I. Competitiveness and current account divergences in the euro area

After a decade of steady divergence of external positions and competitiveness within the euro area, the global financial crisis has triggered a partial reduction of Member States' current account deficits and surpluses. Member States which entered the recession with large current account deficits have experienced a combination of a sharper drop in private-sector demand and a less dramatic fall in exports than the rest of the euro area. These forces have tended to curb their current-account deficits, an effect which has been amplified by changes in the composition of domestic demand with, in particular, a substitution of imports with domestic products. Conversely, Member States which entered the recession with large current account surpluses have experienced more resilient private-sector demand and a bigger exposure to the slump in world trade due to their export specialisation and greater trade openness. The resulting current-account rebalancing has, however, not been accompanied by a significant rebalancing of competitiveness. As such, the recent rebalancing is likely to prove, at least in part, temporary.

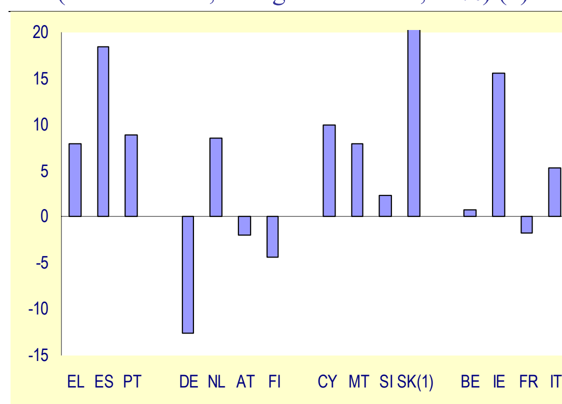
The surveillance of competitiveness and current account imbalances in euro-area Member States has become an important part of the European Commission's macroeconomic surveillance. A special issue of the Quarterly Report on the Euro Area published in March 2009 provided an in-depth analysis of divergences in competitiveness and external positions in the euro area since the launch of the single currency. ([1]) Since then, the global economic and financial crisis has had a profound and lasting impact on Member States' economies, including their external sectors. The present report updates last year's work by looking further into the impact of the crisis on intra-euro-area divergences.

The pre-crisis decade saw a steady divergence in competitiveness within the euro area ...

In the decade preceding the global economic crisis, the euro area experienced significant and persistent divergence in its Member States' competitiveness as measured by real effective exchange rates (REERs). Some Member States saw significant falls in their REER (DE, FI), while others registered sharp rises (EL, ES, IE, IT, NL, PT) (Graph I.1). ([2])

Most of the countries that introduced the euro in the last couple of years (CY, MT but especially SK) also experienced periods of sustained appreciation, but most of it preceded euro adoption and was consistent with underlying fundamentals. The broad pattern of divergence is visible irrespective of the price deflator used (i.e. GDP deflator, unit labour costs or export prices) or the reference group (i.e. intra-euro area or total REER).

Graph I.1: **Intra-area real effective exchange rate developments, euro-area countries**
(GDP deflator, change 1998-2007, in %) (1)



(1) SK is off-scale; actual value is 52.5 %. BE also includes LU.
Source: Commission services.

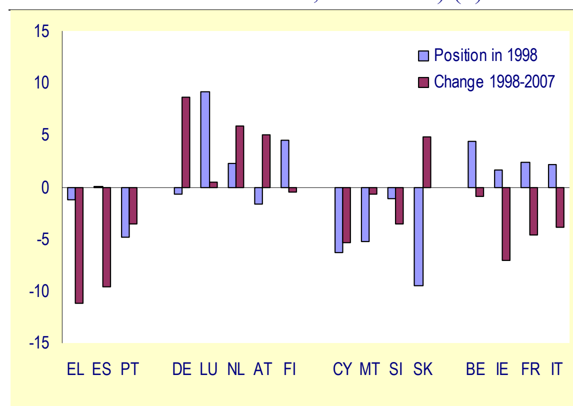
... together with a continuous divergence in current accounts

Since the introduction of the euro, Member State differences in current account positions have increased rapidly, reaching an all-time high in 2007 (Graph I.2). Some Member States entered the euro area with sizeable surpluses or deficits (e.g. BE, FI, PT and the countries that joined the euro recently), but much of the divergence in current account positions has taken place under the euro. To a large extent, the divergence trend can be traced back to developments in the balance of goods and services, which is usually the largest component of the current account.

