European Economics

Speed limits

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The improvement in the trade balances of peripheral countries has been impressive, in our view. Having run large trade deficits ahead of the crisis, the peripheral trade balance is now moving tentatively towards a surplus. That adjustment has **come at a great price**, through a sharp downwards correction in domestic demand in the periphery that consequently reduced imports.

And that process is not yet over. The peripheral economies have moved out of trade deficit, but **they need to move into, and sustain, trade surpluses**. With the exception of Italy, the sustained current account deficits of the 2000s have led to very large, negative net international investment positions. Current account surpluses are necessary for these countries to speedily delever external debt, similar to the experiences of other countries and regions in the past.

That is clearly the trend these economies are on. But so far that **process has been a brutal one for domestic demand** and economic activity.

But there have also been **improvements in fundamentals**. To the extent to which large trade deficits were due to a deterioration in relative competitiveness as well as excessively strong domestic demand, there is evidence that **competitiveness is improving**. In general, the relative export performance of the periphery has improved thanks to better wage and price competitiveness.

So there is cause to expect that the **remaining external adjustment can be associated with rising economic activity rather continued recession**. But, a recovery in the periphery's GDP will bring about a recovery in its imports, so to the extent to which these economies need to have and sustain trade surpluses, their **GDP growth will be limited by the strength of exports**.

That means there are likely to be **limits to the pace of any recovery** in growth in the periphery. We estimate that, given nominal export growth rates of 5% and a desired trade surplus of 4% of GDP by 2017, **Spanish, Italian and Portuguese GDP could grow around 3-5% per annum in nominal terms** (around 1-3% in real terms). In Greece, we estimate such constraints would impose nominal growth of around 2%.

So, despite the improvement in financial fundamentals in recent months, the economic backdrop for the periphery's fiscal and debt consolidation over the coming few years will remain extremely challenging.

The ability of these economies to recover will depend on external growth. That implies **peripheral financial assets will continue to trade as risky assets sensitive to fluctuations in global growth momentum**. The ECB notwithstanding, it is possible that the strong performance of peripheral fixed income and equities in recent months is partly due to an acceleration, or "speed up scare", in global economic momentum. Past experience suggests it is not evident that the latter can be sustained for too long, especially with the fiscal cliff in the US looming.

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The recent financial stability in the euro area has been accompanied by growing evidence that the external imbalances in peripheral countries have been easing. As we discussed a few weeks ago (*Turning German*), the collective trade balance of the five peripheral countries is moving into surplus, having narrowed sharply in the past few years.

In our view, that adjustment is an important indication that – despite these countries paying a heavy price in terms of lost output and employment – their economic fundamentals are improving. In turn, that could make prospects for a recovery to a sustainable growth path from here look plausible.

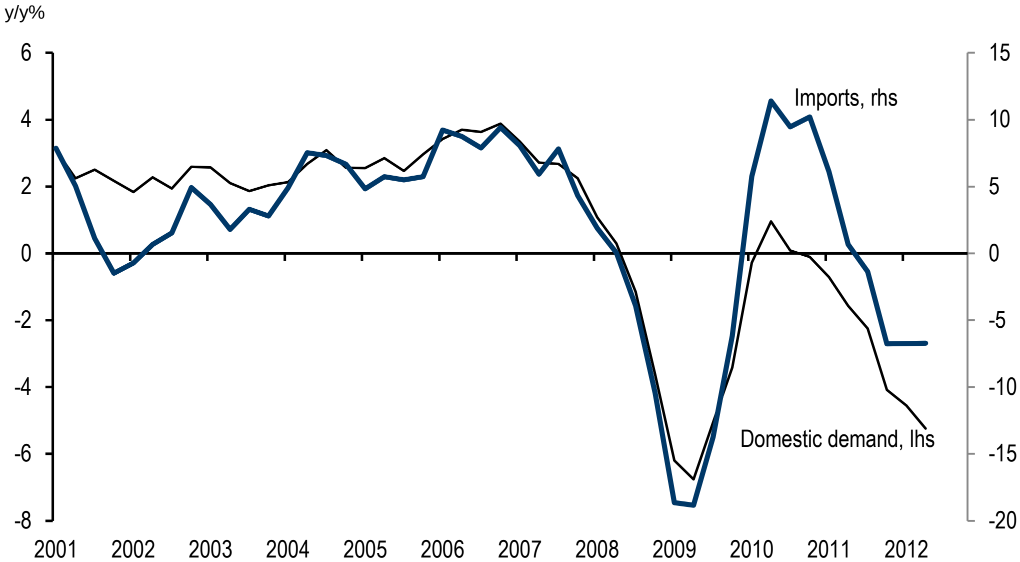
Exhibit 1: Euro area periphery trade balance

