Box 4

SECTORAL CONTRIBUTIONS TO REBALANCING WITHIN THE EURO AREA

Drawing on the sectoral accounts, this box analyses the ongoing current account rebalancing within the euro area. It updates a similar analysis presented in February 2012.[1] The sectoral accounts are aggregated for two groups of euro area countries, clustering those that ran current account surpluses over a five-year period up to the onset of the financial crisis in 2007 and those that ran current account deficits. The "external surplus group" comprises Belgium, Germany, Luxembourg, the Netherlands, Austria and Finland and the "external deficit group" is made up of Ireland, Estonia, Greece, Spain, France, Italy, Cyprus, Malta, Portugal, Slovakia and Slovenia. This grouping makes it simpler to derive and present some common stylised facts.[2]

Starting from the basic national account identity, in which the current account is the balance between total economy saving and investment, the box shows that the current account rebalancing

1 See the box entitled "A sectoral account perspective of imbalances in the euro area", *Monthly Bulletin*, ECB, February 2012.

2 Like any grouping criteria, it has obvious limitations, but these do not affect the main thrust of this exercise. For instance, the groups are rather heterogeneous, comprising countries that ran large external deficits (or surpluses) at the peak of the cycle, as well as countries that had current account positions closer to balance. Countries within a group may also differ considerably with respect to other indicators, such as their fiscal position or the presence of specific boom-bust market cycles, etc. Most notably, the composition of the group is closely tied to the reference period and would change over time. Germany, for instance, would have been in the "external deficit group" for a similar exercise conducted in the early 2000s, while Italy and France would have been in the "external surplus group" at that time. This shows that corrections and reversals of imbalances within Monetary Union occur over time.

within the euro area since 2008 has been driven by investment compression, with little progress on the savings side. In particular, in the external deficit group relative to the external surplus group, corporate saving remained depressed and business margins, which had been weak or declining up to 2008, have continued falling. The convergence in unit labour costs (ULC) has been limited despite substantial progress in programme countries.

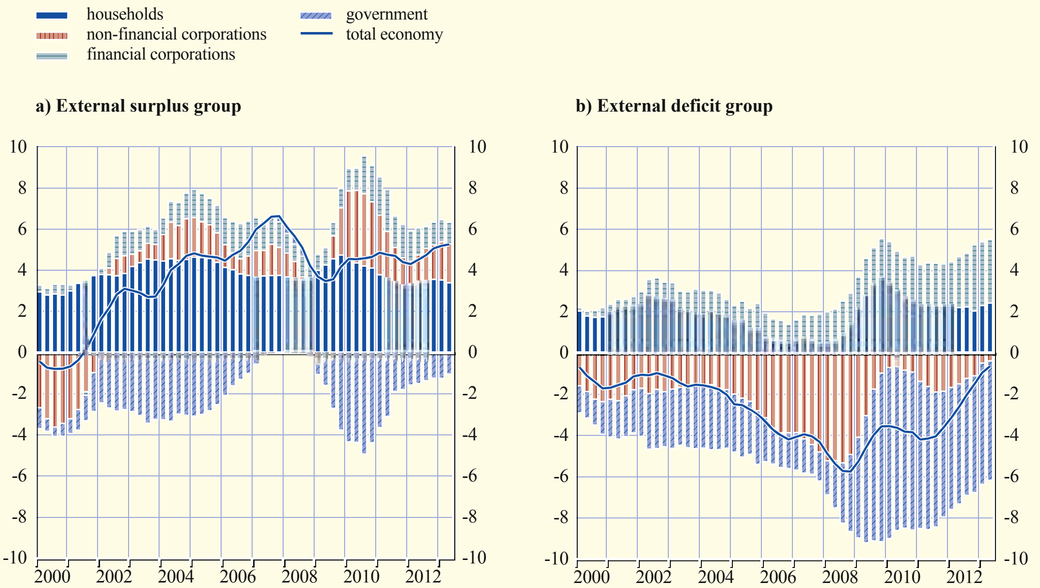
Development in net lending/net borrowing

Chart A shows, for each group, the evolution over time of the net lending/net borrowing of the economy as a whole (essentially the current account), according to the traditional sectoral breakdown (households, non-financial corporations (NFCs), government and financial corporations).[3] In the external surplus group (Chart A(a)) current account positions deteriorated between 2007 and 2009, but improved thereafter, especially from 2011. The improvement can be mainly attributed to developments of the NFC balance (which remained in an atypical financial surplus throughout almost the whole 2002-2013 period) and to the correction of the government sector deficits.

