Box 5

ADJUSTMENT PROCESSES WITHIN THE EURO AREA: DEVELOPMENTS IN IRELAND, GREECE, SPAIN, CYPRUS AND PORTUGAL

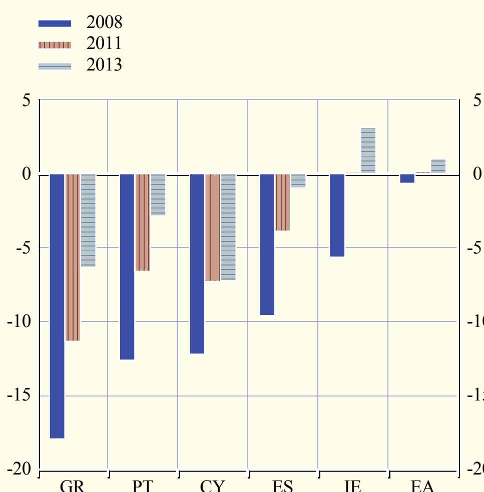
This box describes developments in the four euro area countries currently under financial assistance programmes ("programme countries")[1] and in Cyprus.[2] Adjustment processes and, more recently, accelerated corrections have started in all these countries suffering from significant macroeconomic imbalances. However, although some progress has been made – and additional adjustment is expected by 2013 – considerable efforts are still needed to increase competitiveness, reduce unemployment and restore the sustainability of public finances.

Recent progress in the adjustment of imbalances

On the external side, the current account positions of all five countries have recently improved on their 2008 levels, with Ireland already reaching a balanced current account position in 2010 (see Chart A). In all countries,

Chart A Current account positions (national accounts)

(as a percentage of GDP)



Source: The European Commission's European Economic Forecast – spring 2012.
Note: Countries are grouped in ascending order for 2008.

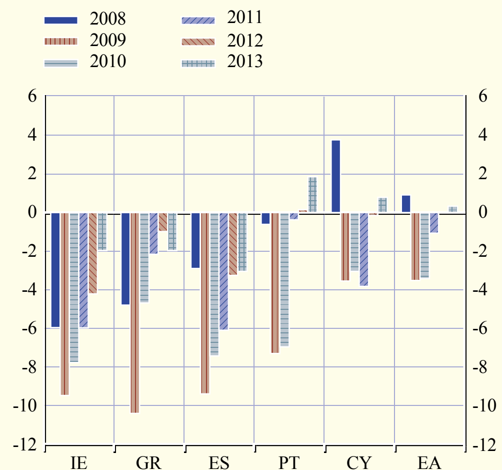
1 While Ireland, Greece and Portugal are under joint EU-IMF financial assistance programmes, the Spanish programme, approved on 20 July 2012, is restricted to financial assistance from the EU only and targeted specifically at the recapitalisation of financial institutions. However, progress in the commitments under the excessive deficit procedure and on structural reforms, with a view to correcting macroeconomic imbalances, will be regularly reviewed in parallel with the financial sector conditionality. In the case of Spain, the IMF provides only technical assistance.

2 On 27 June 2012 the Cypriot authorities submitted requests for financial assistance from the EU and the IMF.

this has mostly resulted from developments in trade balances over the period 2010-11, which were also reflected in strong positive contributions from net trade to real GDP growth. In most cases, the strong net trade contributions resulted from a combination of relatively strong export growth (particularly in Spain and Portugal) and very weak or negative import growth (notably in Greece and Cyprus). The European Commission's European Economic Forecast – spring 2012 foresees a continued improvement in the current account positions of all programme countries; for Cyprus, the European Commission expects only a very limited reduction in the current account by 2013, as export growth, in particular, is forecast to remain very weak. Apart from the trade outlook, current account developments in some of the countries are also largely driven by energy-related imports and net interest payments. These have contributed, for example, to the large current account deficit that is expected to persist for Greece in 2013. Overall, despite the expected improvements, the current account deficit in 2013 is still expected to remain higher than desirable, particularly in Greece, but also in Cyprus and Portugal.

