Will the eurozone reap what it has sown?

by Simon Tilford

The slowdown in emerging markets leaves the eurozone even more reliant on exports to the US and UK to compensate for its feeble domestic economy.

The eurozone is banking on a weak euro and strong global growth to boost exports and inflation and offset the weakness of domestic demand. How likely is this? China might yet avoid a recession, but there is no doubt that it is set for a period of much slower growth. At the same time, pretty much every emerging market is weakening, partly because of their dependence on China, and partly because of sluggish productivity growth. The US Federal Reserve's decision not to increase official interest rates is welcome: a rise would have prompted further capital outflows from emerging markets. But there is no doubt that the global economy is labouring, and that this poses a threat to the eurozone's anaemic recovery.

The eurozone ran a trade surplus of €125 billion over the first six months of 2015. Over the same period of 2011, it had a deficit of €17 billion. Over the last four years, exports have risen 18 per cent; imports just 2 per cent. The data for net exports (exports minus imports), which measures the impact of foreign trade on economic growth, is striking. Between the first half of 2011 and the first half of 2015, the eurozone economy expanded by 1 per cent. Without rising net exports, it would have shrunk by 1.3 per cent. In short, without global demand, there would have been no eurozone recovery at all.

The eurozone's rising surplus is down to trade with developed countries, especially English-speaking ones, and commodity producers, not China or other emerging markets. Just 7 per cent of the increase in eurozone exports over the last four years was to China, whereas nearly half of the increase was with the US, the UK and Canada. Moreover, these countries accounted for over 40 per cent of the rise in the eurozone's net exports (as imports from these countries barely rose). Most of the rest of the increase in eurozone net exports was with commodity producers, as falling oil and other raw material prices reduced the value of eurozone imports from these countries. By contrast, net exports to China fell over this period, as the value of eurozone exports to China rose by less than the value of imports from China.

The eurozone will certainly be hit by the slowdown in China and elsewhere. Emerging markets buy over a quarter of eurozone exports, and these are set to come under pressure, while the competitiveness of emerging market manufactured goods will increase as the value of their currencies falls. Eurozone net exports to these economies, especially China's, could weaken substantially. Can the Anglo-Saxons continue to act as the eurozone's 'consumer of last resort' and offset the impact on the currency union of the slowdown in emerging markets?

Both the US and UK economies are growing relatively robustly and investors are currently sanguine about their rising trade deficits. This may well persist for a while, especially as capital flows out of emerging markets into developed ones. But it leaves the eurozone vulnerable to a slowdown in the US and UK, which are themselves not immune to weakening global growth, especially the UK which is more dependent on foreign trade than the US. They will not be able to sustain a big drag on their economies from negative net exports indefinitely. So far, the US dollar and sterling have been rising in value against the euro, just as US and UK trade deficits with the eurozone have been widening. But this positive sentiment could easily reverse if investors turn bearish about the growth prospects of the US and UK.

Meanwhile, there is little to suggest that domestic demand in the eurozone will be strong enough to deliver robust GDP growth. Domestic demand has picked up over the last year as lower inflation and energy prices have temporarily boosted household incomes. But this is largely a one-off boost to growth. There is no sign of a pick-up in investment in the eurozone as a whole. Fiscal policy has become mildly expansionary, and should remain so, but there is no prospect of a major programme of fiscal stimulus.

"The eurozone can no longer rely on a weak euro and strong global economy to offset anaemic domestic demand."

The eurozone's need to focus on boosting domestic demand is as pressing as ever. The currency union cannot rely on a weak euro and strong global economy to offset economic fragility at home. Aside from leaving it highly vulnerable to external events, the eurozone has become a major drag on the global economy itself. Unfortunately, the European Commission is powerless to do anything about the biggest obstacle to stronger growth in eurozone domestic demand: excessive savings in Germany and the Netherlands. Germany's current account surplus is on course to exceed 8 per cent of GDP this year and the Netherlands' 11 per cent. In all likelihood, the eurozone will only adopt the aggressive monetary and fiscal measures needed to raise domestic demand when it can no longer rely on external demand. That time might not be too far off.

Simon Tilford
Deputy director, CER

CER in the press

The Financial Times
22nd September 2015
"It [the refugee crisis] is a real European problem: just looking at the geography makes that clear," said Camino Mortera-Martinez of the **CER**. "But the sad thing is that many EU member-states seem to be following just national logic."

The Wall Street Journal
17th September 2015
"There are some ways to unblock the logjam. Rather than immediately force banks to hold significant capital on their holdings of government bonds, European regulators could set limits for how many bonds from one country a bank can hold," suggests Christian Odendahl, chief economist at the **CER**.

Reuters
8th September 2015
"The more he [David Cameron] makes these concessions and the longer he delays clearly coming out for a 'Yes', the more that damages his reputation with his EU partners and the less likely they are to help him get a good deal," said Charles Grant, director of the **CER**.

The Telegraph
7th September 2015
According to Rem Korteweg, a senior research fellow at the **CER**: "[Juncker] knows all these individual leaders and their predecessors, and the predecessors of their predecessors. He is the grandfather of the eurozone."

The Daily Mail
1st September 2015
"This has become a humanitarian crisis on a scale we have not seen on our continent since the Second World War. Yet we seem paralysed to respond," said Yvette Cooper during her speech at the **CER**.

The Wall Street Journal
27th August 2015
"The assumption has been that the eurozone would be able to piggyback on demand generated in emerging markets plus English-speaking countries," said Simon Tilford, deputy dirctor of the **CER**.

Reuters
27th August 2015
"Those who lose most from Google's behaviour are producers, not consumers, at least in the UK," said John Springford of the **CER**. "If Google's prioritisation of its own shopping service gave it monopoly power, one would expect prices to be higher in its own service [than those of its competitors]."

ABC (Australia)
26th August 2015
"[EU migrants] actually contribute an enormous amount to our economy. But there's a perception that they are damaging the interests of British workers," says Ian Bond, director of foreign policy at the **CER**.