Southern Europe – Will the outperformance last?

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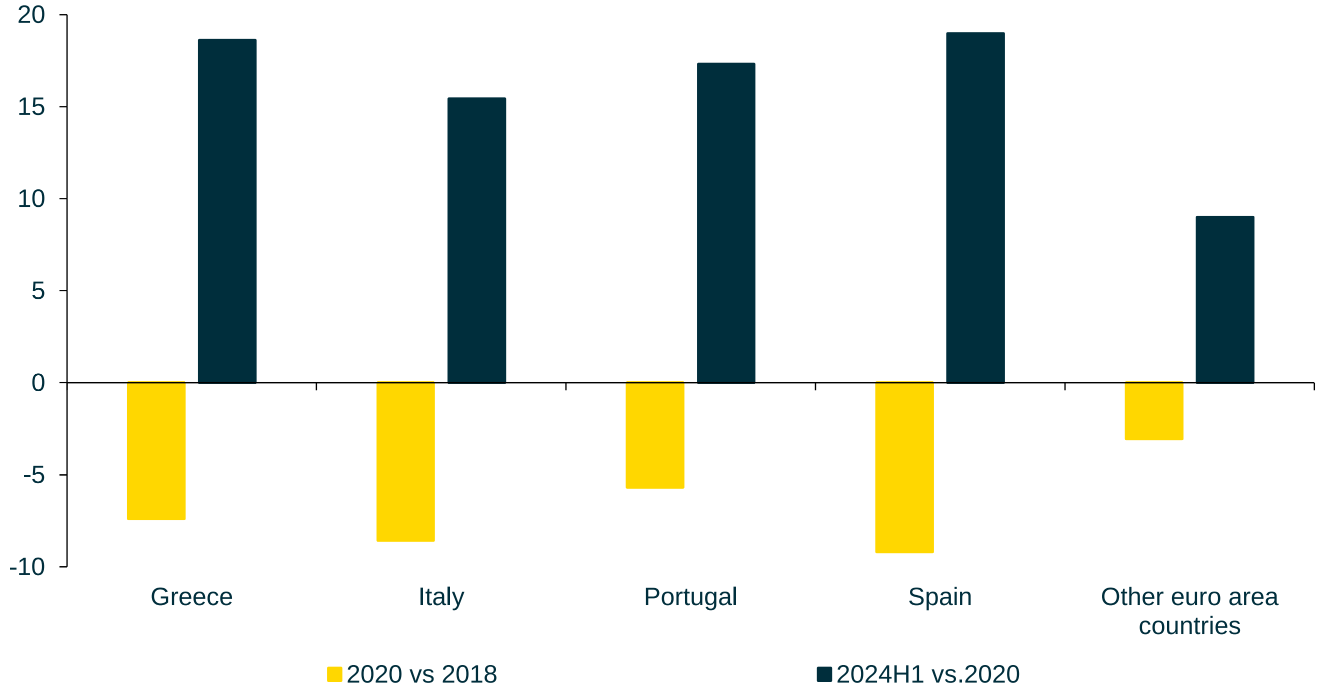
The countries in the south of the euro area have grown significantly faster than the other member countries in recent years. However, this does not mean that they will continue to do so going forward. In Spain and Italy in particular, there have been hardly any structural improvements in recent years that could pave the way for sustained stronger growth. Rather, a considerable part of the stronger growth has only compensated for the generally much deeper slump during the coronavirus pandemic. In addition, there were above-average contributions from the European reconstruction fund and a massive subsidy for the construction sector in Italy, the effect of which is likely to fade by 2026 at the latest. This should also put an end to the outperformance of these countries.

Periphery as the new growth star?

With the German economy stagnating for more than five years, many are pinning their hopes for the eurozone on the countries in the south of the monetary union. After all, the economy in these four countries (Greece, Italy, Portugal and Spain) has recently grown much more strongly than in the rest of the eurozone. In the first half of this year, real gross domestic product there was between 15% and 20% higher than in the pandemic year 2020, while the economy in the rest of the eurozone only grew by just over 8%
(Chart 1). This trend has continued until recently. For example, the Spanish economy is expected to grow by more than 2½% this year, while economic output is expected to increase by less than 1% in the eurozone as a whole and even shrink slightly in Germany.