Chart B General government primary balance

(as a percentage of GDP)



Sources: Eurostat, European Commission's European Economic Forecast – spring 2012 and ECB calculations.
Notes: The 2009-11 levels of the primary balance for Ireland are adjusted for large one-off effects on account of capital support to the banking sector. The data in the chart still include a large one-off effect for Portugal, recorded in 2011. Except for the euro area, countries are grouped in ascending order for 2008.

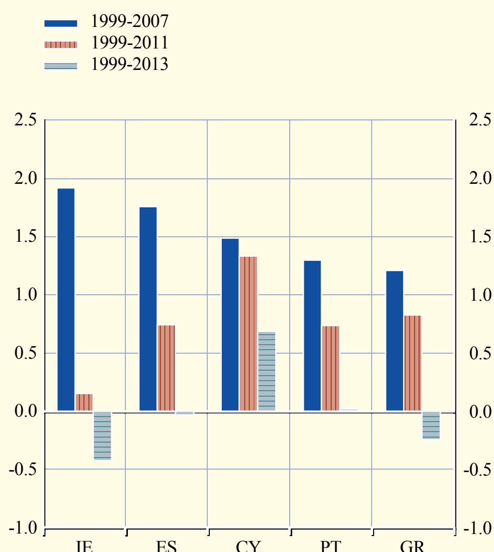
On the fiscal side, Ireland, Greece and Portugal have undertaken considerable consolidation efforts since entering the financial assistance programme. This has led to significant improvements in the general government primary balance (see Chart B), largely on account of the wide range of fiscal and structural reforms implemented as part of the programmes. According to the European Commission's spring 2012 forecast, this improvement is expected to continue in 2013. Portugal is the only country receiving financial assistance that is expected to record a primary surplus. Similarly, in Spain, fiscal adjustment is well under way and the primary balance is improving, although, in 2010 and 2011, deficit reduction was lower than expected. Overall, the debt-to-GDP ratios of all programme countries are still projected to rise in 2013.

Restoring competitiveness

The increase in export growth and the reduction in current account deficits partly reflect improvements in competitiveness which are linked to a decline in unit labour costs (see Chart C). When comparing developments up to 2007 with those up to 2011, differentials in the average annual growth of unit labour costs relative to that in the euro area have already fallen somewhat, with all five countries recapturing some of the losses in competitiveness incurred previously. Part of the correction seen thus far reflects countries' structural measures to correct relative price and cost developments in a more lasting manner. However, part of it is also the result of labour shedding, for example in low-productivity sectors, which has increased aggregate productivity, particularly in Ireland and Spain, but also, to a lesser extent, in Greece and Portugal. The flip side of this has been a rise in unemployment rates, which has been particularly pronounced

Chart C Average annual increase in unit labour costs relative to the euro area

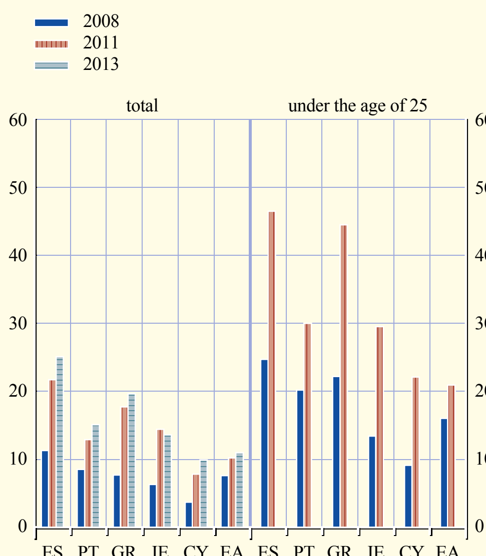
(in percentage points)



Sources: Eurostat and the European Commission's European Economic Forecast – spring 2012.
Notes: Countries are grouped in descending order for the period 1999-2007. Data for Greece and Spain are only available from 2001.

