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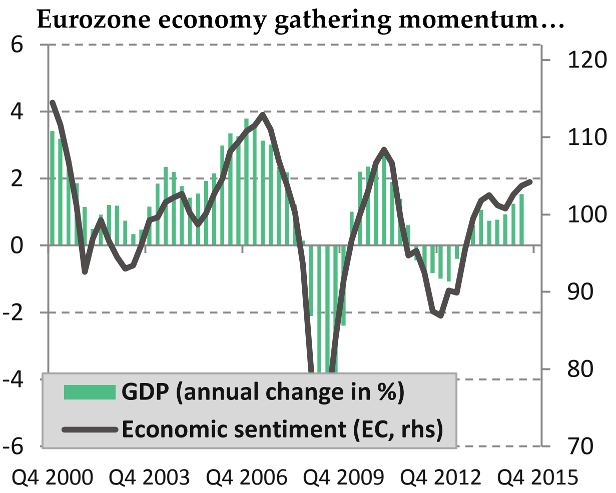
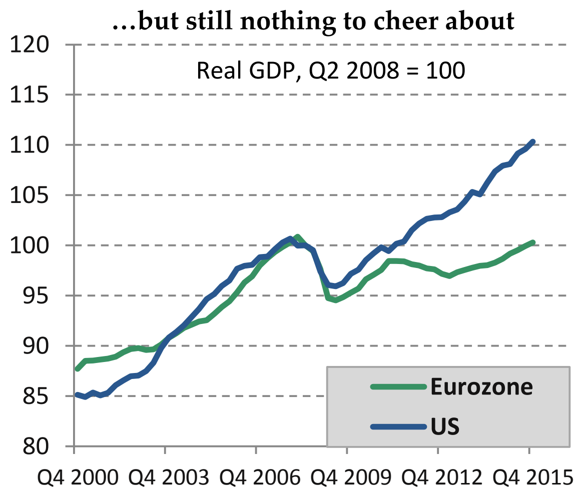
Eurozone economy gathering momentum but currency union still facing big challenges

Supported by a weaker exchange rate, sustained monetary stimulus, lower oil prices and less fiscal tightening, economic activity in the Eurozone has regained momentum. Leading indicators suggest economic growth is now hovering around 2% against the back of a gradual recovery in the labour market. This is encouraging after years of stagnation. That said, given the presence of the strong tailwind noted earlier, the recovery is still nothing to cheer about. This is illustrated by the fact that the region's GDP level is now only slightly above its early 2008 level. Measured in GDP per capita terms, living standards are still around 2.5% lower compared to the pre-crisis level. Referring to this economic situation as a lost decade, from this perspective, is clearly no exaggeration. Moreover, as noted by ECB President Draghi in a speech for the European parliament this week, clear downside risks remain in place.

Certainly, reforms have been implemented in recent years. First, Southern European countries have made considerable progress in making their labour markets more flexible. Second, the first steps towards a full banking union are also encouraging in order to increase the resilience of the financial sector and to reduce so-called doom-loop between sovereigns and banks. It's also worth mentioning that the fiscal and macroeconomic surveillance has been strengthened. Finally, the setup of the European Stability Mechanism, despite its relatively small size, can potentially act as an emergency backstop instrument. That said, more progress is necessary and none of these reforms can be described as game changers. Arguably, the only game changer so far has been Draghi's "whatever it takes speech" in the summer of 2012 after which financial markets calmed down and interest rate spreads on peripheral bonds decreased significantly.





Critically, much more effort is needed when it comes to the creation of a political and fiscal union. Despite fairly broad consensus among economists that this is absolutely crucial to keep the monetary union alive in the long run, it would probably also be naïve to expect much progress in this respect anytime soon. The rise of populistic parties is worrying and the budgetary issues linked to population ageing will only bring about more difficult fiscal choices in the future, at times when public debt levels in many countries are already (unsustainably) high. The role of the ECB, therefore, remains of the utmost importance. But however

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important its role is in terms of limiting interest rate spreads between countries and trying to create a significant dose of inflation that helps to free up budgetary room for manoeuvre, this may still not be enough to secure the Eurozone's future. Political will is what matters here. The latter will ultimately be determined by the presence or lack of sustainable economic conditions. Although it seems to have disappeared from the headlines, the case of Greece is still worrying in this respect.

That same political will, however, could also help to improve economic activity so that a virtuous cycle emerges. In the current extremely low interest rate environment, large scale pan-European investment projects could make a real contribution. However, not all policymakers seem convinced that this extensive form of collaboration is a good idea. The Juncker plan looks like a first good step but its characteristics make a beneficial outcome far from assured. The present lack of ambition is revealing and worrying at the same time. That is why in a longer term perspective, despite encouraging signs of improvement seen more recently, the Eurozone still faces existential challenges.

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