Chart 1 - Southern Europe: Stronger growth follows sharper slump during the pandemic
Real GDP, change in percent



Source: Eurostat, Commerzbank Research

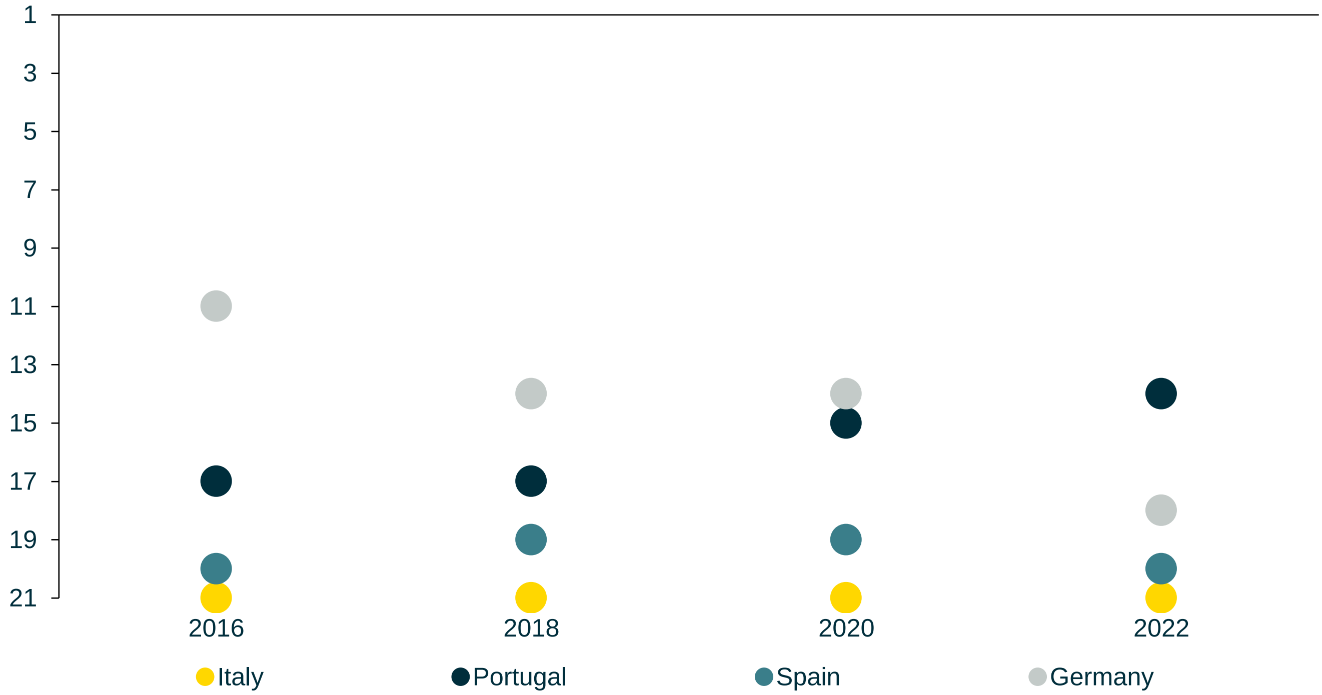
No structural progress in Italy and Spain, ...

For various reasons, we are skeptical as to whether this above-average development of the countries in the south of the monetary union will continue for much longer. For example, we cannot see what structural changes have taken place in recent years that have turned a country with many years of very weak growth like Italy into an outperformer. For example, in the ZEW's location analysis for the German Family Business Foundation, Italy performed the worst of the 21 countries surveyed in the last study in 2022, as in the three previous studies (Chart 2). There was also no improvement in the case of Spain. Instead, the country was again in penultimate place in 2022, just ahead of Italy.

The trend is better in Portugal, which has worked its way up from 17th to 14th place since 2016, with the business conditions having improved compared to the other 20 countries, primarily in the areas of “taxes” and “energy”. The study does not look at Greece, where there have been significant structural improvements over the past ten years – partly due to pressure from the aid programs.