Source: Credit Suisse, Thomson Reuters DataStream

However, one of the main reasons why the periphery's trade balance has improved is that it has had a deep recession in domestic demand which, as Exhibit 2 below shows, has meant a sharp fall in imports. In the long term, that is not a sustainable basis for expansion!

The deep recession in the periphery means that some of the improvement in the periphery's trade balance is cyclical. So a key issue is whether there has also been a marked structural improvement in the trade balance, so that a further move into surplus can be consistent with recovery rather than recession.

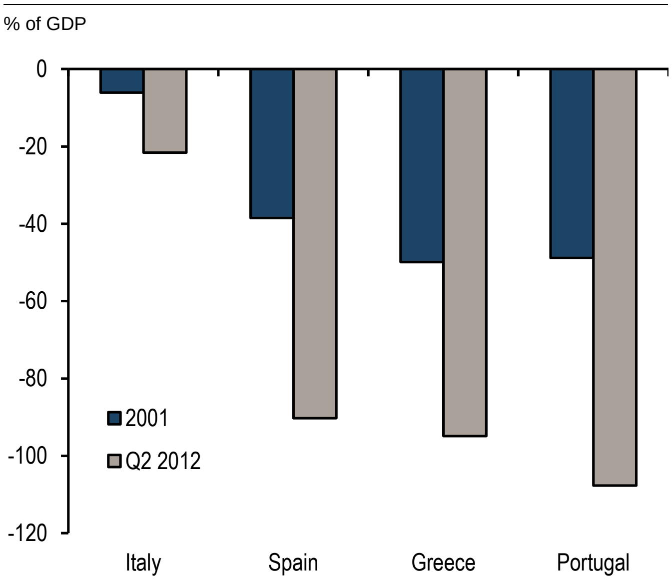
Exhibit 2: Real domestic demand and import growth in the periphery



Source: Credit Suisse, Thomson Reuters DataStream

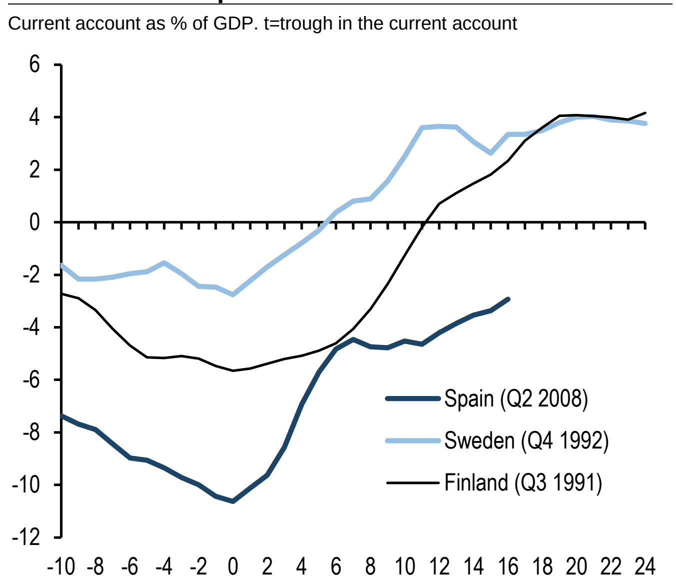
That is important because although the peripheral countries have more or less closed their trade deficits, they are likely to need to run sustained and significant trade and current account surpluses in coming years. In part, that will be necessary to bring about a reasonably swift improvement in their net international investment positions (especially in Spain, Greece and Portugal) and make them increasingly less dependent upon external financing. Indeed, the deterioration in these countries' net international investment positions in the last decade or so has been remarkable, with their negative net international investment positions at around 100% of their GDP, as Exhibit 3 shows.

