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Is the euro crisis over?

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In recent months many politicians have declared the Eurozone crisis to be over and, with the crisis waning, the Eurozone is no longer feared to fall apart. Sovereign bond yields have fallen and economic growth has returned. But growth remains weak and unemployment high - so is the euro crisis really over?

Addressing underlying crisis causes

The risk of a Eurozone collapse has diminished following policy adjustments by the crisis countries, improvements to the Eurozone institutional framework and, in particular, the pledge made in the summer of 2012 by Mario Draghi, president of the European Central Bank (ECB), to do "whatever it takes" to protect the euro.

The austerity measures and structural reforms implemented by the crisis countries of Greece, Ireland, Portugal and Spain have contributed to the rebalancing of their economies. The measures were both impressive – making those countries the top reformers among the 34 OECD countries – and painful. But the hardship is paying off. Falling unit labour costs – by between 8.5% (Spain) and 13% (Greece) - have improved competitiveness, boosted exports, reduced imports and transformed the current account from large deficits into surpluses. This is beneficial for the longer-term sustainability of the Eurozone.

Institutional reforms at the supranational level have also helped as they address some other underlying causes of the crisis: lack of policy coordination, the failure of the fiscal surveillance and the fact that the Eurozone is a halfway house. Measures with fancy names such as ʹSix Packʹ and ʹTwo Packʹ improve policy coordination, strengthen fiscal surveillance, broaden surveillance to macroeconomic imbalances and reinforce corrective measures. This will strengthen economic integration and deepen fiscal integration. Additionally, impressive progress is being made with the extension of the Eurozone 'house' to a banking union, which will enhance the soundness of the

European financial sector. Important aspects of the banking union are a common bank supervision (the Single Supervisory Mechanism currently being set up by the ECB) and a common bank resolution fund (the Single Resolution Mechanism). The latter is meant to break the vicious link between sovereigns and their banks, which proved to be highly disruptive during the crisis. According to the new rules, bank creditors will also be involved in bank resolution measures, thereby putting an end to the massive bailouts paid for by taxpayers.

Last but not least, policy measures by the ECB after Mario Draghi became its president in November 2011 have contributed to the stabilization of the Eurozone economy and restoration of market confidence in the Euro project itself. Interest rates were cut further, banks in the Eurozone were provided with long-term financing through the long-term refinancing operations (LTROs) and, as mentioned already, the ECB stated that it would do "whatever it takes" to protect the euro.

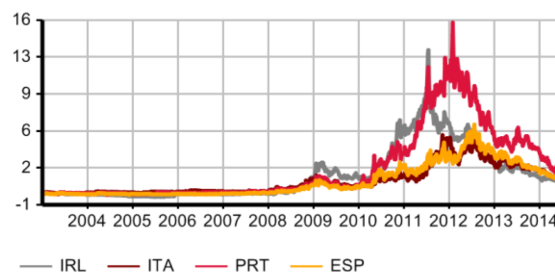
Restoring confidence and growth

As a result, sovereign bond yields have dropped significantly, funding conditions for Eurozone banks and corporates have improved - particularly for the Southern European countries - and economic sentiment has jumped above its long-term average. Combined with improvements in the global environment, this contributed to a return to growth in the Eurozone economy during the course of 2013, including the crisis countries except Greece. However, even in Greece the pace of economic contraction is slowing.

Higher growth and lower funding costs have reduced the debt burden and improved the solvency of Eurozone governments and the private sector. They have also enabled the crisis countries Spain, Ireland and Portugal to end their official support programmes. Greece is on track to do so but might need some further financial assistance, albeit at much lower figures. All of these countries have returned to the private market and issued large long-term government bonds in recent months.

