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'GREXIT' FEARS ARE GIVING WAY TO 'CREXIT' OPTIMISM

by Michael Heise

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For many, 2012 will be remembered for just three words: "whatever it takes". The marked rebound on European financial markets, triggered by Mario Draghi's famous statement at the end of July, has been impressive.

Back in the early summer, prior to the European Central Bank president's tour de force, gloom lay over Europe as progress towards resolution of the debt crisis remained elusive and the fragmentation of the eurozone seemed a distinct possibility.

Since then, yields on peripheral government bonds have narrowed sharply (Italian 10-year bonds down from 6.4 per cent to 4.2 per cent, Spanish from 7.4 per cent to 4.9 per cent) and stock markets have bounced back strongly. The Euro-Stoxx 50 is 25 per cent above its "pre-speech level" and the Frankfurt DAX enjoyed its best year since 2003. This was despite a persistent drip of weak economic indicators, with the euro-bloc slipping back into technical recession in the third quarter and unemployment rising further.

Is this optimism warranted or are the markets overdoing it? Are they simply shrugging off weak economic activity and slow-motion political progress in Europe, and focusing on the signs of re-invigorated growth in the US and China? Are markets just fatigued by the seemingly endless debt crisis and now underestimating the probability of renewed euro turmoil? Although euro break-up scenarios are less likely than a few months ago, they are still not unthinkable and their shock waves for the global economy would dwarf those following the Lehman collapse.

So what could justify some optimism that Europe, if not yet fully out of the woods, has at least left the worst behind it? Mr Draghi's commitment to the irreversibility of the euro was certainly a key factor in shoring up confidence, but it was also supported by tangible progress in the political sphere.

Since the summer policymakers have demonstrated a greater sense of purpose in getting to grips with the crisis. Proposals on a single European banking supervisor were fleshed out further at the December gathering of EU leaders. On top of this, the de-risking and de-leveraging of bank balance sheets has progressed, so that systemic banking risks have clearly diminished. Correspondingly, the decline of cross-border bank claims (which amounts to around €750bn since the third quarter of 2009) has stopped and the deposit base of peripheral banks has stabilised. On fiscal issues, the new, more rigorous fiscal compact came into force at the beginning of the year and work on a time-bound roadmap towards enhanced integration is high on the agenda in the first half of this year.

Markets will also be taking heart from growing evidence that the reform drives in the distressed economies are starting to bear fruit. Although much of the progress is currently masked by the scars of recession, the data provides evidence that key macroeconomic indicators are now moving in the right direction. Recent reports have confirmed that the adjustment of imbalances in the problem countries is well underway. Competitiveness is on the rise, external imbalances are shrinking, and fiscal rectitude is returning. Of course, further action needs to be taken to improve medium-term growth potential in the economies. But the scale of some of the reforms already launched is often underestimated.

In Spain and Portugal the process began two years ago, in Italy around one year ago. Besides pension and welfare reforms, the focus has been on improving the functioning of labour markets through various measures like changes in layoff regulations, more decentralisation of wage bargaining to protect jobs, less indexation and a reduction of unemployment allowances. While direct comparisons are difficult, many measures within these specific national reform drives resemble steps taken in the Agenda 2010 in Germany. Here, they quite rapidly and substantially improved the job situation. In an overall assessment, it is therefore not implausible to expect positive effects on GDP and the labour market to become visible in the periphery in the course of this year or next.

In summary, there is good cause to think that current market optimism is not merely a shaky festive season rally and the light at the end of the tunnel will not turn out to be the proverbial oncoming train. Although the road ahead is still long and arduous in the euro periphery, quite some distance towards a brighter future has already been travelled. Given signs for a global recovery, the year 2013 should provide further encouraging indications, both economic and political. It may well not be a “Grexit” for Greece but indeed a “Crexit” – an exit from the crisis – that will come into sight. Financial markets are not just complacent, they are running ahead of a turn for the better, after years of gruelling financial turmoil.

Michael Heise is chief economist and head of corporate development at Allianz SE