Chart 2 - Only in Portugal has the business environment improved

Rankings in 2016, 2018, 2020 and 2022 in the "Family Business Country Index" among 21 countries



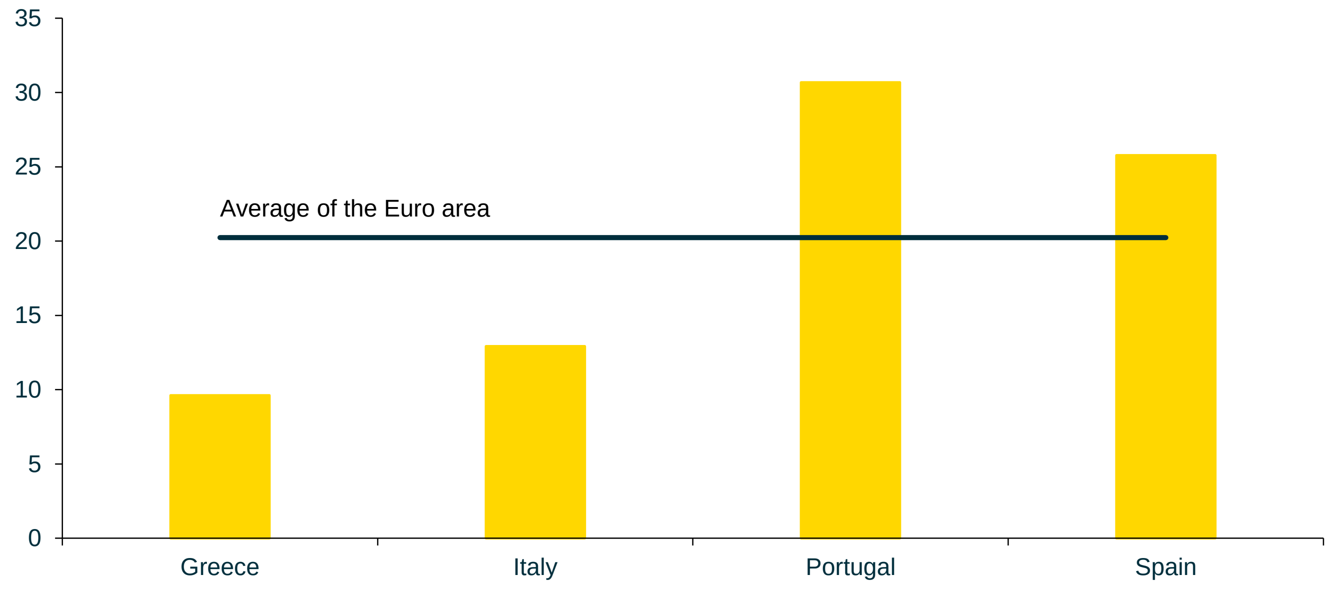
Source: Stiftung Familienunternehmen, Commerzbank Research

… and only partially improved price competitiveness

The situation has also only partially improved in terms of price competitiveness. Over the last six years, unit labor costs have only risen more slowly than the eurozone average in Italy and Greece (Chart 3). In Spain and Portugal, on the other hand, unit labor costs have risen well above average, partly due to a significant increase in minimum wages.

Chart 3 - Portugal and Spain have lost competitiveness

Unit labor costs in the overall economy, change in the first half of 2024 (seasonally adjusted) compared to 2018, in percent