Exhibit 3: Net international investment positions



Source: Credit Suisse, Thomson Reuters DataStream

Exhibit 4: Current account adjustment − the Scandinavian experience



Source: Credit Suisse, Thomson Reuters DataStream

The experience of other economies that have had similar financial crises – Asia in the late 1990s; Scandinavia in the early 1990s (Exhibit 4) – suggests that current account balances in the periphery still have some way to go before they can stabilise.

Large, unsustainable current account deficits in the periphery were a consequence of unsustainably rapid expansions in domestic demand and a loss of market competitiveness. It is clear that those expansions in domestic demand have reversed. But the more that the continued adjustment has to take place through contracting output and domestic demand, the less achievable – economically, politically and socially – these countries will find it. So the more the improvement in the trade fundamentals is structural, rather than cyclical, the more these economies should be able to sustain a modest expansion in GDP in the next few years.

One reason to think that part of the improvement in these trade balances is structural rather than cyclical is that the narrowing of the trade deficit has not entirely been due to weaker imports. There have also been some strong performances by exports, and not just in an absolute sense. In Exhibits 5 to 9 below, we plot the strength of export growth in the periphery relative to export growth for the euro area as a whole.

In the last decade or so, exports from the periphery have generally underperformed the euro area average, on the back of lax financial and monetary conditions supporting domestic demand and the relative loss in competitiveness.

Exhibit 5: Export performance in the periphery

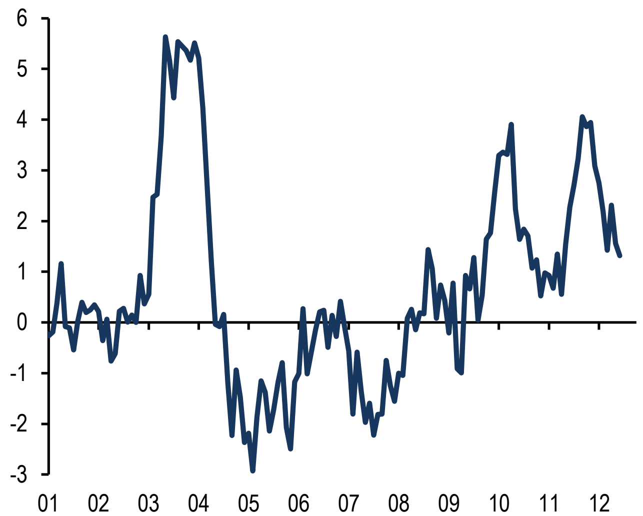
pp, 1 year moving average. Periphery includes Italy, Spain, Greece, Portugal and Ireland

Note: The series shows the difference, in percentage points, between export growth in the 5 peripheral economies and euro area export growth minus export growth in the periphery itself
Source: Credit Suisse, Thomson Reuters DataStream

However, in the last year or so export growth in the periphery has been stronger than the euro area average, suggesting that some of the improvement in the periphery's trade dynamics is indeed structural. As we show in these exhibits, the improvements have been the clearest in Spain, Portugal and Greece. Italian exports have been just in line with euro area export growth, while Irish exports growth has broadly underperformed the euro area average since the early 2000s, with the exception of the 2008-09 episode.

