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The Lights and Shadows of European Dichotomies

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Occasionally, the EU calendar happens to throw up a neat synopsis of the complexity of the euro crisis, revealing both its flashes of light and its enduring shadows. The beginning of the upcoming week is emblematic in this respect. Tomorrow, Monday, March 9, the ECB will begin security purchases under its quantitative easing (QE) program, an event already greeted with unbridled market enthusiasm. At the same time the Eurogroup will meet, once again, to discuss Greece, in the midst of mutual distrust and prevalent pessimism, with the non-trivial possibility of eventual Grexit looming in the background.
This basic dichotomy is accompanied by other tensions. For government bonds, the markets' euphoria is counterbalanced by the fear (increasingly expressed by analysts) that recent developments reflect an utterly irrational exuberance, set to be pricked – one does not know when, but possibly quite abruptly. For its part, the rise in equity markets seems largely disconnected from developments in the real economy, again setting the stage for a possible correction.

What indications are we to draw from such mixed signals? It is of course fairly common that the variety of signals coming from the economy and the markets fail to provide a clear-cut picture. It is in fact quite rare that they point to a single, unequivocal path. What is important in the midst of such woods is that there be a discernible way out, reliable enough to inspire confidence in those who invest and consume. Positive market trends are of little use if they do not affect impact businesses and households directly, providing funding in support of their ability to invest and consume.

There are however still too many shadows on this virtuous path for businesses and households. Let us consider two of these, both valid for the euro area as a whole, though to varying degrees: the state of the banking system and the uncertainty emanating from the situation in Greece.

Though much has undoubtedly been done, Europe's banking system continues to be fragile, and most banks are still unable – or at least diffident – to provide financing to the economy. To the point that the fact that bank lending to the private sector, while still contracting, did so at a lesser negative rate in January, was hailed as a possible “turning point." No doubt, quantitative easing aims to alter this reality. The immediate effect of QE on bank portfolios, still gorged (especially in Italy) with government bonds, is clearly positive, but an awareness that it's simply "too good to be true," and the associated fear of a correction, induces continued prudence. Indeed, there is no way out: until bank balance sheets are truly cleansed, the ballast of a shaky banking system will continue to weigh on any recovery. In this setting, the various transmission channels, interestingly introduced by the ECB in its updated forecasting models, risk remaining clogged.

Then there is Greece. The upcoming meeting of the Eurogroup does not appear promising: the list of reforms presented by Athens was received coolly, if not with scorn. Mutual distrust seems to be on the rise rather than waning, and possible solutions are far from clear. Markets seem to have made peace with this, but there is a concrete risk that they are overestimating the effectiveness of firewalls against euro area contagion. One can only hope that they will not be put to the test by an eventual Grexit.

Under the shadow of these clouds, the latest ECB forecasts shed a glimmer of light, in the possible awareness of the important role of positive expectations. But the optimism is only relative. Even if one believes the growth forecasts for 2015-16 (1.5% and 1.9%), the euro zone would continue to lose ground versus the US and, a fortiori, the rest of the world. In this setting, there is in particular even less to cheer for Italy, set once again to bring up the rear within an area itself in relative decline. Italy's expected return to growth is certainly welcome, and merit should be given where it is due. But the decades-long growth gap vis-à-vis the rest of Europe is set to persist, furthering Italy's comparative impoverishment. This is Italy's real drama, dictating an unabated reform effort. An effort that needs to cover all fronts, but with a full-scale cleansing of the banking system in the lead – on this, we are already sorely late.

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