Government bond yields drop like stones

(10-year bond yields over the German bund, percentage points)



Source: IHS Global Insight

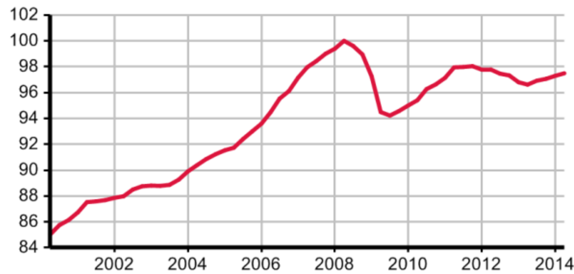
Full economic recovery is still distant

Despite the improving conditions, economic growth remains slow across the Eurozone. Growth is weighed down by weak business investment and feeble consumer spending. Consumer purchasing power remains under pressure as governments increase taxes and lower subsidies in an attempt to improve public finances. Unit labour costs may have fallen, but this has come at the expense of household incomes rather than as a result of rising productivity. High unemployment is also weighing on consumer demand. The unemployment rate is still at record levels in Spain (25%) and Greece (26.5%). With economic growth weak and inflation falling (0.5% year-on-year in May), fear of a prolonged period of stagnation in the Eurozone economy is rising.

The Eurozone economy is still smaller than before the crisis and is unlikely to recover lost ground soon. As a result of the deep contraction in 2009 and weak growth since then, the economy was still 2.5% smaller at the end of the first quarter of 2014 than it was before the crisis. This means that 2014 will be the seventh year of below-peak performance. The situation is most severe in the Southern European member states; Italy and Spain are currently 9% and 7% smaller than in 2008, while Greece has lost a quarter of its economic output. The current marginal economic growth levels are insufficient to stem the tide.

Eurozone economy still below peak

(Real GDP level index, 2008Q1 = 100)



Sources: IHS Global Insight; OECD

Weighed down by debt

Despite disappearing from the headlines, the debt problem has yet to be resolved. Government debt levels increased rapidly after 2008 as governments bailed out their financial sector, tax income evaporated and spending on the social safety net rose. Debt has continued to grow and is forecast to rise further as most countries still face a government budget deficit. Debt as a percentage of economic output is above 100% in Ireland, Portugal and Belgium and is a worrying 133% in Italy and 175% in Greece. With investor confidence currently high, financing the cost of the debt is easing, but a return of risk aversion would quickly erode the government finances and the government's solvency.

However, it is not just governments that are weighed down by debt. Households and companies accumulated large amounts of debt in the run up to the crisis and this is now impeding consumption and investment: especially holding back the recovery in Southern European markets. Despite a fall in interest rates on consumer loans and corporate borrowing over the past year, the rates remain high across Southern European countries and much higher than German rates. Companies in Spain and Italy pay around 50% more on large new loans than German firms. Due to the low and falling level of inflation, the real interest rate has fallen much less than the nominal figure and may even have risen in some markets. Banks in Southern Europe are also extremely cautious with lending and are instead focused on cleaning up their balance sheet as a result of the ongoing European wide banking stress test.

More reform is necessary, but challenging

The institutional framework may have been improved, but it remains questionable whether this will be sufficient. The numerous measures fall far short of the often mentioned necessity of full mutualisation of financial obligations. The creation of a Eurozone-wide deposit insurance scheme has been completely scrapped due to political resistance while the banking union has yet to be fully implemented and prove its effectiveness in practice. At EUR 55 billion, the size of the bank bailout fund is also relatively small and, while the permanent rescue fund (ESM) has a EUR 400 billion capacity to back-up sovereign debt, it took more than EUR 200 billion to bailout just Greece. The fear of a large economy such as Italy swamping the emergency funds may have eased, but fundamentally has not been addressed.

Many governments have started much needed structural reform, but need to do even more to increase their long-term growth rate. In June the European Commission singled out France and Italy, the second and third largest Eurozone economies, to step up their reforms. The difference between these countries' performance and that of Germany is growing, instead of narrowing. The easing of financial market pressure reduces the incentive for governments to continue their reform efforts. Reform fatigue, after so many years of austerity, is also a risk for delay of reforms. Without continued reform the Eurozone will grow further apart, making it more difficult to implement and enhance the existing Eurozone institutional framework.

Panic over, but vulnerabilities remain

European politicians are right to point out that the stress and imminent crisis has faded. The existence of the euro is no longer questioned. But the economic crisis is ongoing: the economic recovery is still far from complete, unemployment remains stubbornly high and inflation is low. Many consumers and companies across the Eurozone are still feeling the pinch. In addition, the fundamental problems underlying the euro crisis have not been fully addressed. The institutional framework remains insufficient and reform efforts are hindered by complacency and reform fatigue. Public and private debt also remain high. This leaves the euro area vulnerable to new crises in the future.

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