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Eurozone on path to strong recovery

Growth, jobs and debt figures paint a positive picture of the euro area, in contrast to some other parts of the world

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THE second half of 2013 will show an unexpectedly strong economic recovery for the eurozone, auguring well for 2014. The figures rarely lie and they are quite good. The second quarter 2013 revealed growth of 0.3 per cent. The Markit purchasing managers' index rose to 51.4 in August from 50.3 in July, indicating that the recovery is gaining momentum.

Most mainstream prognoses still point to a contraction of 0.5 per cent for 2013, but this is wildly pessimistic; we may end with the surprising result of close to zero – neither growth nor contraction. The current account is running at a healthy surplus of 1.8 per cent of gross domestic product (GDP) on an annual basis. Unemployment is still high – 12.1 per cent – for the fifth consecutive month, but has stopped going up and may fall in view of growth figures coming in.

The debt burden – for so long a millstone around the neck – is under control at a level between 90 and 95 per cent of GDP for 2013 and 2014, depending on actual growth. No further upside in sight. Public deficit for the zone as a whole fell from 4.1 per cent in 2011 to 3.7 per cent in 2012 and is forecast to be around 2.7-2.8 per cent for 2013 and 2014.

Household debt as a share of GDP looks reassuringly good. With figures between 80 and 100 per cent for Britain and the United States, Germany is below 60 per cent, France below 50 per cent and Italy at about 45 per cent, leaving only Spain slightly above 80 per cent and thus vulnerable – but still below Britain and the US. The household debt level is decisive for a recovery. Low debt ratio removes the incentive or even necessity for households to channel rising income into balance-sheet recovery (deleveraging). The hike in incomes following from the recovery will lead to higher consumption, consolidating the recovery.

The high US debt ratio for households may lead to deleveraging of debt, preventing rising incomes from stimulating consumption and thus hold growth down. If higher consumption does occur – the current-account deficit would go up, augmenting the already high need for US borrowing on global capital markets. The eurozone is not caught in a similar trap.

Eurozone austerity has worked. In a number of "weak" eurozone countries – Greece, Italy, Spain and Portugal – unit labour costs have fallen, improving competitiveness. They are all now in balance for the current account or even in surplus.

Better times ahead? *An anti-eviction activist blocking a window of a house in Madrid to prevent its jobless occupant's eviction due non-payment of rent. Unemployment in the eurozone is still high, but has stopped rising and may fall in view of growth figures coming in.* PHOTO: REUTERS

Structural reforms have been undertaken, forcing a more flexible economic economy allowing adjustment to take place, instead of the old model built on privileges and restrictions that clearly did not work but was kept alive by depreciations, and after the single currency, by reckless borrowing.

Just one or two years ago, many observers expressed the opinion that the banking sector in one or several of these countries (Spain most frequently mentioned) would implode. Not any more. On the contrary. The leading Spanish banks trade on the stock market about 1/3 above the price a little more than one year ago. The figures for Italy may be slightly lower, but are still good. France, often mentioned as the next domino to fall, has stock-market prices for banks displaying even higher profits.

Compared to third quarter 2011, Italian and Spanish 10-year Treasury bonds have risen, for Italy slightly above 20 per cent, for Spain slightly below 20 per cent, bringing the yield down to 4.4 per cent. The equivalent US rate is 2.84 per cent.

Confidence is growing. The *Financial Times* reported some weeks ago that pension funds and other big US groups invested US$65 billion in European stocks in the first six months of 2013, the highest in 36 years.

The longer-term plans to put things right after the hard-earned lessons during the financial crisis are maturing. First of all, a banking union addressing most, if not all, of the shortcomings is well underway, although some issues still remain to be settled. The eurozone does not work like a camera's shutter – click and the business is done. It takes time and the political process is cumbersome and laborious; seen from the outside unnecessarily so.

It moves towards the targets incorporating compromises to bring everybody on board. A stricter regime covering fiscal deficits and borrowing – some kind of fiscal union – also seems to be on its way. These new elements are not perfect – but how many political milestones can safely be said to fall in this enviable but almost unattainable category?

Now we come to the best part of the story; for the eurozone at least. Irrespective of all the commotion surrounding the nomination of a new chairman for the US Federal Reserve, the world is going to see tapering of quantitative easing. It is only a question of when and how much; in fact, it has already started.

Only people living in a quixotic world or closing their eyes can eschew the conclusion that this will lead to higher global interest rates. Again, it is already here. On June 1, 2012, the 10-Treasury note yield hit the lowest level for 200 years with 1.442 per cent. Now it is at 2.84 per cent approaching 3 per cent and expected to go above 3 per cent before the end of the year. After that still higher.

For the US, the omens are disturbing without any mitigating elements. Just do the maths. It takes approximately 64 months to renew the outstanding mass of US Treasury bonds. About five years from now the net interest burden for US government will have more than doubled, maybe even tripled, with an interest rate exploding upwards towards 3.5 per cent, possibly higher.

A number of other countries around the world with current-account deficits are in for a similar agonising awakening. The global capital markets may still be able and may be willing to step in and finance these deficit countries, in particular the US, but not indefinitely and not without a hike in price of servicing the existing high US public debt. Prognoses show that from 2013 to 2016 the federal deficit will be manageable – about 4 per cent of GDP – whereafter it will rise again. This will not escape the attention of those having the funds to finance the US, especially as the prognoses are built on rather optimistic assumptions of economic growth.

Look, an earthquake has taken place in the global capital market over the previous five years. Before the financial crisis, the world's savings was supplied by China, Japan and the Middle East but it was not invested by them. Instead, it was shuffled around by financial institutions under American and British management. Neither of these two circumstances prevails any more.

The world's savings in 2014 and the years after that will take place in China, the eurozone and parts of the Middle East, barring catastrophic political developments. Japan's surplus on the current account is shrinking fast as it moves towards deficit somewhere around 2016-2017. After the outbreak of the financial crisis in 2007-2008, a number of sovereign wealth funds and other players in Asia bought partnership in Western financial institutions.

The consequence is obvious. Placement of the world's savings will increasingly be done with an eye to their interests, not America's. Both elements augur a much less benign global capital market than the US has grown used to.

When the world sails into this vortex, and it will in the course of 2014, the eurozone will be among the creditors; not the debtors. What a difference a couple of years can make.

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