• The eurozone remains on the right track. Almost all countries in need of adjustment are slashing their underlying fiscal deficits and improving their external competitiveness at an impressive speed.
• If the eurozone and its member countries stay the course, the euro crisis could be largely over by the end of this year.
• The Euro Plus Monitor, produced jointly by Berenberg Bank and the Lisbon Council, tracks the adjustment progress of all 17 euro members as well as Poland, Sweden and the United Kingdom.
• In our last full report, published in November 2012, we found that the eurozone is turning into a much more balanced and potentially more dynamic economy. All of the four member countries that have been granted external assistance – Greece, Ireland, Portugal and Spain – strengthened their adjustment effort over the course of 2012.
• The Spring 2013 Update shows that progress continues. Greece (No. 1), Ireland (No. 2), Spain (No. 3) and Portugal (No. 4) take the four top spots in the Adjustment Progress Indicator. Thanks to rapid external adjustment, Italy has narrowed the gap with the top four countries, but it remains in the No. 8 position.
• Unfortunately, we find hardly any progress at all in France (No. 13), which remains below the eurozone average with a worsening score. France urgently needs to reform its economy if it does not want to fall ever further behind Germany.
• The adjustment progress shows up clearly in the external accounts. The joint current account deficit of the five major peripheral countries – Greece, Ireland, Italy, Portugal and Spain – has narrowed to 0.6% of gross domestic product at the end of 2012, down from a deficit of almost 7% in 2008. On current trends, the euro periphery as a group will balance its collective current account by mid-2013. The five countries as a group would no longer need to import capital thereafter.
• External balance, fiscal progress and the return to growth which we project for all peripheral countries by the end of 2013 could herald the end of the euro crisis – as long as policymakers stay the course.

Chart 1: Rapid External Adjustment at the Periphery

Euro periphery: current account balance

12-month rolling sum, Greece, Ireland, Italy, Portugal and Spain combined, in percentage of GDP).

Sources: Eurostat, national statistics
The euro confidence crisis has forced a brutal front-loaded adjustment on the peripheral economies of the eurozone. To correct past excesses in public and private spending, governments and households need to consume less relative to what they produce.

The Adjustment Progress Indicator (see Table 1 and Chart 2 below), which forms a core pillar of the Euro Plus Monitor, tracks the progress countries are making on the most important short- to medium-term adjustment criteria. We focus on three measures of adjustment: 1) a reduction (or increase) in the fiscal deficit, adjusted for interest payments and cyclical factors, 2) the rise (or fall) in exports relative to imports in the external accounts, and 3) changes in unit labour costs. In addition to these three measures of adjustment, we also include the results of the OECD’s 2013 annual assessment of pro-growth structural reforms as a further component of the overall Adjustment Progress Indicator.

The Spring 2013 Update uses additional data releases since last November and/or incorporates some revisions to previous official data, for instance those for previous fiscal deficits and debt levels.
The fiscal position of the eurozone as a whole is significantly better than that of the US, the UK or Japan. But doubts about the political will to keep the euro together have contributed to major turmoil in the eurozone, with investors often shunning the bonds and banks of the weaker members.

Under the pressure of crisis, those eurozone members most in need of reigning in their excessive deficits have corrected their fiscal stance aggressively and in a frontloaded manner. Markets and the troika left them no choice. Chart 3: Wrenching Fiscal Adjustment below shows the cumulative fiscal adjustment since 2009 corrected for the effects of the short-term business cycle, interest rates and some one-off factors. Greece (No. 1) stands out as the country with the most severe fiscal squeeze and thus the most serious recession. But the fiscal correction has also been very significant in Portugal (No. 2), Ireland (No. 4), Spain (No. 5), Italy (No. 7) and even France (No. 8). Outside the eurozone, Poland and the UK have also raised taxes and reined in spending to a significant degree. Part of the progress has been the mere unwinding of the post-Lehman fiscal stimulus.

As full data for 2012 are not yet available, the ranking and the chart below are based on the European Commission’s latest projections. The partial data that are available so far for the overall unadjusted deficits indicate that many eurozone members reduced their headline deficits in 2012 significantly despite serious economic headwinds:

- The eurozone fiscal deficit likely fell to 3.3% of GDP, down from 4.2%
- Germany registered a 0.2% surplus after a 0.8% deficit in 2011.
- Italy brought its deficit to 3.0% of GDP, down from 3.8%.
- Spain reduced the deficit to 6.7% from 9.4%.
- Greece cut the shortfall to around 8.1% from 9.4%.