Exhibit 6: Spain's export performance relative to the euro area

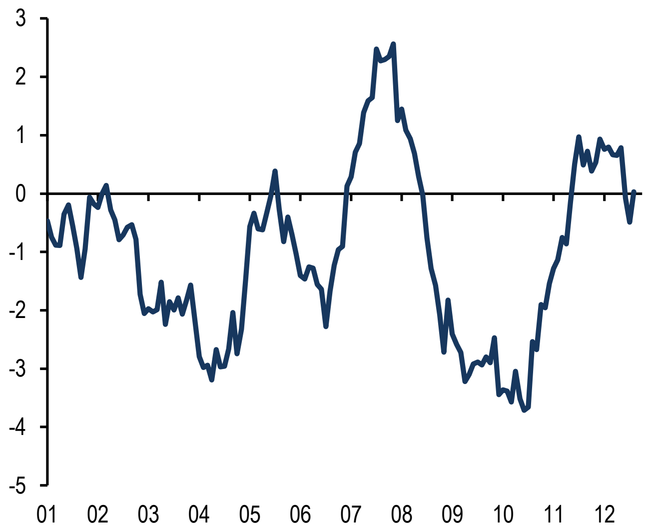
pp, 1 year moving average



Note: The series shows the difference, in percentage points, between export growth in Spain and euro area export growth minus Spanish export growth
Source: Credit Suisse, Thomson Reuters DataStream

Exhibit 7: Italy's export performance relative to the euro area

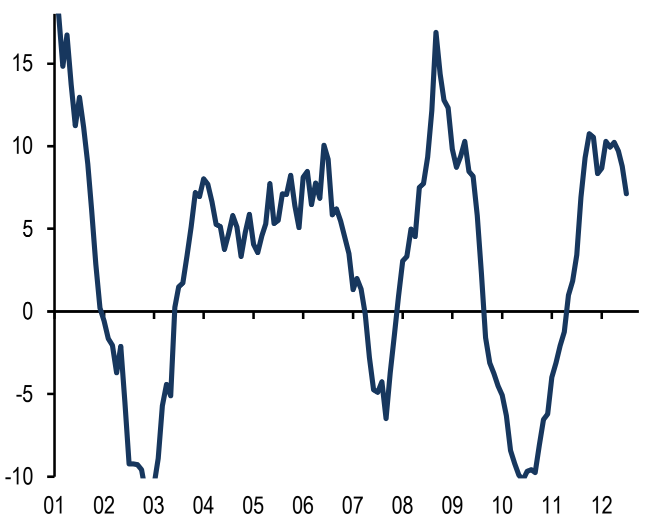
pp, 1 year moving average



Note: The series shows the difference, in percentage points, between export growth in Italy and euro area export growth minus Italian export growth
Source: Credit Suisse, Thomson Reuters DataStream

Exhibit 8: Greece's export performance relative to the euro area

pp, 1 year moving average



Note: The series shows the difference, in percentage points, between export growth in Greece and euro area export growth minus Greek export growth
Source: Credit Suisse, Thomson Reuters DataStream

Exhibit 9: Portugal's export performance relative to the euro area

pp, 1 year moving average

Note: The series shows the difference, in percentage points, between export growth in Portugal and euro area export growth minus Portuguese export growth
Source: Credit Suisse, Thomson Reuters DataStream

The relative export outperformance of most of the peripheral economies suggests that if global growth remains steady and resilient in 2013 – as we expect – then the periphery should continue to see solid export growth.

For the trade balance, of course, imports also matter. And here there is also some evidence that the decline in imports in the periphery is not just a consequence of a collapse in domestic demand.

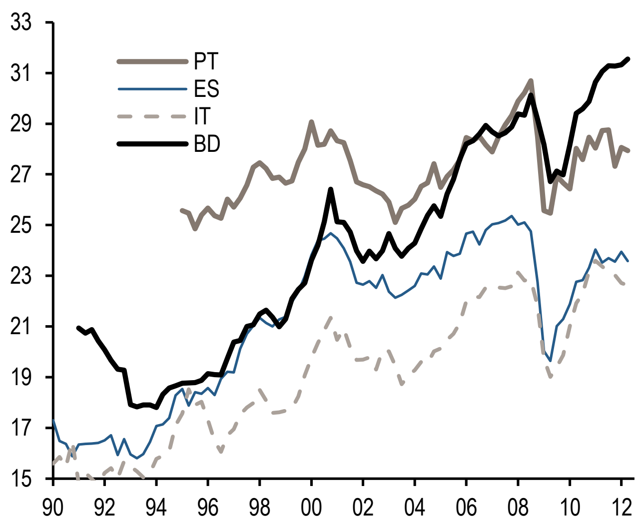
Measures of import penetration (imports as a share of domestic demand plus exports) have fallen in the periphery (see Exhibit 10). This suggests that structural changes may have changed the import demand per unit of final sales.