A correction in the current account balances of external deficit countries (Chart A(b)) began in 2009, with an acceleration from 2011 onwards.[4] After the Lehman Brothers insolvency, NFCs saw an abrupt reduction of their net borrowing in 2009 (reversing the strong increase up to 2008)

Chart A Net lending/net borrowing by sector

(four-quarter sums; percentages of GDP)



Sources: Eurostat and ECB.
Note: The net lending/net borrowing shown in the charts has been adjusted to exclude "acquisitions less disposals of non-financial non-produced assets" (in order to avoid the distortions caused by the large proceeds from the sale of UMTS mobile phone licences in 2000).

3 The net lending/net borrowing or financial surplus/deficit of a sector is the balance of its capital account. It measures the excess of saving and net capital transfers received over capital investments (net lending), or vice versa (net borrowing); it expresses the difference between the revenue and expenditure of each sector; and it is the balance of the financial accounts of the sector which measures the difference between transactions in financial assets and transactions in liabilities.

4 Within the external deficit group, only France saw a deterioration of its current account after the 2008 crisis.

and a stabilisation thereafter at a reduced level. Household surpluses recovered sharply from their lows in 2008 and remained relatively stable from 2010 onwards. As regards the government sector, the limited reduction in deficit observed recently in the external deficit countries partly reflects the impact of large bank recapitalisations undertaken by some governments (for a total of €61 billion, equivalent to 1.4% of GDP, in the year to the second quarter of 2013), which in turn explains the increasing net lending position of financial corporations.

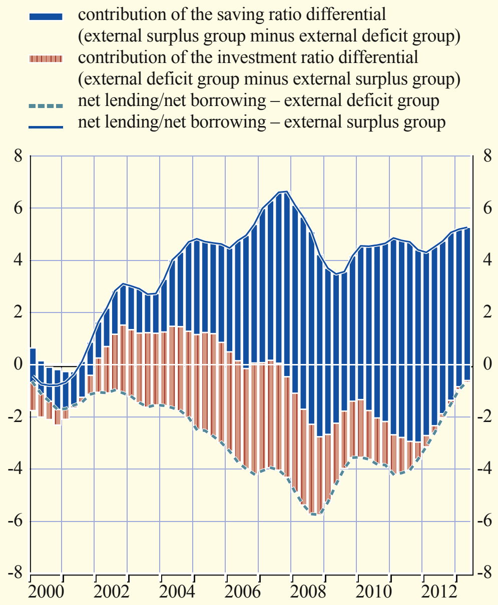
Saving and investment breakdown of the current account differential

Chart B shows the developments in the current account (net lending/net borrowing) of each group and the contribution to the current account differential of the saving ratio differential and the investment ratio differential (between the two groups).[5] The reduction in the current account differential since its peak in the second quarter of 2008 is essentially due to the elimination of the investment differential and only marginally (over the last two years) to a reduction in the saving differential. The saving differential as a percentage of GDP peaked in the third quarter of 2011 (see Chart C); it is currently about 8 percentage points – a differential similar to that observed in 2007, while it was close to zero (i.e. saving ratios were nearly identical) in the early 2000s. The NFC saving gap between surplus and deficit countries contributed the most to the increase in the total saving gap in the years 2004-2008, and, hence, to the widening current account differentials. It narrowed somewhat between 2008 and 2009. Thereafter, the contribution of the NFC saving differential to the total economy saving differential remained broadly stable at around 4% of GDP. By contrast, a large gap in government saving emerged from 2008.

The persistence of the total economy saving differential can be affected by the different cyclical positions of the two groups and thus partly reflects more depressed activity in the deficit countries, to the extent that lower GDP reduces business profits. However, while a GDP recovery would generally boost business profits, it would not necessarily reduce the total economy saving gap. This would critically depend, from the demand side, on the driving forces of the recovery, and from the supply side, on developments in competitiveness. In the case of a domestic demand-driven economic recovery (increased consumption or investment), the expected increase in business and government saving might not be enough to compensate for the likely deterioration of the current account associated with higher

Chart B Net lending/net borrowing in external surplus and deficit groups, and differentials in saving and investment ratios between the two groups

(four-quarter sums; percentages of GDP)