Shortly after the peripheral economies emerge from recession, the headline deficits will likely fall substantially. After the harsh austerity of recent years, little extra tightening is now needed to put public finances on a sustainable path in most of these countries. The worst should soon be over.

Chart 3: Wrenching Fiscal Adjustment

Fiscal adjustment 2009-2012

Cumulative change in the underlying primary fiscal balance 2012 over 2009, in percentage of GDP.

Source: European Commission
‘Economies with excessive external deficits have turned their external balance around convincingly.’

External Adjustment: Major Progress

If a country has lived beyond its means, the adjustment after the party should show up most visibly in its external accounts. To track the progress, we examine two different aspects, namely 1) the shift in the balance of exports and imports (net exports) and 2) the rise of the share of exports in a country’s GDP. For both components, we look at the overall shift as well as the shift relative to the 2H 2007 starting situation.

The results reveal a clear pattern. All economies that were running excessive external deficits until 2007 (or 2009) have turned their external balance around convincingly. Ireland (No. 1), Spain (No. 3), Greece and Portugal (tied for No. 5) are among the top six economies in our sample for their overall external adjustment progress (see Table 1 on page 2).

Chart 4 External Adjustment (seen below) shows the swing in exports and net exports relative to the 2H 2007 starting situation, with the countries ranked according to their biggest relative improvement in net exports.

As most countries have not yet reported full GDP statistics for late 2012, the data only extend through Q3 2012. However, other evidence suggests that the external adjustment progress continued through late 2012 and into 2013.

- Greece boosted its non-EU exports by 30.4% year-on-year in 4Q 2012.
- Italy raised its non-EU exports by 13% year-on-year in January 2013.
- The entire eurozone periphery narrowed its joint current account deficit to 0.6% of GDP in late 2012 (see Chart 1 on page 1).

However, serious headwinds from the eurozone recession and a temporary slowdown in the US held back overall export growth in late 2012 for the eurozone periphery. Portuguese exports rose merely by 1.4% year-on-year in 4Q 2012 while volatile Irish exports even contracted by 1.3% at that time. As a result, the narrowing of the current account gap in late 2012 owes more to lower imports than to rising exports. But once the eurozone recession ends, export growth is likely to become the major driver of external adjustment again for the eurozone periphery.

Chart 4: External Adjustment

Swing in exports and net exports

Change in export share in GDP 2H 2007 to 3Q 2012; relative to starting level, in percentage. Change in net export share in GDP 2H 2007 H2 to 3Q 2012, relative to 2H 2007 share of exports in GDP, in percentage. Data for Greece are Berenberg estimates.

Sources: Eurostat, Berenberg calculations
‘Labour costs are rising in Germany, which can afford it, and in France, which cannot.’

Labour Cost Adjustment: The Great Convergence

Competitiveness is an ill-defined buzzword. The ultimate proof as to whether a country can compete is whether its producers can find customers for their wares and whether the country as a whole can attract enough investment to provide jobs for its people. Labour costs are one of many aspects that determine the competitiveness of a country.

Under the pressure of crisis, wage moderation has taken hold with a vengeance across the euro periphery. In many countries, nominal wages are falling amid high rates of unemployment and cuts in public spending. At the same time, wage moderation has ended in Germany. The result is a rapid convergence of unit labour costs across much of the eurozone.

Chart 5: Labour Costs – The Great Convergence shows by how much the cumulative changes in real unit labour costs over- or undershot the eurozone average before and after 2009. As nominal wages decline or stagnate and companies shed less productive workers in the severe adjustment recession, real unit labour costs are tumbling in the eurozone periphery. At the same time, costs are rising in Germany, which can afford it, and in France, which cannot.

By and large, Chart 5 shows that wage costs are converging rapidly within much of the eurozone.

Chart 5: Labour Costs – The Great Convergence

Real ULC adjustment 2009-2012

Cumulative change in real unit labour costs, deviation from the Eurozone average in percentage points, 2012 over 2009 and 2009 over 2000. Sources: Eurostat, Berenberg calculations
Outlook: Stay the Course for a Jobs Rebound

The Euro Plus Monitor: Spring 2013 Update shows that the eurozone is on the right track. The periphery continues to make impressive progress. The adjustment is painful. Harsh and frontloaded austerity has pushed almost the entire eurozone periphery into a wrenching recession. But the end of the tunnel is near. After the harsh austerity that has already been implemented, most of the crisis countries at the eurozone periphery need only modest further fiscal cuts (Greece, Ireland, Portugal and Spain) or none at all (Italy).