Chart D Total and youth unemployment

(as a percentage of the labour force)

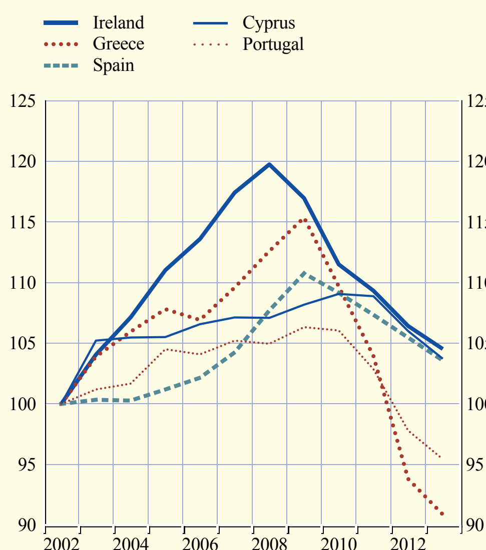


Sources: Eurostat and the European Commission's European Economic Forecast – spring 2012.
Note: Except for the euro area, countries are grouped in descending order according to the total unemployment rate in 2008.

among younger workers (see Chart D). As Chart E suggests, this may also have been partly due to delayed actions by the wage bargaining partners, both in the private and the public sector. In particular, in the case of Spain, the authorities finally approved in February 2012 a far-reaching and comprehensive labour market reform that could have proved very beneficial in avoiding labour shedding if it had been passed some years ago. After the onset of the global financial crisis in 2008, with the exception of Ireland, wage moderation only set in with a significant delay (in Portugal in 2010) or has remained very limited (in Spain and Cyprus, at the end of 2011). Going forward, a strong decline in compensation per employee is expected: (i) for Portugal, as a result of cuts in public sector wages and the impact of labour market reforms in moderating private sector wage claims; and (ii) for Greece, as a result of the recent reforms in private sector wage-setting.

Chart E Compensation per employee relative to the euro area

(indices: 2002 = 100, euro area = 100)



Sources: Eurostat and the European Commission's European Economic Spring Forecast – spring 2012.

Need for further structural and fiscal reforms

As there is still a substantial need for rebalancing, all countries will need to undertake further far-reaching reforms and introduce appropriate measures to increase both price and non-price competitiveness, reduce unemployment and restore the sustainability of public finances.

Regarding competitiveness, given the low level of competition, further significant reductions in unit labour costs and excess profit margins are particularly urgent, especially in countries where unemployment is very high. To achieve this, first, flexibility in the wage determination process has to be strengthened, for example, where relevant, by relaxing employment protection legislation, abolishing wage indexation schemes, lowering minimum wages and permitting wage bargaining at the firm level. And second, the competitiveness adjustment must be strengthened through permanent increases in labour productivity, for example through privatisation, innovations in processes and the development of new products, measures to boost the skills of the labour force, and initiatives to create a more favourable business environment. This calls for courageous policy action on structural reforms (e.g. the liberalisation of closed professions and immigration, a reorientation of spending towards education and R&D, and reforms of key framework conditions, such as amending judicial and regulatory frameworks to enhance their business friendliness) and boldness in the face of lobbying by privileged groups and vested interests. Excessive profit margins are particularly prevalent in domestically-oriented sectors (predominantly the services sectors). Structural reform measures can address the issue of excessive rents by removing obstacles to (international) competition, particularly in the sheltered professions, for example by lowering entry barriers for new firms and, more generally, by reducing red tape.

On the fiscal side, ensuring strict adherence to the agreed fiscal consolidation paths remains essential in order to lock in the benefits of the consolidation efforts undertaken so far and credibly anchor financial market expectations.