

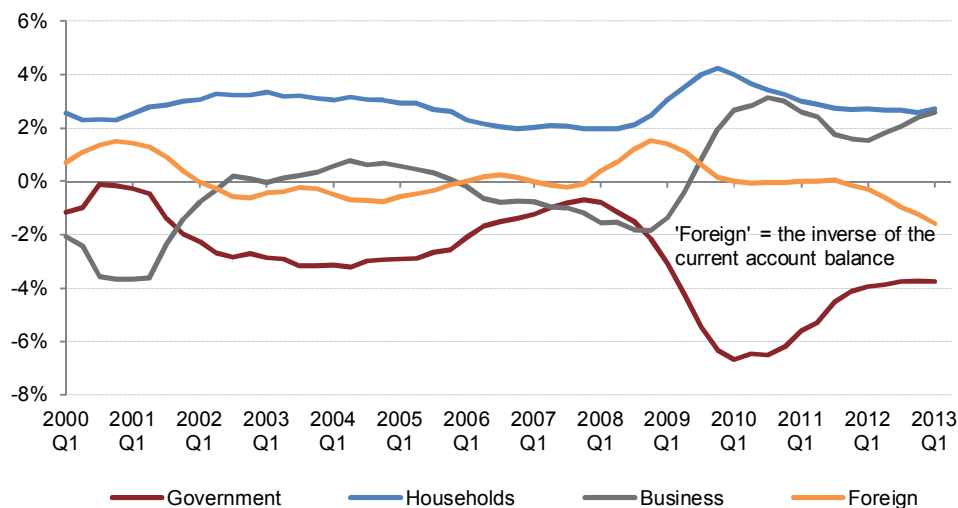
## Narrowing EA budget deficits further will be difficult

- **Q1 sectoral financial balances show EA public sector deficit levelling out**
- **Meanwhile, EA activity should have bottomed out**
- **Good news for EA equities – but US remains more attractive**

At the end of July Eurostat published quarterly accounts for the euro area for Q1 this year, making it possible to update EA sectoral financial balances. While less extensive than the Financial Accounts of the United States, there is still enough in these numbers to provide some food for thought about euro area developments.

A key aim of EA economic policy over the past three years has been fiscal consolidation. We already knew from numbers published on 22<sup>nd</sup> July that the government debt/GDP ratio rose in most EA countries in Q1 (the exceptions were Germany and Estonia). The sectoral financial balances provide a further dampener. The household sector financial surplus edged up slightly in Q1 (this is a four-quarter moving average, since the raw data is not seasonally adjusted), and has broadly speaking been moving sideways since Q3 2011. By contrast, the business sector has seen a major change over the past year, going from a financial surplus of 1.5% of GDP in Q1 2012 to 2.6% in Q1 2013. Although the EA current account balance has moved decisively into surplus, the shift over the same period (from 0.3% to 1.6% of GDP) was not enough to accommodate the surging private sector surplus. As a result, the public sector financial deficit stalled at 3.7% of GDP, where it has remained for three quarters.

**Euro area sectoral financial balances, % of GDP, four-quarter moving averages**



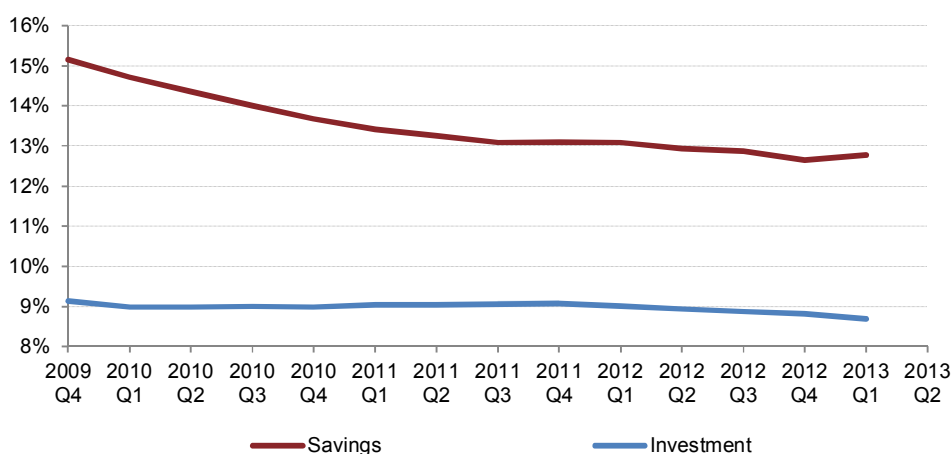
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Sectoral financial balances must, as a matter of accounting identity, add up to zero. A pre-condition for allowing all domestic EA sectors to increase their savings is therefore that foreigners save less; ie that the EA current account surplus widens further. But this runs into two problems. The first is that the rest of the world may not be able or willing to accommodate a wider EA current account surplus. Although the US economy is improving, American growth remains below trend in H1 and may only reach trend towards the end of the year. The second, related to the first, is that the desire of the EA private sector to increase its savings may run ahead of the current account development. This forces the extra adjustment onto the EA public sector, which needs to dissave more, or at least not dissave less.

But causality does not have to run from the private to the public sector. Could it not be the other way around, ie, increased public and less private sector saving? That is possible, but currently unlikely. It would have to mean that the EA private sectors react to further fiscal tightening by increasing their own spending. While the narrowing of the public sector financial deficit from 2010 to 2012 was indeed accompanied by narrower private sector surpluses, this was more a consequence of the EA crises, which led to the household savings rate falling faster than housing investment. Over the period, the savings rate fell from 15.2% of disposable income to 12.6%, while housing investment fell from 9.1% of disposable income to 8.8%.

**Euro area household savings and investment, % of PDI, four-quarter moving average**



Most euro area indicators currently show some improvement in activity – although this has yet to translate into harder data such as car sales, retail sales or broad money and credit developments. However, barring any political crisis (eg, in Italy or Portugal) or further revelations of black holes in public accounts (as is already the case in Greece), euro area activity should pick up during the second half of the year. Stronger growth, coupled with a continued acceleration in US activity, should benefit euro area equities. There should also be some improvement in cyclical budget balances, although since EA growth will

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remain below trend, this will be limited. But what the sectoral balances show is that it is likely to be difficult for EA governments to narrow their structural budget deficits further. This can either be accepted – which should be more good news for equities, as it will imply a further erosion of austerity – or resisted with calls for renewed tightening of fiscal policy. The most likely course will be the former, not least since austerity is already fraying at the edges and following the German September election there will be no imperative to re-impose stricter measures. However, the ever-present risk of a new political crisis with its economic repercussions should still make EA equities less attractive than their US counterparts.

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