The signs that the eurozone can emerge from recession this spring are getting stronger. After the European Central Bank finally stepped in to calm financial tensions in August 2012, financial markets and the banking system have started to heal. Most leading economic indicators have turned up. Current plans suggest that the eurozone suffered its peak fiscal pain in 2012. This year, it will have much less additional austerity than in 2012, and a smaller fiscal hit than the US and the UK. If policymakers stay the course and if no external shock intervenes, even the weakest eurozone members (Greece, Spain and Portugal) are likely to see the first growth in their quarterly GDP numbers late this year. Shortly thereafter, rising tax revenues and expanding nominal GDP will put the debt-to-GDP ratios of these countries on a downward trajectory.

With the eurozone now broadly on track, the key task for policymakers is to safeguard the progress. The stronger members and the ECB need to be ready to support all reform countries if need be, and the weaker members including Italy need to be ready to accept the strings attached to such actual or potential support. If the political will to keep this bargain holds on both sides, the eurozone crisis could be largely over by the end of 2013. Policymakers cannot do much to create jobs directly. But the German example shows that reforms pay handsome dividends after a while: two years after Germany’s 2004 wave of reforms, the labour market started to turn up strongly. That Germany now has a fiscal surplus is more the result of a growing number of people with a decent job who pay payroll taxes on their wages than of outright austerity. The eurozone periphery finds itself in this interim phase: waiting for the results of the recent reforms.

Chart 6: Germany’s Jobs Miracle

German core employment

Core employment = subject to payroll taxes. Source: Bundesbank
Policymakers could make three major contributions to promote the economic recovery and hasten the turnaround in the eurozone labour markets. Specifically, they should:

1. enact further reforms to make the labour market more flexible so that companies hire workers earlier and in greater numbers once demand picks up;

2. signal clearly that the worst of austerity is over. Countries which miss their fiscal targets because of an unexpectedly deep recession should not be asked to tighten their fiscal policy beyond the agreed plans;

3. take steps to strengthen confidence in the future of the euro. For example, any reversal of austerity and reforms in Italy would make the country ineligible for the protective umbrella which can otherwise be provided by the European Stability Mechanism (ESM) and the ECB. This could send shock waves across the eurozone and re-ignite fears that the common currency may still collapse. As a result, any attempt to "create jobs" artificially through a reversal of austerity could backfire badly.

In the second half of 2012, business investment fell across the eurozone despite further gains in exports. Even German companies held back from buying new machinery amid a pervasive climate of fear and uncertainty. The resulting drop in German GDP in late 2012 made it even harder for the eurozone periphery to export itself out of trouble.

To put an end to this confidence shock which has weighed on business investment across Europe, policymakers need to stay the course. The more investors trust policymakers to indeed do what it takes to keep the euro together, the more will they dare to take advantage of the eurozone’s improving fundamentals to invest and create jobs.

**Chart 7: Export Progress - Italy**

**Italian exports to non-EU countries**

<table>
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<th>Year</th>
<th>Total Exports (€ billion)</th>
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<td>Jan 2011</td>
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<td>Jan 2012</td>
<td>170</td>
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<tr>
<td>Jan 2013</td>
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**Source:** ISTAT

**Chart 8: Export Progress - Greece**

**Greek exports to non-EU countries**

<table>
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<tr>
<td>Jan 2009</td>
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</tr>
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<td>Jan 2013</td>
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**Source:** National Statistical Service of Greece
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Berenberg is one of Germany’s leading private banks. Established for over four centuries, it has developed into a dynamic, modern private bank. The origins of Berenberg Bank go back to 1590 when the brothers Hans and Paul Berenberg established their firm in Hamburg. It is now the oldest private bank in Germany and one of the oldest in the world, with a balance sheet total of 4 billion, assets of more than 26 billion under management, liable equity of 217 million and roughly 1100 employees.

About the Lisbon Council
The Lisbon Council for Economic Competitiveness and Social Renewal asbl is a Brussels think tank and policy network. Established in 2003 in Belgium as a non-profit, non-partisan association, the group is dedicated to making a positive contribution through cutting-edge research and by engaging politicians and the public at large in a constructive exchange about the economic and social challenges of the 21st century.