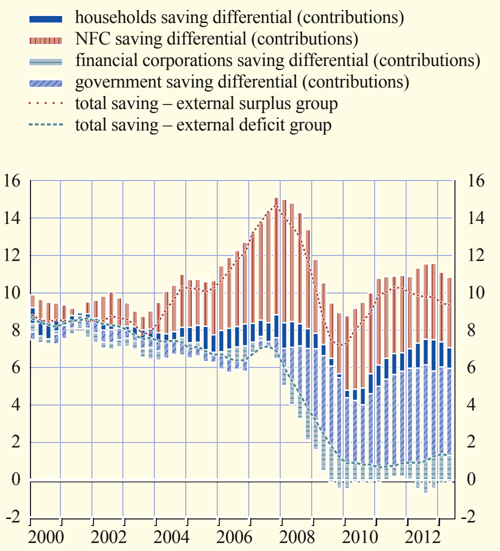


Sources: Eurostat and ECB.
Note: The saving ratio differential includes net capital transfers. An investment ratio that is higher in the external surplus group is shown as a bar below the lower line.

5 Given that the current account balance is equal to the excess of national savings over investment (capital formation), the current account to GDP ratio differential is equal to the difference between the saving ratio differential and the investment ratio differential.

Chart C Savings ratios in external surplus and deficit groups, and sectoral saving ratios differentials between the two groups

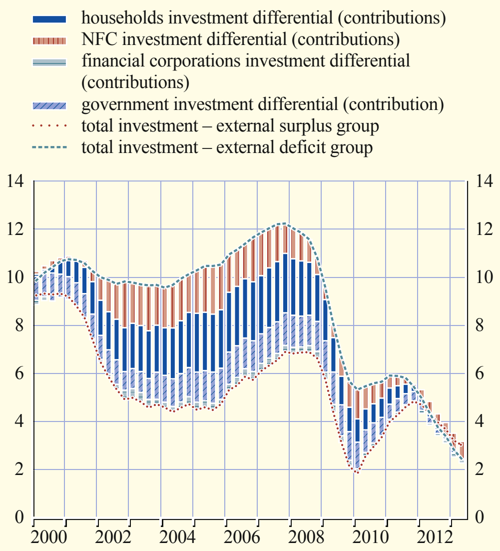
(four-quarter sums; percentages of GDP)



Sources: Eurostat and ECB.
Note: Negative sectoral differentials for government, households and financial corporations (i.e. higher saving ratios in the external deficit group) are shown as bars below the lower line.

Chart D Investment ratios in external surplus and deficit groups, and sectoral investment ratios differentials between the two groups

(four-quarter sums; percentages of GDP)



Sources: Eurostat and ECB.
Note: Negative sectoral differentials (i.e. higher investment ratios in the external surplus group) lead to bars below the lower line. When "total investment – external deficit group" becomes the lowest line, the sign of the contributions by sector is inverted.

investment or lower household savings. By contrast, an export-driven recovery will not only increase business saving, but may even boost saving in other sectors and further improve the current account. As discussed below, developments in nominal wages have a crucial influence on competitiveness, profitability, corporate savings and current account balances.

Chart D shows that, after a rapid fall of the investment ratio in the external surplus countries in the period 2001-2002, the positive investment gap between the external deficit group and the external surplus group remained elevated in the run-up to the crisis. The investment differential tended to be fairly equally distributed across sectors, being positive in government, corporate and household sectors alike. After 2008, the investment gap narrowed in all three sectors, virtually disappearing for households and government (government investment net of consumption of fixed capital fell in external deficit countries from a peak of 1.4% of GDP in 2007 to -0.1% in the second quarter of 2013). The positive gap in corporate investment until 2008, which did not seem primarily driven by profitability differentials (see below), afterwards turned negative, with a higher net investment ratio in the external surplus group than in the external deficit group, by 0.7 percentage points at the end of the period.

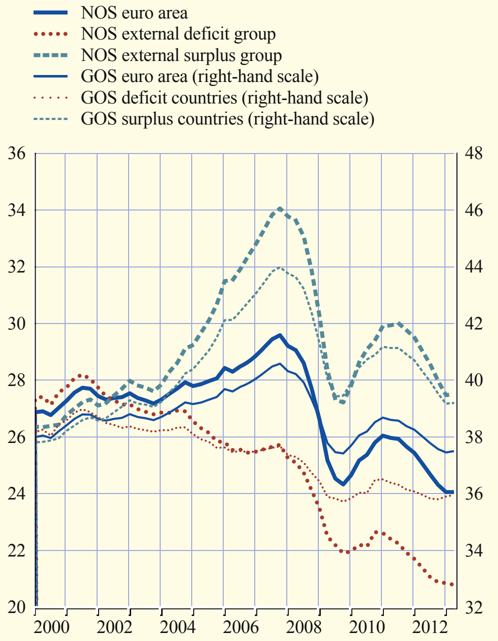
Corporate margins

The increase in the NFC saving differential between the two groups in the run-up to the crisis originated from an increase in the business margins differential and thus in the profitability differential (Chart E). This differential in margins, measured by the ratio between the net operating surplus (NOS) and value added, which did not exist at the start of Monetary Union, increased gradually to peak at 8.5 percentage points in 2008. It declined to about 5 percentage points in the second half of 2009 and has since increased again to around 7 percentage points. Business margins in the external deficit group are thus still depressed relative to those in the external surplus group, which may impede a stronger pick-up in investment.[6]