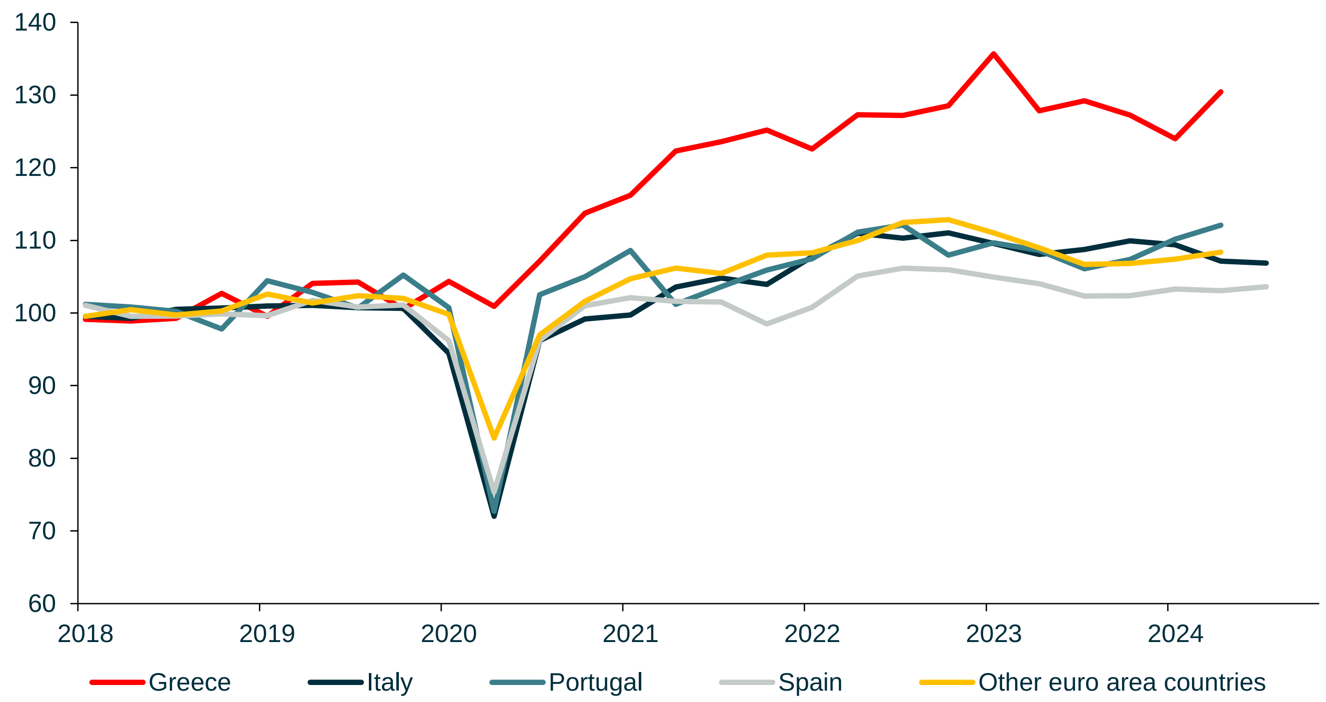


Source: Eurostat, S&P Global, Commerzbank Research

It is therefore not surprising that exports of goods from Italy and Portugal have not performed any better than the rest of the eurozone since 2018. Spain is even lagging behind here (Chart 4). Only Greece is a clear outperformer here.

Chart 4 - Only Greece can expand goods exports more strongly

Exports of goods, volumes, 2018=100, seasonally adjusted quarterly figures



Source: Eurostat, Commerzbank-Research

Strong growth initially counteracts sharp slump during Corona ...

As a result, the economic environment may have improved in Greece and, to a lesser extent, in Portugal. In Italy and Spain in particular, however, the comparatively good development in recent years is likely to be primarily due to a number of special factors.

