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Gauging the risk of a new eurozone crisis

The eurozone crisis following the global financial crisis of 2008-09 had its roots in economic divergence. What is the situation today?

Introduction

A decade after the last eurozone crisis, new fears are raising old ghosts. As Warren Buffet is fond of saying, it is only when the tide goes out that you discover who's been swimming naked. This is not just true of financial markets. Major shocks also reveal important structural problems in the broader economy that were previously masked by economic growth or low interest rates.

The financial crisis revealed major flaws in the economic solidity of certain eurozone member states, as well as in the European construction itself. A negative spiral was created between poor economic or fiscal performance and the confidence that investors had in the ability of certain countries to maintain their position in the eurozone. This led to a sharp rise in bond spreads which further weakened public finances, hitting economic performance and so on.

After the major shock of the pandemic and in the midst of a war on European soil, it is easy to draw parallels with the post-financial crisis period and to ask the same question: is there a risk of a new negative spiral, with bond spreads as a major catalyst?

More unity in GDP

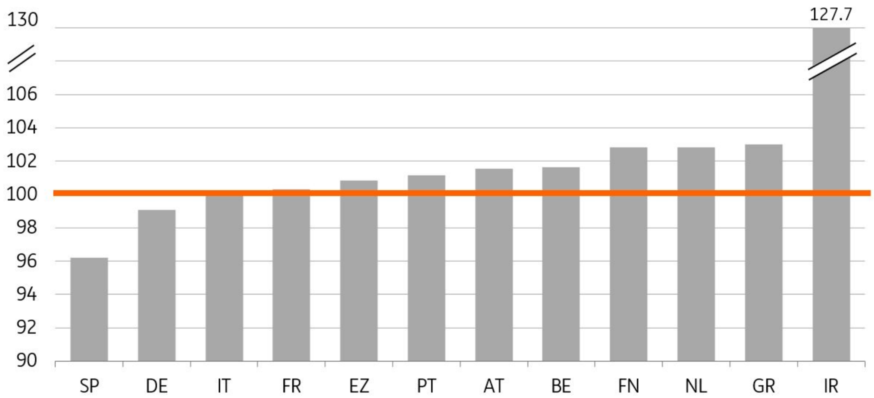
During the 2009-2012 period, three factors sewed doubt into the minds of investors: (i) the very uneven ability of eurozone countries to recover economically from the financial crisis, (ii) competitive positions that had become untenable within the framework of a monetary union, and (iii) severely deteriorating public finances in some countries.

The first factor does not seem to be a major problem right now. The approach followed during the Covid crisis and in the face of the war in Ukraine with both fiscal and monetary policy has allowed most euro area economies to recover rapidly to their pre-crisis level of activity (see chart below).

It is probably still too early to say that growth will not be a source of divergence between euro area members (the impact of the inflation wave is still to be felt and calls for caution) but so far, the situation seems more stable than in the post-financial crisis period.

Real GDP level in 1Q 2022 (Q4 2019 = 100)

In this analysis, we include the 11 largest economies in the euro area, accounting for 97% of euro area GDP.

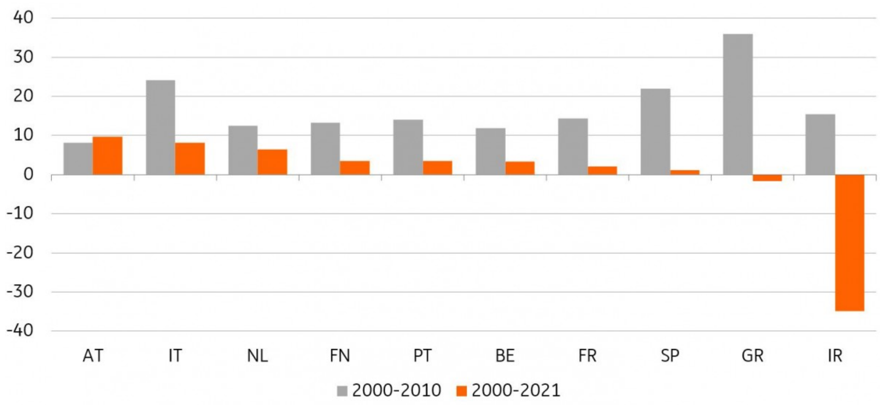


Source: Refinitiv Datastream, ING

... and in competitiveness

One can be even more positive about the second factor. Indeed, the structural reforms imposed on the weakest countries during the eurozone crisis have borne fruit and led to a convergence of the competitiveness levels of the member states. In terms of unit labour costs, the huge differences accumulated during the first 10 years of the euro area's life have given way to much smaller differences now (see chart below). Meanwhile, the cohesion of the euro area (and thus its viability), which was a key factor of the 2009-2012 crisis, is rather more reassuring today.

