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A short critical note on the Eurozone economy

1. Introduction

Over the past year economic confidence among Eurozone firms and households has been rising steadily to levels consistent with about 1.5 to 2% growth. In the first 6 months of this year growth accelerated to 1.8% annualized, up from 1% in the second half of last year. Some observers have already jumped to the conclusion that the Eurozone economy is back on track and will soon connect its car to the US locomotive. While acknowledging recent progress, this short note warns against too much optimism in this respect and states that the economy remains fragile both cyclically and structurally. Following the July 12 deal between Greece and its creditors and the approval of it in several European parliaments, negotiations have finally resulted in a third rescue program for Greece. Although it was a close call, our base case scenario that a last-minute deal would be found was proven right. On the other hand, it's far from certain that this deal is sustainable so that a Greek exit from the monetary union is still very plausible. An imminent exit may well be avoided but without significant changes to the program the Eurozone is likely to find itself in difficulties again rather sooner than later. Clearly, the Eurozone is not doomed: there's still time to save the deal and bring the Eurozone project into calmer water. Recent negotiations don't leave much room for optimism in this respect. Some would argue that because of the small size of its economy Greece could not possibly pose a real threat in the first place. Although I doubt it, these claims may be proven right. Yet, even if the Greek crisis can be contained, the union's institutional architecture is still far from finished. Future crises, therefore, could still take down its foundations.

2. The Eurozone recovery remains fragile

Several factors including ECB stimulus measures resulting in lower interest rates and euro depreciation, reduced budgetary tightening efforts and lower energy prices are driving a cyclical Eurozone recovery. Moreover, credit growth is back in positive territory for the first time since late 2011 and business and household confidence indicators hold up nicely for the Eurozone as a whole. This is encouraging following years of stagnation. That said, the recovery looks set to prove fragile once the temporary tailwinds in the form of lower energy prices and cheaper currency fade. In addition, the recovery is also uneven. While confidence shows signs of strength in countries like Germany, Spain, Ireland or the Netherlands, it's still fairly weak in France, Austria and Finland. The situation in Greece of course is very worrying with leading indicators in depression territory. All in all, despite recent improvement, the recovery is still nothing to cheer about as aggregate Eurozone GDP has just reached its early 2008 levels. Importantly, this is mainly due to the contribution of Germany (+5%) and France (+2.6%). The situation in Italy (-8%), Portugal (-6%) Spain (-4%) is obviously much less rosy. All this stands in sharp contrast to conditions in the US (+9%) or the UK(+6%) where GDP is significantly (though not spectacularly) higher than pre-crisis levels.

Eurozone unemployment, meanwhile, though coming down a bit in recent months, look set to remain at unsustainably high levels in the foreseeable future. This, in turn, will keep inflation (too) low. Underlying inflation, although set to pick up from the current 1%, is likely to stay low by historical standards. The ECB has been completely missing its 2% inflation target over the last seven years and it remains doubtful whether it will be achieved anytime soon. Criticism about the negative consequences of the ECB's QE policy has been increasing. In combination with improving economic data, this has put pressure on the ECB to reduce the program prematurely. However, given the still fragile recovery and the presence of massive challenges in the Eurozone, the chances that this will happen remain small. If anything, the main risk is that QE will have to be extended beyond late 2016. Against the back of the economic picture painted above, it should not come as a surprise if this were to happen earlier. After all, the ECB (compared to the Fed, the BoE or BoJ) started its program later and (unitil recently) also acted more modestly.

The Greek situation remains problematic in several ways. A third follow-up program for Greece has started and will make sure that the country's funding issues are resolved at least temporarily. At the same time, the agreement between Greece and its creditors still looks very unbalanced. Against the back of a deepening economic depression, it's very unlikely that Greece will be able to meet the harsh austerity and reform conditions. Unless Greece's creditors choose to loosen their stance and allow for more budgetary flexibility (an assumption that seems not very plausible at the moment), a Greek exit from the monetary union is almost inevitable. Despite the recent deal, Grexit has now become our base case scenario. It's unclear what would happen next but it would be close to impossible to close the backdoor again. To be sure, this should not be destiny. As stated earlier, there is still time to save the Greek deal before reform fatigue sets in. At this point, however, it's difficult to imagine that this can be done without having another (Greek) crisis first.