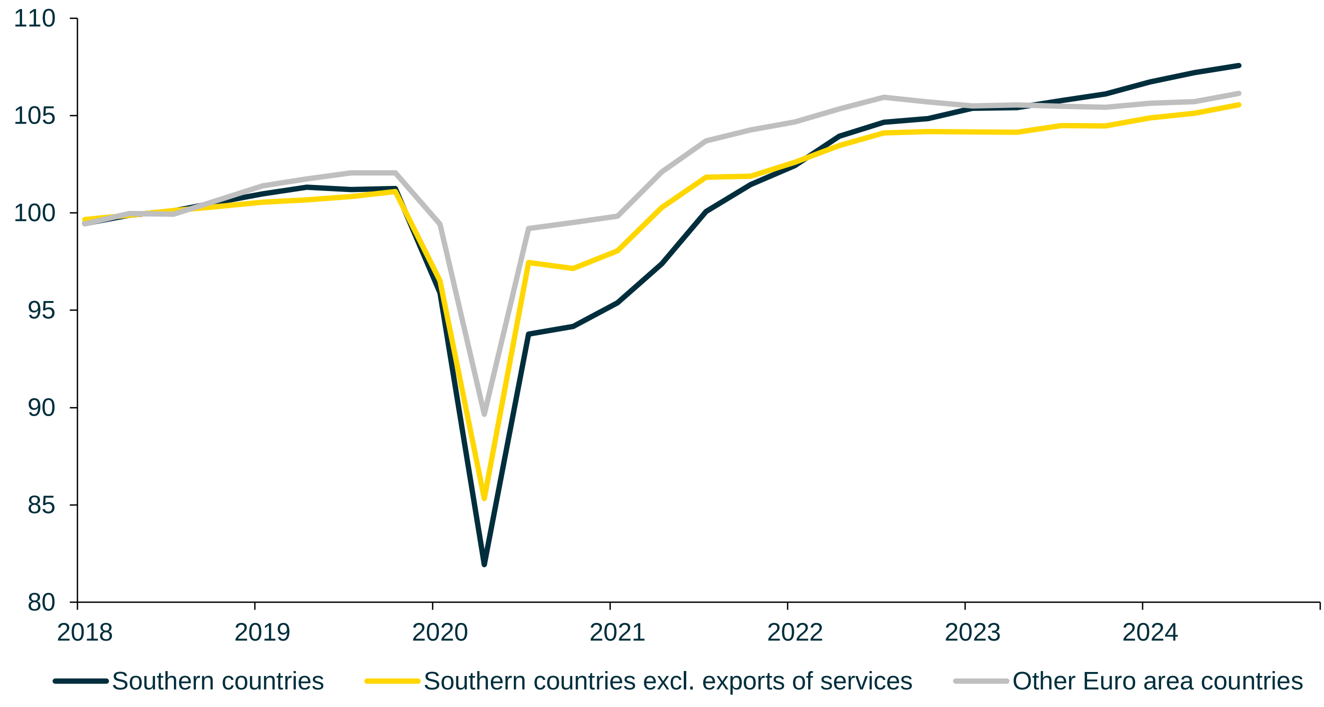
When comparing the development in recent years, it is often ignored that the economies of these countries were hit much harder by the pandemic than those of the other eurozone countries. As a result, the stronger growth recorded since 2020 initially only made up for the resulting shortfall. This race to catch up was only completed at the beginning of last year (Chart 5).

... and then due to booms in tourism, ...

Both the massive slump and the subsequent stronger economic recovery can be attributed to a considerable extent to the great importance of tourism for the economies of the four countries. Excluding exports of services – in which tourism is likely to play a major role in all four countries – the decline in 2020 is much smaller, and the rest of the economy has not grown more strongly than the rest of the eurozone since 2018 (Chart 5).[1] This means that the recent outperformance is probably primarily attributable to one sector, albeit an important one for these countries. By contrast, the rest of the economy has performed similarly (weakly) to the rest of the eurozone over the last 1½ years.

Chart 5 - Tourism as the main driver of the outperformance

Real GDP, seasonally adjusted monthly figures, 2018=100, figures for 2024Q3 partly estimated



