deflationary equilibrium during the last two decades.

Failure to rapidly clean-up private balance sheets following the collapse of the asset bubble in 1991, a delayed monetary policy response, undue early tightening of fiscal policy that suppressed a nascent recovery, and an ageing and declining population have all been blamed for Japan's structurally weak demand that led to its two-decade long deflationary experience. However, deflation also persisted because sovereign bond yields remained low, thanks not only to the disinflationary pressures, but also to high domestic savings and a home bias by domestic banks and institutional investors, who favored Japanese sovereign bonds over alternative investments. In fact, since the asset bubble burst in 1991 Japan has been able to fund its ballooning sovereign debt domestically, and, at the same time, continue to accumulate net financial assets abroad.

In stark contrast to Japan, across Southern euro zone countries, Greece has run current account deficits for 34 years straight, while Portugal and Spain registered current account deficits in 28 and 30 of the last 34 years, respectively. This means two things: first, these countries are structurally net dis-savers; and second, they have accumulated a massive stockpile of net foreign liabilities.

If deflation becomes entrenched, foreign investors will demand higher risk premiums to hold Southern euro zone debt, because deflation makes it harder for borrowers to repay. Furthermore, the expected increase in U.S. Treasury yields alongside Germany's economic outperformance relative to its euro brethren will exacerbate the upward pressure on Southern euro zone sovereign bond yields. This could lead to renewed concerns about debt sustainability, especially taking into consideration the modest progress achieved thus far through fiscal adjustment and structural reform.



Thus, although deflation could ensue across Southern euro zone countries – it already has in Greece – it is less likely it would prove a persistent phenomenon, unless official creditors step-up to fill the funding void left by fleeting foreign investors.[2] Moreover, as we mentioned above, if there was any indication that deflation could become entrenched, or if inflationary expectations begin to drift lower, the ECB would react much more forcefully, as those threats would solidify consensus within the its governing council about the need to provide more stimulus.

From a medium- to long-term perspective, though, the one element most euro zone countries will have in common in the coming decades with Japan's 1990's experience is demographics. An ageing population and a declining labor force played a prominent role in Japan's deflationary experience. As the accompanying chart shows, most euro zone countries are set to experience that demographic shift over the next 30 years; Germany is already experiencing it. Hence, although we believe a key element that shaped Japanese deflation – i.e., domestic ownership of sovereign debt – is missing in Southern euro zone, demographic trends are a concern. If there is one lesson to be draw from Japan's post-bubble history, it is that structural reforms should be implemented before it is too late to turn the tide.

Final Remarks

The relative calm in financial market conditions across the euro zone over the last year has resulted not only from the policy actions taken by the ECB, but also from lower external financing needs across the periphery. In addition, shrinking private demand for loans, a tougher regulatory environment, and the possibility of using sovereign bonds as collateral for ECB funding has led many euro zone banks to ramp-up their holdings of sovereign debt of their home countries. This has also contributed to the narrowing of sovereign bond spreads.

This recipe of concealed financial repression could continue to work for a number of years. However, the combination of weak economic growth, low inflation, large net external liabilities, and high and still rising government debt might prompt foreign investors to demand higher risk premiums on peripheral euro zone sovereign debt. Deflation would only heighten those odds, especially against the backdrop of higher U.S. Treasury rates caused by an accelerating U.S. recovery. Higher interest rates would once again raise concerns about debt sustainability for many euro zone members, especially in light of the modest results achieved after three years of fiscal austerity and structural reform. Therefore, other more drastic measures, such as debt restructuring, cannot be ruled out from the menu of potential future policy actions. But before we cross that bridge, we are likely going to see a more resolute response from the ECB.

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Endnotes:

1 Indeed, although the ECB is using the current definitions of common equity Tier 1 (CET1) capital for its ongoing AQR, this will not be the case in next year's stress test. Instead, they will apply to each year under the stress-projection horizon, the progressively more stringent CET1 definitions that will be in force according to the Basel III phase-in calendar. Therefore, in anticipation of the stress tests, euro zone banks will continue to adjust their risk exposures to meet those more stringent standards. As a reference point, it is worth mentioning the results of the Basel III Monitoring Report released in September by the EBA. They showed that, based on their December 2012 exposures, the largest 40 European banks would have had a CET1 ratio of 8.4% under Basel III, which is 3.1 percentage points lower than what the same banks reported under the current Basel 2.5 CET1 definition. For a group of 122 smaller banks, a CET1 definition fully compliant with Basel III would have yielded a CET1 ratio of 7.9%, which compares to 11.3% under Basel 2.5. In line with these results, the EBA estimated hypothetical capital shortcomings of €96 billion to meet Basel III CET1 definitions.

Furthermore, raising new capital to cover the potential shortcomings arising from the AQR and the stress test will prove very challenging for many euro zone banks. The prospect of weak credit demand caused by ongoing private-sector deleveraging, and compressed profit margins caused by low interest rates and deteriorating asset quality will make bank shares a though sale. Therefore, although fostering healthier euro-zone banks is an absolute "must do" for European authorities, in the short-term, the AQR and stress testing will cause banks to tighten credit supply.

2 In the case of Greece, this risk is mitigated by the fact that most of its debt instruments in foreign hands are held by official creditors, and sizeable repayments are not due until 2017-18. Nevertheless, at some point, euro zone authorities and the IMF will have to grapple with the fact that Greece will not be able to repay its debts in the terms agreed under its two bail-outs and debt swap.

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