Besides the net operating surplus to value added ratio, Chart E also shows the gross operating surplus to value added, a measure which is often used to track business margins. The gross operating surplus (GOS) behaves broadly similarly to the net operating surplus in the surplus countries, but less so in deficit countries. In the latter group, the net operating surplus ratio has fallen by 3 percentage points more than the gross operating surplus ratio since 2007. The net operating surplus ratio is currently significantly below its 2009 trough (by more than 1 percentage point), while the gross operating surplus ratio is at the same level.

Chart E Business margins: ratio of the operating surplus to value added of NFCs

(four-quarter averages; percentages)



Sources: Eurostat and ECB.
Note: NOS is the net operating surplus, GOS is the gross operating surplus.

Overall, when using the gross operating surplus, the reduction observed in the business margins gap between the two groups is less marked than it is when using the net surplus measure, the latter showing a weaker profit picture for deficit countries. This reflects the role of amortisation, which should be deducted when analysing profitability.[7] As a fixed cost, amortisation tends to move steadily across the business cycle, making net operating surplus more pro-cyclical than gross operating surplus.

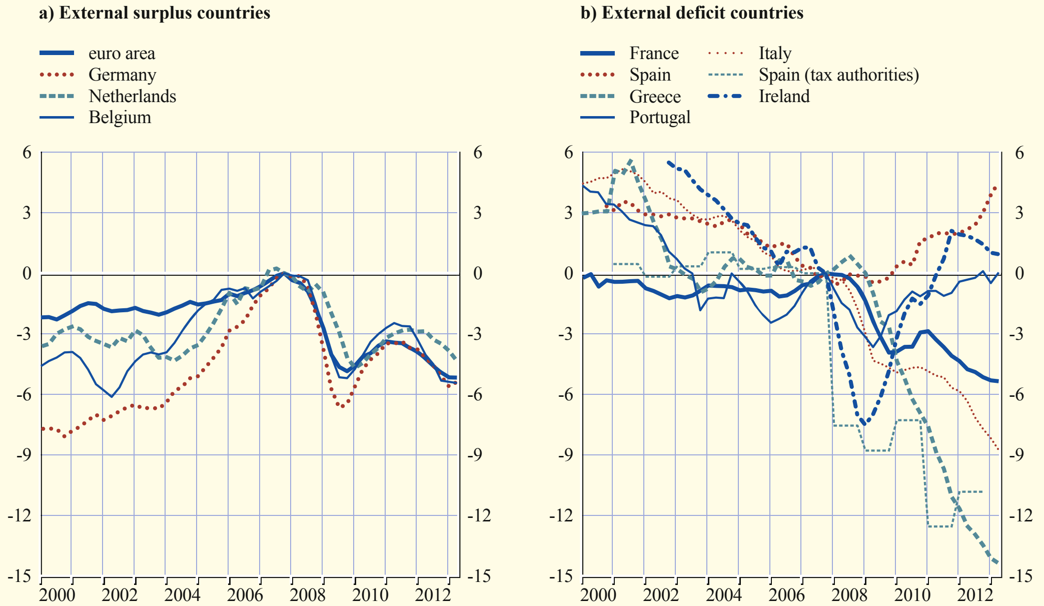
Chart F shows the net operating surplus ratio of NFCs across selected countries (ratios rebased to their 2007 values). Margins exhibit no clear trend in surplus countries, showing a strong increase up to 2008 and a fall thereafter (Chart F(a)). By contrast, profit margins in France, Italy and Greece were weak or progressively weakening up to 2008. This weakening accelerated after 2008, bringing margins down to their current low levels in these countries. In the case of Greece, the pronounced fall in net operating surplus ratio stands in sharp contrast to an increase in gross operating surplus ratio, as the impact of the fixed cost of capital is particularly pronounced amid strongly contracting activity and increasing consumption of fixed capital. By contrast, in some other stressed countries, national accounts data show resilient margins, which are currently back to

6 It is difficult to disentangle the cyclical dynamics of the decline in average business margins, which may either reflect volume effects (in the presence of fixed costs) or price effects (mark-up, i.e. profits over marginal costs).