3. The Eurozone project: what's next?

In contrast to conventional wisdom, the Euro crisis was not, at its roots, a public debt crisis. True, the newly elected Greek government back in late 2009 revealed that the country's public deficit, at more than 12% of GDP, was twice as large as previously announced. Yet, this should be mainly seen as the trigger of the crisis. The Eurozone crisis, instead, is best understood as a balance of payments crisis. Daniel Gros (2010) states that: "the crisis started as a classic sudden stop to cross border capital inflows. As boom turned into bust, governments lost their tax base and had to assume private debt, thus creating a public debt crisis. The highly leveraged Eurozone banking system, tightly linked to national governments, provided a multiplier, which made the crisis systemic".

Even before the start of the single currency area economists had warned repeatedly how damaging the idea could be in the absence of a political and fiscal union. For example, Milton Friedman (Project

Syndicate, 1997) wrote an excellent piece that could well have been written today. Belgium's Paul De Grauwe (1998) explicitly stated that the introduction of the euro would bring a dramatic liberalisation of Europe's financial markets while the regulatory and institutional environment would be overwhelmingly domestic. Several others authors, moreover, stressed that flexible exchange rates provide an extremely useful adjustment mechanism and added that the Eurozone was still far from an optimal currency area.

Yet, European leaders at the time decided to ignore all this and proceed with their ambitious political project. However absurd this may seem from an economic point of view, the setup of the monetary union is much easier to understand when seen against the back of the post-war political developments in Europe. Anyhow, a well-functioning political union was not feasible at the time. Instead, several mechanisms were put in place as to avoid problems further down the road (the Stability and Growth Pact to keep public finances in check, the ECB's independence in order to rule out debt monetization, and the no-bailout clause to protect against moral hazard). However, these safeguards did little to prevent imbalances from building. Cross border private credit flows went hand in hand with excessive leverage in the banking sector while its supervision and resolution remained national responsibilities. This led to the so-called doom-loop between sovereigns and banks.

Since the crisis broke out in the spring of 2010, European leaders found themselves permanently behind the curve. The adjustment programs brought short-term relief but the ad-hoc nature more often led to major doubts about their sustainability, hence gave rise to more market turmoil. It wasn't until Draghi's 'whatever it takes' speech in the summer of 2012, more than two years after the crisis began, that financial markets calmed down and interest rate spreads on peripheral bonds started to decrease again.

Some argue that this is the only major (though belated) measure seen so far. I would agree but also add that it would be unfair to fully neglect other areas of improvement, especially the first steps toward a full banking union. The latter includes the supervision of the banking sector by the ECB, the single-bank resolution procedure with bail-in rules and the prospect of a deposit re-insurance scheme in order to raise the resilience of the banking sector. It's also worth mentioning that the fiscal and macroeconomic surveillance was strengthened through the creation of the so-called Macroeconomic Imbalance Procedure although its future success looks far from guaranteed. What's more, the setup of the European Stability Mechanism, despite its relatively small size, can potentially act as an emergency backstop instrument (at least when swift pan-Eurozone decisions are possible in this respect).

Critically, however, much more effort is needed when it comes to the creation of a political and fiscal union. Despite fairly broad consensus among economists that this is absolutely crucial to keep the monetary union alive in the long run, it would also be naïve to expect too much if any progress on this in the foreseeable future. Or, as Charles Wyplosz (2015) puts it: "a much deeper Europe is simply not

thinkable at a time when the rising political forces are the Front National in France, the Five Star Movement in Italy, Podemos in Spain, True Finns in Finland, the Party for Freedom in the Netherlands and, until recently, the Alternative in Germany”.

It’s close to impossible to call when the Euro crisis will make headlines again but it’s almost certain that it will again one day. My best estimate is that it could happen rather soon. First, implementation risks surrounding the Greek deal are high as explained earlier. But this reality is not confined to Greece. Portugal and Spain will see general elections on 4 October and before mid-December respectively. Unlike in Greece, none of the anti-austerity is likely to gain full majority. That said, there is a real risk that uncertainty surrounding the elections and the prospect of a new political landscape will weigh on economic confidence in these countries and perhaps spill over to other countries.

Finally and more in general, given the large negative output and high unemployment rates present in most of the European periphery, a modest (muddle through) recovery does not seem like a workable solution. In this case, populistic parties will continue to gain votes, in turn fueling further the disintegration of the currency union. In early 2012, The Economist newspaper magazine pictured the Eurozone as a little girl lost in the dark woods. Now, almost four years later, I would argue that it has learned how to make fire. However, this still does not guarantee her survival.

References

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