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How resilient is the eurozone?

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Although stability indicators have not returned to pre-crisis levels, it seems unlikely that a contained flare-up caused by Greece could plunge the entire currency union into economic turmoil, writes Michael Heise.

The worst of the eurozone crisis is behind us – or so many observers claimed last year. Today, with Greece and its eurozone partners constantly at the verge of showdown, analysts and politicians once again fear that the single currency area could be fraying. However, if we turn our attention from shrill political rhetoric to economic fundamentals, we find that the eurozone economy as a whole today is more resilient than in 2012, the last time that Grexit risk was being discussed.

We measure the underlying stability of the euro area by looking at the sustainability of public finances, private and foreign debt levels as well as developments in employment, productivity and competitiveness. By collating such numbers into a single indicator, we get an early warning signal for macroeconomic imbalances in the eurozone.

At the moment, our warning indicator is not flashing red – at least not if we look at the eurozone as a whole. Although stability indicators have not returned to pre-crisis levels, it seems unlikely that a contained flare-up caused by Greece could plunge the entire currency union into economic turmoil.

Over the last year, all 18 eurozone countries have moved towards more balanced economic growth. This includes Greece, although in that country, hard-won macro-economic stability is today endangered by political developments. None of the other eurozone countries today fall below the score that we define as the danger zone of economic vulnerability.

The eurozone as a whole has made most headway in the area external competitiveness. Several euro countries that used to have gaping external deficits now run current-account surpluses.

Importantly, improvements on the external front are increasingly driven by genuine competitiveness gains: A favorable unit labor cost trend and a gradually recovering domestic demand are evidence that external surpluses are not solely a result of demand compression but that structural reforms are slowly bearing fruit.

Progress has also been notable in the area of debt. Debt ratios have declined for governments, private households and non-financial enterprises – although the absolute stock of debt remains very high. On the other hand, our ratings are abysmal when it comes to unemployment, which still stands at 11.6% across the eurozone. We also worry about the fact that eurozone exports, on average, are not gaining global market shares. This is a reminder that measures of economic stability can differ markedly from those of economic dynamism.

While the eurozone as a whole looks more resilient, there are, of course, big differences between the member countries. There is still a noticeable split between what economists have come to refer to as the core and the periphery of the eurozone. Austria, Germany, Luxembourg, Estonia and Latvia look very balanced. They tend to have stable public finances, low private debt, few external imbalances and they mostly manage to defend their shares in global markets.

The (former) program countries, Greece, Portugal, Spain and Ireland, all have some way to catch up. Greece still brings up the rear in our ranking (only Cyprus scores even worse). Greece has cut its budget deficit and regained competitiveness, but it remains vulnerable because of its mountainous debts, mass unemployment and rigid labor and product markets.

Although other peripheral countries are on the right track, they still have their own problems. Portugal, for example, is struggling with the highest interest rate burden in the eurozone, while Spain's unemployment rate is still 24%. Both factors make it harder to get debt and deficits under control.

Fiscal policy is also Italy's Achilles' heel. Public debt stands at over 130% of GDP and although the Italian government borrows more cheaply these days than the US Treasury, this might leave the country vulnerable to a sudden deterioration in market sentiment. Italy's debt burden looks particularly daunting, given its low scores on employment, productivity and competitiveness.

Although France's economic malaise has been much discussed, in terms of economic stability, the country ranks in mid-field – disappointing but not overly vulnerable. Fiscal indicators look steady but have not improved. France's ongoing loss of world market share stores up trouble for the future.

To assess the resilience of the eurozone, we do not look only at how solid individual member countries are. The broader framework also matters. Over the last five years, the Europeans have made much headway in strengthening the institutional architecture of the euro – including banking union, bail-out funds and more meticulous monitoring – that should help them manage crises better. The European Central Bank has proven that it is willing to interpret its mandate to include propping up markets if and when confidence fails.

It is the interplay between a more solid eurozone framework and the steady progress that literally all eurozone countries are making towards more balanced growth that renders the single currency more resilient. And it is this underlying resilience which allows European governments to engage in sometimes shrill rhetoric and political brinkmanship.