Opinion **Markets Insight**

Euro-phoria requires reforms that strengthen the eurozone

Changes would bolster investor optimism and boost the euro and European equities

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The current plan by European Commission president Jean-Claude Juncker remains one of rhetoric backed by little capital © AFP

Alberto Gallo JANUARY 24 2018

The European crisis is over. Five long years after the 2011 double-dip recession and Mario Draghi's "whatever it takes" pledge, the Eurozone recovery is finally real.

The euro area will grow at nearly 2 per cent in 2018, according to IMF forecasts — and this time the periphery is joining the expansion.

More surprising than macroeconomic data has been the change in investor sentiment.

Just a year ago, euro sceptics were discussing how, not if, the Eurozone would break up. Today, investors are piling into Spanish, Portuguese, Italian and Greek debt. Rating agencies are distributing upgrades. Greek government bond yields have fallen from over 10 per cent in 2016, the same as Ecuador and Ghana at the time, to less than 4 per cent today.

Is this euro-phoria justified?

Negotiations in Germany could soon deliver a grand coalition, with the SPD opposition finally opening up the government to more fiscal stimulus and co-operation.

Unlike in the UK and the US, where inequality fuelled protest votes, populists lost in France, Spain, the Netherlands and Germany.

Chances for the anti-euro Five Star Movement to form a government following Italy's March elections are below 5 per cent, according to our estimates. With stable politics and improving economics, the bulls say, the stars appear aligned for a stronger European Union.

Beyond the optimism, however, lies a crucial crossroads for Europe. Its leaders have a short window of time to reform and strengthen the Union. They must not waste it.

Like every year, policymakers are meeting in Davos to discuss themes ranging from sustainable capitalism, and inequality to how to predict the next financial crisis. This time around, however, there are at least three reasons why the agenda should carry a much higher sense of urgency.

First, the global recovery is nearly ten years long. While Europe is trailing, the cylinders of growth may start over-heating in the US and other major economies, bringing in monetary tightening.

Second, the ECB will probably start removing accommodation towards the end of the year as its president and key members of its governing council approach the end of their mandates.

Third, absent any rebalancing, growing divides between rich and the poor mean that the anti-euro vote may win at the next electoral cycle.

Like a football team trying to defend a fragile one-nil first-half lead, Europe needs concrete solutions to maintain low tail risk and sustain growth momentum. The most urgent task is to strengthen its umbrella institutions before the next storm.

Turning the European Stability Mechanism into a monetary fund able to act independently in an emergency would be a first step to reduce tail risk. A common deposit guarantee fund is also necessary as a firewall to cement the banking union.

After that, Europe needs to play offence. Absent population growth and with high costs to absorb immigration, improving productivity and social mobility are the only ways to make debt sustainable, in the currency union.

For too long, prolonged monetary easing by the ECB has been a substitute for investment in education, infrastructure and defence.

The current plan by European Commission president, Jean-Claude Juncker remains one of rhetoric backed by little capital: €20bn, or 0.18 per cent of Eurozone GDP. To move the needle of growth, one would have put on the table at least three times the money.

Finally, after a decade of crisis which left one in two young citizens without a job, Greece needs a break from the creditors' straitjacket with a debt restructuring and an investment programme to kick-start growth.

Italy, which holds elections on March 4, requires deeper reforms. The most important are unclogging the justice system, among the slowest in Europe, consolidating mid-tier banks, still unprofitable and unable to sell non-performing assets, and reducing oversized entitlements in the public pension system.

With a clear reform road map, Europe's policymakers would live up to investor optimism and even bring further upside to the euro and European equities. These remain about 3-5 per cent undervalued against fundamentals, according to our models.

In the Odyssey, Ulysses ties himself to the mast of his ship and orders his sailors to put wax in their ears to keep his ship on course and hear the sirens' songs, without falling into temptation.

Unlike Ulysses, European policymakers have enjoyed the ECB QE music over the past few years, but deviated from the reform course to focus on their respective electoral cycles. It is now for them to steer the ship more towards Europe, or crash into the rocks at the next storm.

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