([1]) European Commission (2009), Quarterly Report on the Euro Area, 'Competitiveness developments within the euro area', Vol. 8 No 1.

([2]) To facilitate reading, most charts in this section show countries grouped according to the following categories: (i) large current account deficit countries (based on 2008 data), (ii) current account surplus countries (based on 2008 data), (iii) Member States that joined the euro recently, and (iv) remaining countries.

Graph I.2: **Current account positions, euro-area countries** (level in 1998 and changes between 1998-2007, % of GDP) (1)



(1) Net lending (+) or net borrowing (-), total economy; for LU balance on current transactions.
Source: Commission services.

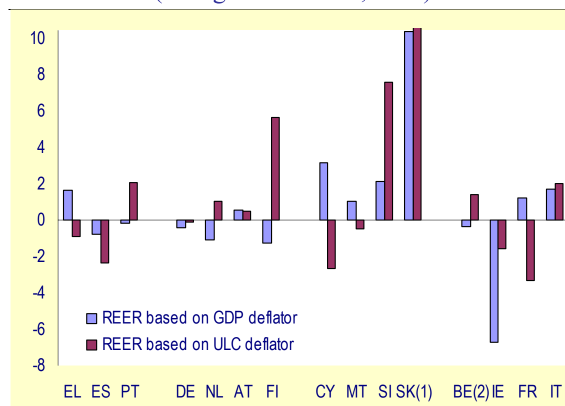
A large part of the cross-country divergence of current accounts since the launch of the euro has been determined by considerable and persistent differences in the strength of domestic demand across Member States. ([3]) Stronger relative demand pressures in a given Member State tend to fuel import demand and depress the current account. Differences in export performance – and therefore price competitiveness – have also contributed to the divergence of current accounts but, in most Member States, this has been of secondary importance compared with domestic demand factors.

Member States which have accumulated large current account deficits in pre-crisis years also saw a sharp deterioration of their external liabilities, with net foreign asset (NFA) positions reaching between 80% and 100% of GDP in 2008 depending on the countries considered. As discussed in section V of this report, the deterioration in NFAs has been amplified by persistent valuation effects. ([4])

The crisis has led to modest price adjustment…

Since the outbreak of the financial crisis in 2008 there has been little evidence of intra-euro-area convergence in price competitiveness. The intra-euro-area REER based on GDP deflators does not show a clear pattern across Member States in 2008 and 2009 (Graph I.3). Most of the Member States registered very small changes in this measure of competitiveness, usually not exceeding 2% over the last two years, except for Ireland, which stands out with a depreciation of around 7%. ([5])

Graph I.3: **Intra-area real effective exchange rate, euro-area countries** (change 2007-2009, in %)



(1) SK is off-scale; actual value is 14.3 % for ULC deflator. (2) BE also includes Luxembourg.
Source: Commission services.

In contrast, there have been modest signs of convergence in cost competitiveness. Since the beginning of the crisis, unit labour cost (ULC) growth has accelerated significantly in most Member States but more so in large surplus countries, most of which also enjoy a strong competitiveness position. ULCs have decelerated sharply or even fallen in Spain and Ireland. This differentiated behaviour of ULCs has entailed a moderate rebalancing of the REER based on ULCs. Nevertheless, except for Ireland, which is experiencing outright cuts in pay, the rebalancing has been mainly due to cyclical developments in labour productivity. Changes in productivity are likely to be mostly temporary, reflecting the cyclical impact of the crisis, including exceptional labour hoarding in several surplus countries and a deep fall in activity of the low-productivity construction sector in Spain and, to a lesser degree, Ireland.