However, it is now unclear how much further import penetration can fall. This is particularly the case in Spain and Portugal where import penetration ratios are well below peak levels, and at around their historical euro area period average. The exception to this is Italy, where import penetration still looks historically high.

Another important metric is the relative growth of exports and domestic demand. If import penetration is assumed to be constant then the path of the trade balance is driven by export growth less domestic demand growth. **As Exhibit 11 shows, the periphery has made substantial improvements in this regard and is now running a larger gap between external and domestic demand growth than Germany was during the years prior to the crisis.**

Exhibit 10: Import penetration

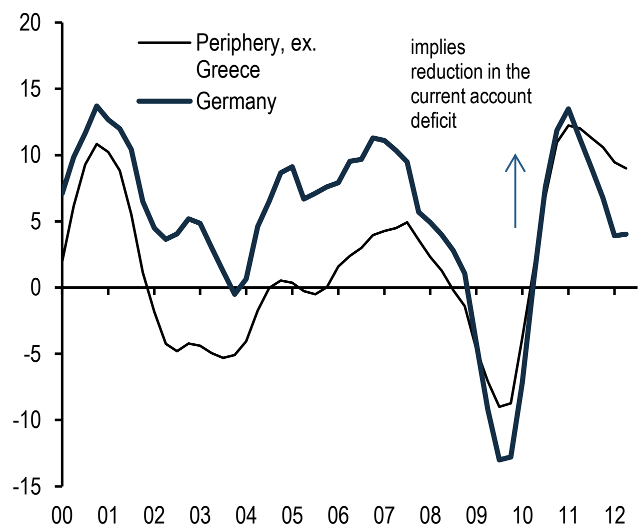
100*(imports/(domestic demand + exports)), BD is Germany



Source: Credit Suisse

Exhibit 11: Export less domestic demand growth nominal

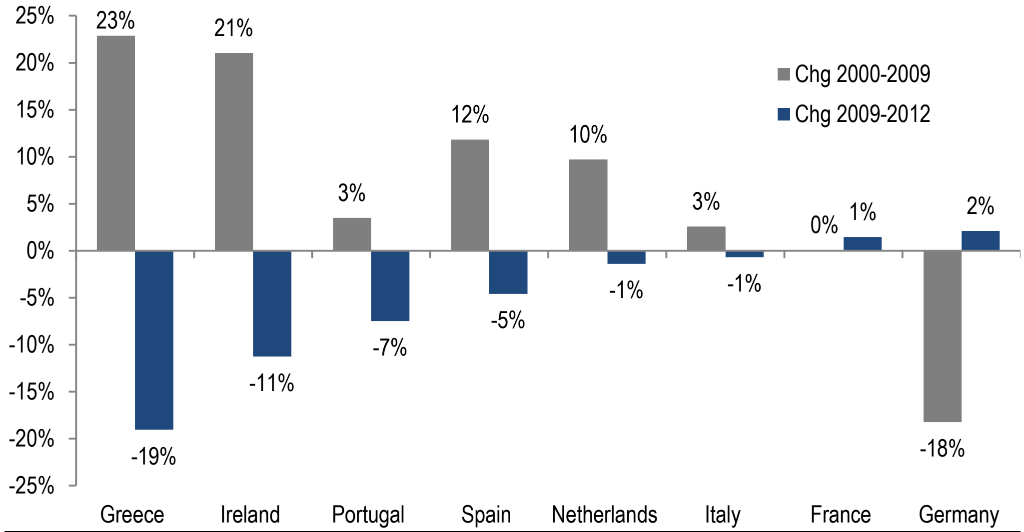
Export growth minus domestic demand growth yy% 1 year moving average



Source: Credit Suisse

There are other indicators that corroborate our view that some of the improvement in the trade balance of the periphery is due to an improvement in these countries' competitiveness. For example, wage costs in the periphery (shown here as growth in compensation per employee) have generally fallen relative to the core in the last couple of years, starting to reverse the losses in relative competitiveness seen in the first years of the single currency.