Nominal unit labour cost: cumulative handicap vs. Germany

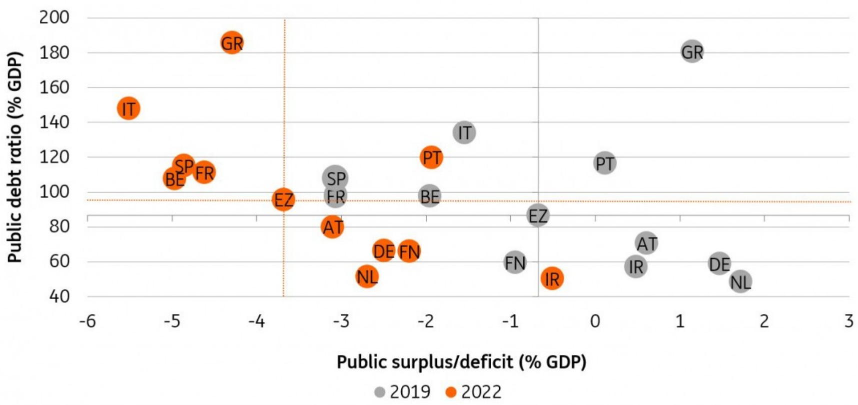


Source: Refinitiv Datastream, ING

The exception is public finances

The third factor is certainly the most problematic. Despite a supportive economic backdrop between 2017 and 2019, economies did not enter the Covid crisis with the same strength in their public finances (see chart below). Taking two basic indicators of the health of public finances (budget surplus/deficit and the debt ratio), four countries – Spain, France, Belgium and Italy - were already “at risk” in 2019. Following the Covid crisis, a general deterioration in fiscal balances and debt ratios was observed for all economies. The group of four countries at risk was joined by Greece, mainly due to a sharp deterioration in its fiscal balance.

Basic public finance metrics in the eurozone



Source: Refinitiv Datastream, ING

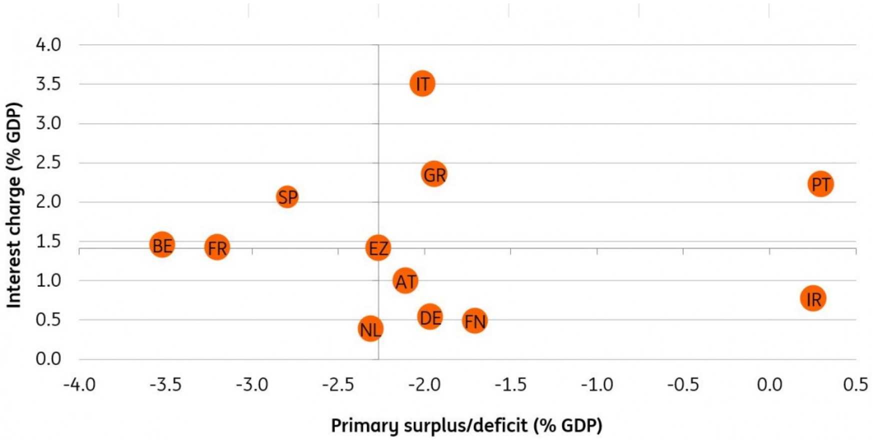
Public balances

The interest burden is an important determinant of the budget balance. Indeed, a good level of the primary balance of public finances could be cancelled or even give way to a deficit because of an excessive interest burden on the debt. In this respect, not all countries in the risk group are in the same position (see chart below):

- Spain is in the most problematic situation. Not only is the primary deficit larger than the eurozone average, the interest burden (more than 2% of GDP expected in 2022) is also higher than average, which puts Spanish public finances further away from the average

budget balance.
- Belgium and France face an interest burden on their debt similar to the EU average (as a percentage of GDP). Therefore, their poor performance in the budget balance is mainly linked to an excessive primary deficit. Only an increase in tax revenues or a decrease in current expenditure will help to correct this.
- Greece and Italy are in the opposite situation: their primary balance is better than the European average. On the other hand, these countries are penalised by a much higher than average interest burden (as a percentage of GDP) due to a larger public debt and a higher implicit rate on the debt.

Budget balance decomposition, 2022



Source: Refinitiv Datastream, ING

To conclude

So who is swimming naked? At this stage, no one is in this very awkward situation. In fact, economic performance and levels of competitiveness are holding the eurozone together rather than acting as a centrifugal force. On the other hand, it cannot be denied that some countries present certain risks in terms of public finances.

It is therefore important that the recovery path continues. Meanwhile, particular attention will have to be given to improving public finances in the countries that have been described as "at risk" here. This will help to avert the sort of divergence seen during the last crisis. The evolution of interest rates will also play a role in maintaining European cohesion, certainly in the case of Spain, Italy and Greece. It is important that bond spreads do not endogenously deteriorate the situation by raising the interest burden of these countries.

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