… but significant current-account adjustment

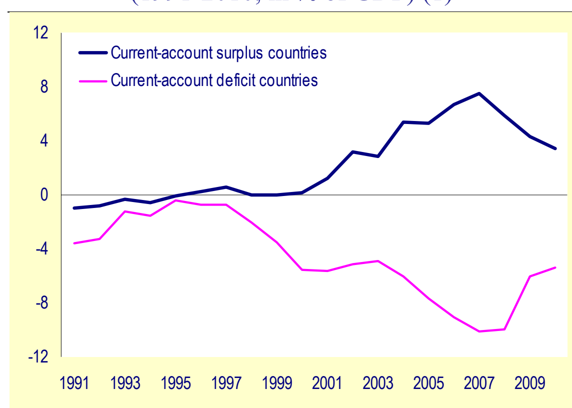
At the same time, however, the crisis has led to an abrupt reversal of the previous divergence trend in current accounts. The reversal can be traced back to both surplus and deficit countries (Graph I.4). Most countries with large current account surpluses (DE, NL, AT and FI) have seen

([3]) For a detailed discussion, see European Commission (2009), ibid.
([4]) See section V, 'External valuation effects in the euro area' in this issue.

([5]) Slovakia recorded an appreciation of almost 17% during 2007-09 but much of this was due to nominal appreciation preceding euro adoption.

significant falls in their external balances with only Luxembourg's position remaining broadly unchanged. Countries with sizeable deficits have typically experienced reductions in their deficit positions (except PT). ([6]) Large improvements have also been registered in the deficits of some of the recent members of the euro area (SI, SK and MT). Finally, developments in the remaining countries (BE, IE, FR, IT) have been heterogeneous, with Belgium reporting a large drop in its current account surplus and Ireland a significant improvement. The position of France and Italy remained broadly unchanged.

Graph I.4: **Current account positions, euro-area surplus and deficit countries**
(1991-2010, in % of GDP) (1)



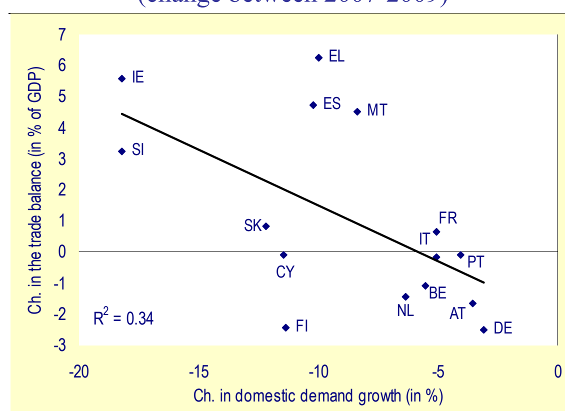
(1) Surplus countries include DE, LU, NL, AT, FI. Deficit countries include IE, EL, ES, CY, PT. Data for 2010 are based on the Commission's autumn forecast.
Source: Commission services.

Recent changes in current accounts reflect mostly domestic demand factors but also different exposures to the trade slump

There is a relatively close cross-country correlation between changes in the trade balance and changes in domestic demand between 2007 and 2009 (Graph I.5). Member States which have seen an improvement in the trade balance since the beginning of the crisis have also experienced a stronger contraction of domestic demand than the rest of the euro area, and vice versa.

A key source of country differences in domestic demand in the past two years has been the private sector response to the crisis. Member States with large current account deficits have experienced a sharp rise in saving and a sharp cut in investment by their private sector, which has been offset to various degrees depending on the country considered by rising government deficits. The change in private sector behaviour has been less pronounced in Portugal and Greece than in Spain. Only Ireland and Slovenia show similar private sector weakness. In contrast, in countries with large current account surpluses, changes in private-sector savings and investment have been far more limited. In those countries, drops in current account surpluses have been mostly driven by increasing public deficits.

Graph I.5: **Changes in domestic demand and in the trade balance, euro-area countries**
(change between 2007-2009)



Source: Commission services.

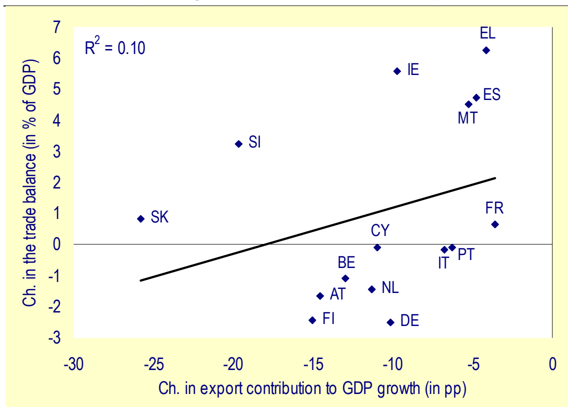
To a lesser degree, recent changes in the trade balance also reflect differences in exposure to the slump in world trade.