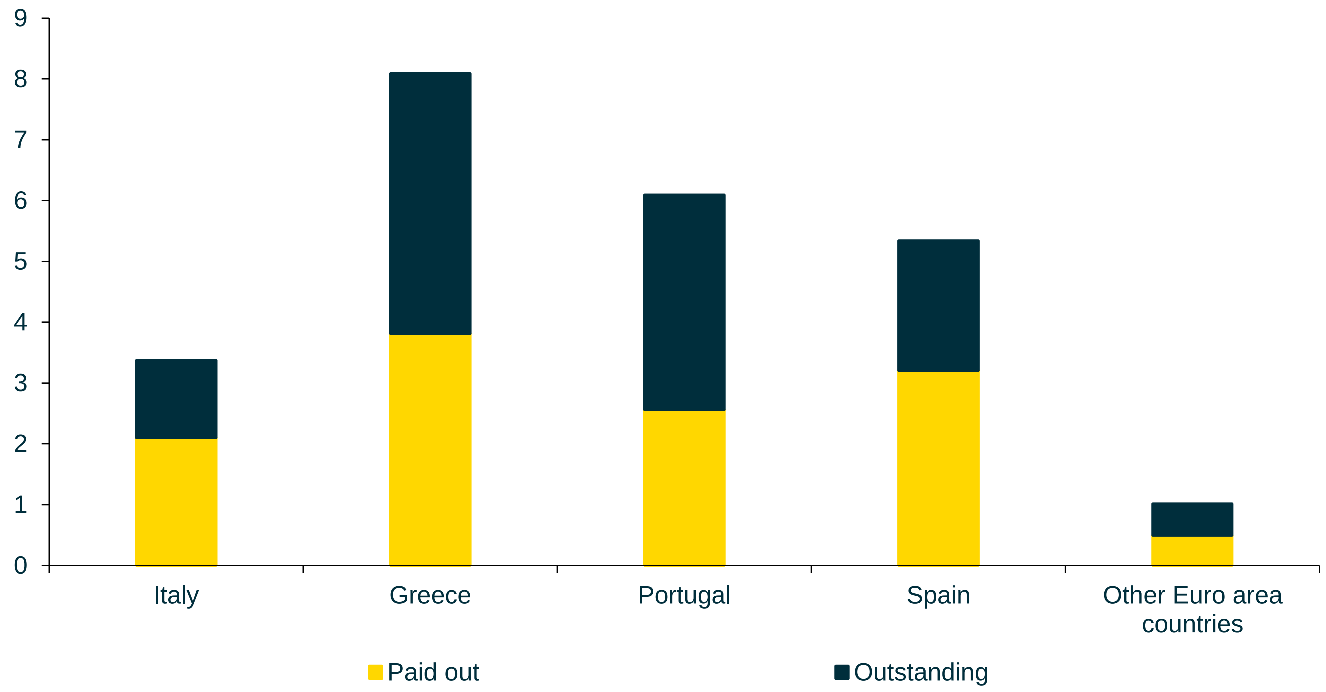
Source: Eurostat, Commerzbank Research

... extensive aid from the reconstruction fund ...

During this period, the southern countries have received significantly larger grants from the so-called “reconstruction fund” (NGEU), which are likely to have boosted growth. In the case of Greece, they have so far amounted to almost 4% of GDP (Chart 6). Italy, while having benefited the least of these four countries with grants amounting to just over 2% of its economic output, has also received significantly higher grants in relation to GDP than the average of the other euro countries (0.5% of GDP). [2].

Chart 6 - Southern European countries benefitting more than average from reconstruction funds

Grants already disbursed and still outstanding from the Recovery and Resilience Facility (RRF), as a percentage of GDP