7 Although amortisation/depreciation is an accounting entry, it does not cover freely available resources and approximately corresponds to associated repayments streams to the lender (for investment financed by borrowing). In other words, amortisation provides a measure of the replacement investment needed to preserve the capital stock. While the gross operating surplus probably provides a better measure of cash flows, the net operating surplus provides a better measure of return on assets. See also the box entitled "The role of profits in shaping domestic price pressures in the euro area", *Monthly Bulletin*, ECB, March 2013.

Chart F Business margins (rebased to 2007) – selected countries

(percentage points)



Sources: Eurostat, Spanish tax authorities and ECB.
Note: Business margins are defined as the net operating surplus to value added ratio, which is shown in deviation from its 2007 value.

pre-crisis levels (Portugal, Ireland) or even significantly above them (Spain). Overall it seems that the picture of declining margins in the external deficit group is mostly driven by developments in France, Italy and Greece, and also in Spain when looking at alternative source data[8] (Chart F(b)).

Labour costs

Differences in profitability between the two groups are associated with differences in the amount of compensation of employees paid by businesses. Chart G shows (for the whole economy) the dynamics of the wage bills in the two groups, and the contributions to the wage bill differential of real GDP and ULC differentials. After reaching a maximum gap between the two groups of nearly 30 percentage points in 2008, the wage bills have tended to converge. However, up to now this convergence has been less driven by price convergence (i.e. ULC) than by volume (output) dynamics. Despite substantial ULC adjustment in programme countries, the limited ULC convergence between the two groups is mainly explained by the lack of adjustment in Italy and France (Chart H).

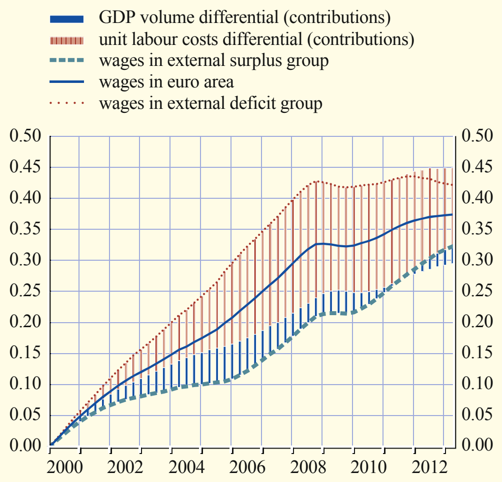
Conclusion

Overall, this box shows that the significant correction in the current account differentials (between external surplus and external deficit countries) observed since 2009 has been mainly

8 Alternative information based on the Spanish tax authorities' public database shows a significant fall in the gross operating surplus of corporates during the years 2007-2012, notwithstanding the known conceptual differences in the definition of operating surplus between the national accounts and business accounting.

Chart G Wage bill (in deficit and surplus groups) and contributions from ULC and GDP volumes to the wage bill differential

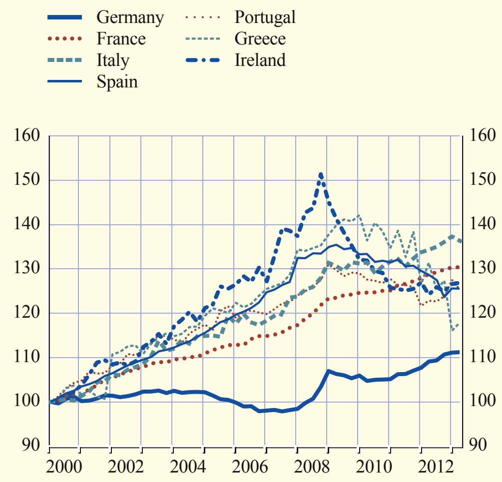
(index: March 2000 = 0)



Sources: Eurostat and ECB.
Note: Index shown for the total economy and presented in logarithm (to ensure additivity of contributions).

Chart H Unit labour costs for selected countries

(index: 100=Q1 2000)



Sources: Eurostat and ECB.
Note: Index shown for the total economy.

driven by investment differential compression rather than by the closure of the saving differential, which remains large. Notably the NFC saving differential between surplus and deficit countries has hardly diminished. The limited adjustment observed until now in the NFC saving differential reflects persistently weaker profitability (measured by net operating surplus over value added) in the deficit group vis-à-vis the surplus group, associated with limited labour cost adjustment.