Graph I.6 shows that changes in the trade balances are positively correlated with the contribution of exports to growth during the crisis. This suggests that, to some extent, Member States which have experienced a stronger fall in exports have also seen a bigger drop in their current account positions. However, the correlation coefficient is much lower than in the case of domestic demand, indicating that country differences in exposure to the slump in world trade have played a less important role than country differences in domestic demand.

The change in the contribution of exports to growth can be interpreted as a measure of the size of the trade shock experienced during the crisis. A lower contribution indicates lower exposure to the slump in world trade. Countries with lower exposure have tended to register more positive developments in the trade balance.

([6]) Data shown in this report is based on ECFIN's AMECO database (storage of early March). More recent data suggest that the current account deficit in Greece may have improved only marginally during the crisis.

Graph I.6: **Changes in exports and in the trade balance, euro-area countries** (change between 2007-2009)



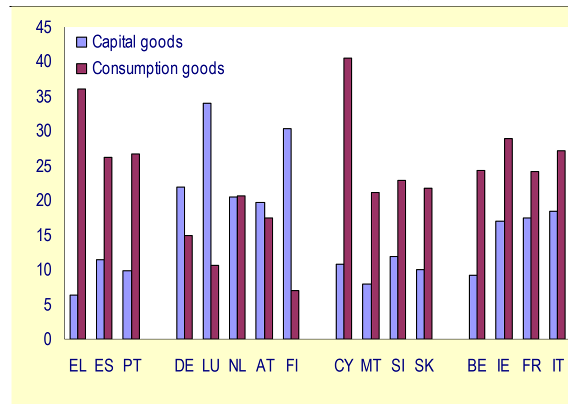
Source: Commission services.

Differences in trade exposure can be partly explained by differences in trade openness. In addition, the crisis has exposed the importance of non-price factors. In particular, the composition of the export basket has been an important determinant of exposure to world trade turbulence during the crisis. (7) The crisis has hit trade flows much more severely for some products than others. Trade in services (except for transport) has in general fared better than trade in goods. Among goods, investment goods have seen much steeper drops. In contrast, trade in traditional 'non-cyclical' sectors such as food and beverages or pharmaceuticals has been more resilient. Surplus countries in the euro area show high relative specialisation in capital goods (Graph I.7) and have faced sharper contractions in exports during the recession. All the other Member States tend to be more specialised in the production of consumption goods, which mitigated the impact of the trade slump on exports.

Overall, the drivers of the differentiated export developments in the euro-area Member States during the crisis have been to a large extent cyclical and may well turn around with the recovery.

Differences in the impact of the recession on trade can also be found on the import side. Some countries (notably EL, ES, CY, SI but also FI) have experienced an exceptionally strong drop in imports, reflecting changes in the composition of domestic demand. These countries have seen substitution of local demand away from imports towards domestic products, reflecting a shift away from imported luxury goods but also a collapse in demand for (mostly imported) investment equipment. The substitution effect is driven by the crisis and is likely to be largely temporary.

Graph I.7: **Share of capital and consumption goods in total exports of goods, euro-area countries** (in %, 2007)



Source: Commission services.

Summing up, the convergence in current account positions observed in the euro area in the past two years can be explained by differences in the reaction of Member States' domestic demand to the crisis as well as differences in trade exposure.

Most Member States which entered the recession with large current account deficits have experienced a combination of a sharper drop in private sector domestic demand and lower exposure to the slump in world trade than in the rest of the euro area. To various degrees, this has allowed improvements in the trade balance via both the import channel – i.e. a drop in domestic demand reduces imports, thereby lifting the trade balance – and the exports channel. Conversely, Member States which entered the recession with large current account surpluses have experienced more resilient private-sector demand and bigger exposure to the slump in world trade. In these countries, the two channels have played in reverse, acting as powerful dampening forces on the surpluses.

(7) See also section IV, 'Differences in Member States' export performance'.