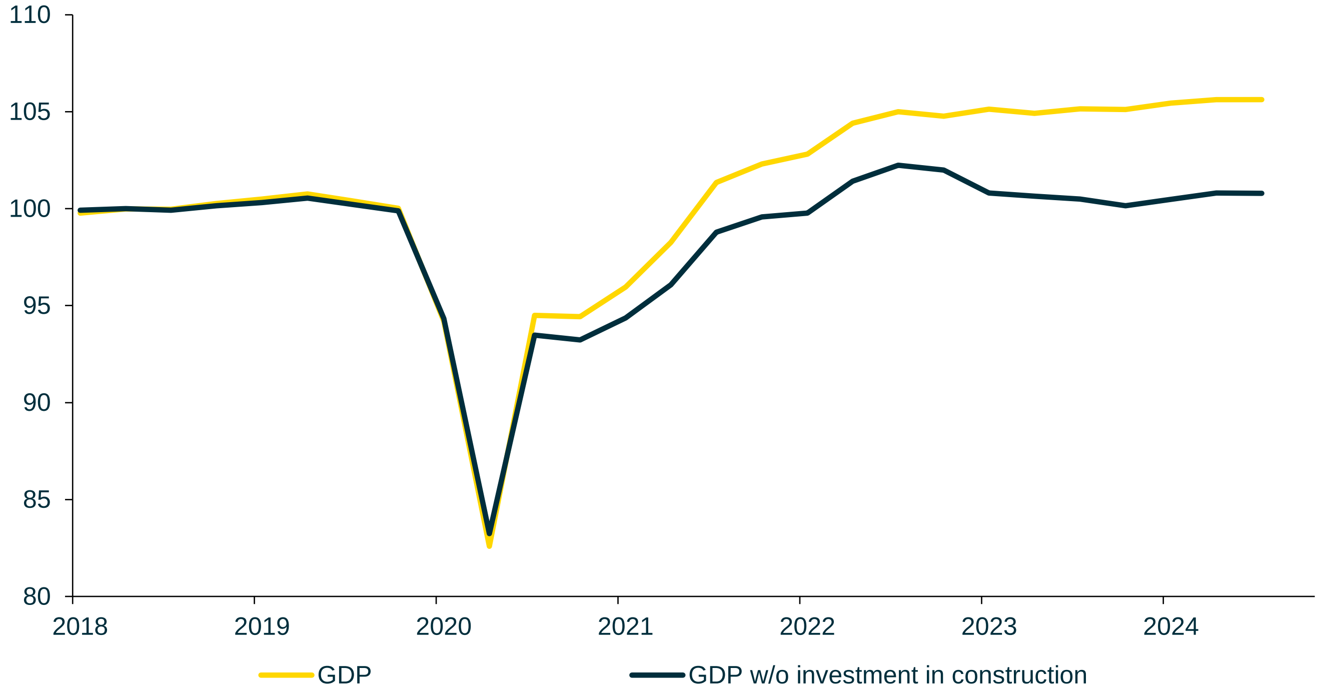
Source: European Commission, Eurostat, Commerzbank Research

... and massive building subsidies in Italy

With regard to developments in Italy, it should also be noted that the construction sector has benefited massively in recent years from the fact that the state has covered the entire cost of energy-efficient refurbishment of buildings. As a result, price-adjusted residential construction investment in the first half of the year was more than 80% higher than in 2018. Other construction investment, which has increased by almost 50% in the last six years, is also likely to have benefited from higher government spending, which is likely to have been at least partially financed by the subsidies from the reconstruction fund. Without the massive increase in construction investment, Italy's economic output would have been 5% lower than it was in the second quarter (Chart 7).

Chart 7 - Italy: GDP growth strongly driven by investment in construction

Italy, real GDP, 2018=100



Source: Eurostat, Commerzbank Research

Outperformance of the south not a permanent phenomenon

The ***Greek*** economy may therefore continue to outperform the rest of the monetary union in the coming years, as progress has indeed been made here in terms of structural weaknesses and the economy is far from having made up for the slump following the debt crisis. However, the lead over the eurozone average is likely to shrink due to the expiry of subsidies from the reconstruction fund.

The structural improvements in ***Portugal*** also point to above-average development. One risk factor here, however, is the sharp rise in unit labor costs. If this continues, it would probably put an end to the country's outperformance in the long term. In this respect, the weaker growth rates of just 0.2% in both the second and third quarters could be a warning sign.

In ***Spain***, too, the tailwind from the reconstruction fund is likely to become less significant and the boom in the tourism sector will at least cool down. As a result, the gap between Spain and the growth rates of the other euro countries is likely to narrow significantly.

In ***Italy***, the expected end of the construction boom due to the expiry of subsidies will have a particularly negative impact. As a result, economic growth in Italy is likely to slow significantly from 2026 at the latest.

[1] By factoring out individual sectors – here exports of services as a proxy for tourism and construction below – the effect of developments in these sectors on the economy as a whole can of course only be approximated. This is because they also influence other demand components. For example, stronger tourism leads to additional investment, which further boosts the economy. On the other hand, however, imports are also likely to increase in order to supply tourists, which in itself reduces the positive effect on domestic production. The comparisons in charts 5 and 7 therefore only give an impression of the magnitude of the effects and not an exact calculation. (back to text)

[2] Only the grants not to be repaid by the countries are considered here and not the loans from the reconstruction fund, which also flowed on a large scale with the exception of Spain, as the latter are counted towards the countries' debts and therefore do not expand the countries' fiscal leeway. (back to text)

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