Exhibit 12: Change in nominal compensation per employee relative to European average



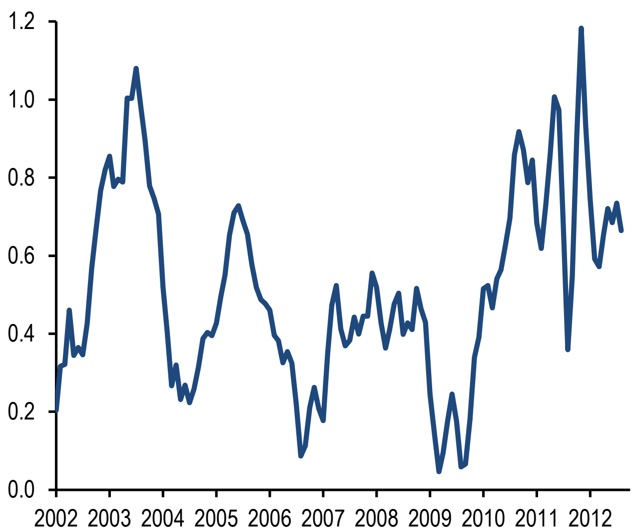
Source: Credit Suisse, Eurostat

The extent to which wages in the periphery are starting to bring about a real exchange rate depreciation is also reflected in the behaviour of domestic prices. Although headline inflation rates in the periphery have been kept high by energy prices and sharp increases in indirect taxes (a consequence of fiscal consolidation), **measures of core inflation excluding the effect of tax changes show an improvement in relative competitiveness.** Exhibits 13 to 16 below show the difference between core inflation ex taxes in the periphery and the euro area average.

It is clear from these that there has been considerable progress made in restoring a degree of price competitiveness in Portugal and Greece and, to a lesser degree, in Spain. However, it is interesting to note that core inflation in Italy has been consistently, and remains, well above the euro area average. On that basis Italy is still losing competitiveness rather than gaining it.

Exhibit 13: Italian core inflation relative to euro area average

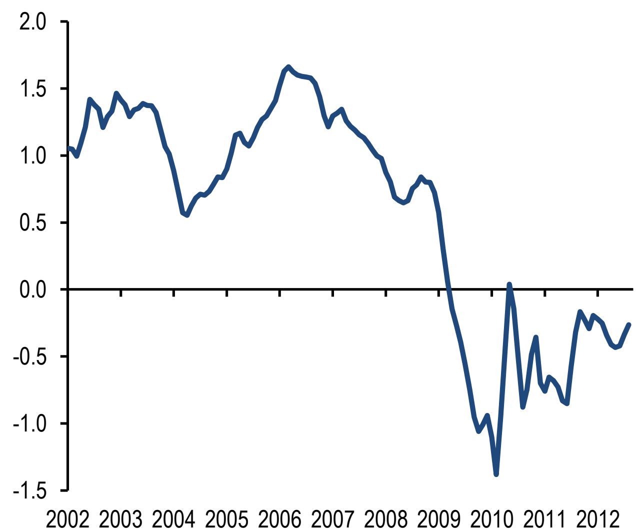
Excluding indirect taxes, 3 month moving average



Source: Credit Suisse, Eurostat

Exhibit 14: Spanish core inflation relative to euro area average

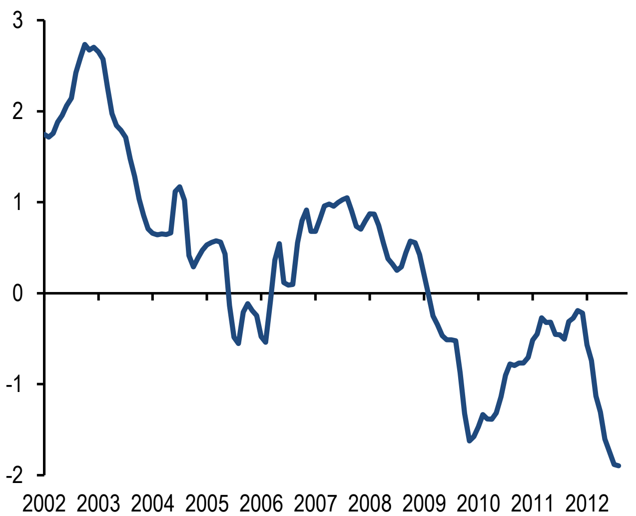
Excluding indirect taxes, 3 month moving average



Source: Credit Suisse, Eurostat

Exhibit 15: Portuguese core inflation relative to euro area average

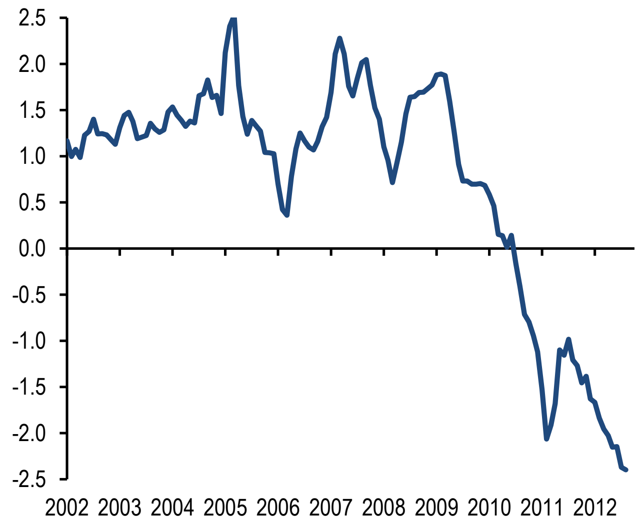
Excluding indirect taxes, 3 month moving average



Source: Credit Suisse, Eurostat

Exhibit 16: Greek core inflation relative to euro area average

Excluding indirect taxes, 3 month moving average



Source: Credit Suisse, Eurostat

In all, there is good reason to think that the recovery in trade balances in the periphery is in some part due to fundamental improvements in competiveness as well as a consequence of weak domestic demand. The evidence suggests that the "fundamental" improvements in competitiveness have been the greatest in Greece and Portugal, and to a much lesser degree in Italy, where there is still evidence of a loss in relative competitiveness. **Surprisingly, however, Italy also has basically closed its current account gap over the past year or so.**

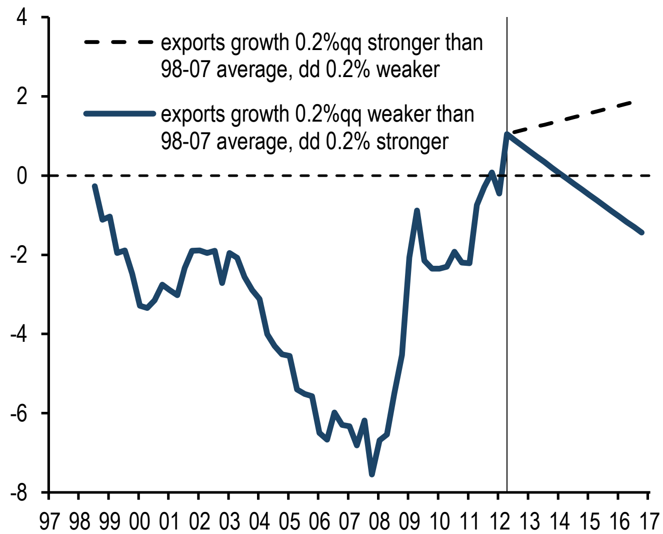
That is important because it means – after a significant downwards adjustment in domestic demand in most peripheral countries in the last few years – these economies may be able to grow – rather than contract – without reversing the necessary improvements made in their external balances. As an illustration, Exhibit 17 shows stylized projections of Spain's trade balance on the basis of different assumptions for domestic demand and export growth.

Exhibit 17 shows the possible path of the Spanish trade balance under two different situations. In both we have assumed that the import penetration ratio remains constant (this is in keeping with the growth rate between H1 2011 and H1 2012). **By fixing the import penetration ratio we are able to calculate the trade balance under different assumptions for exports and domestic demand.** The dotted black line shows the situation in which export growth is 0.2%qq stronger than the 1998-07 average, and domestic demand is 0.2%qq weaker. The dark blue line is the opposite. **Overall, this stylised projection suggests that peripheral trade balances are still very sensitive to external demand.**

Exhibit 18 shows a stylised "trade-off" curve between export growth and GDP growth (in nominal terms) given a desired level of the trade balance. It shows the rate of GDP growth that is possible (y-axis) given an annual export growth rate (x-axis) if the country is to hit a 4% GDP trade surplus by the end of 2016 (assuming that import penetration remains unchanged). Note that all the growth rates are in nominal terms. Given the improvements in trade balances over recent months, we have estimated Q3 numbers, and the estimated export growth and GDP growth figures refer to the period 2012 Q4 to 2016 Q4. In the case of each country we have taken the rate of change of the import penetration ratio between H1 2011 and H1 2012 and assumed that this continues over the next three years. For all countries apart from Spain this is consistent with moderate continued falls in import penetration. **The purpose of this is to simulate continued improvements in these countries' competitiveness.**

Exhibit 17: Spanish trade balance simulation

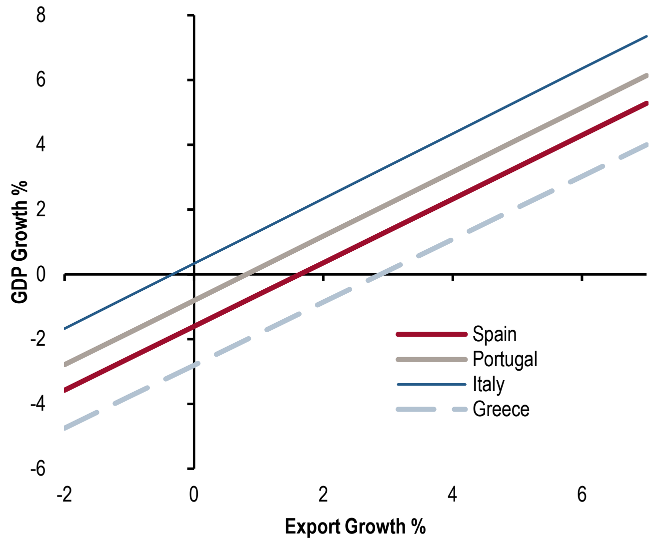
Trade balance as % of GDP, simulation after 2012Q2



Source: Credit Suisse. Note: We assume constant import penetration from Q3 2012 onwards, therefore given export growth an domestic demand assumptions we can estimate the trade balance

Exhibit 18: Trade-off between exports and GDP

All data are nominal annual growth



Source: Credit Suisse

Exhibit 18 shows that for most of the peripheral countries annual nominal export growth of around 5% (somewhat below the historical average post-2000 for Spain) would allow nominal GDP growth of around 3-5%, and consequently annual real GDP growth of around 1-3%. Broadly, this seems like a reasonable, sustainable level of trade-off. And it means these economies should now be able to grow on a 3-5 year view without their external balances deteriorating.

The one exception is Greece, where the analysis suggests that the above assumptions would allow an annual nominal growth rate of 2%.

But, even if financial conditions improve significantly over the next year or so, the ability of these economies to use stronger growth to slowly deal with their high debt ratios will be limited. **The need for "external deleveraging" to reduce these countries' large negative net international investment positions means they will need to run a sustained trade surplus.** And the need to sustain that means they face genuine "speed limits" on growth in coming years. Even if the external backdrop for export growth remains benign and the financial and fiscal backdrop to domestic demand growth improves, their ability to post solid GDP growth would still be limited. **And, as Exhibit 18 makes clear, a slower growing global economy would be even more problematic.**

Indeed, the ability of these economies to recover will be critically dependent on external growth. That implies peripheral financial assets will continue to trade like classic risky assets, highly sensitive to fluctuations in global growth momentum. The ECB notwithstanding, it is possible that the relatively strong performance of peripheral fixed income and equities in recent months has been partly due to an acceleration, or "speed up scare" in global economic momentum. It is not evident that will be sustained for too long, especially with the fiscal cliff in the US looming.

The stronger global growth is, the easier the adjustments in the periphery. And vice versa.

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