

AN ANALYSIS OF THE RECENT EUROZONE RECOVERY: IS IT SUSTAINABLE?

Ivo Pezzuto *

* International School of Management (ISM), Paris, France; ISTUD Business School, Milan; Catholic University of Milan, Italy



Abstract

How to cite this paper: Pezzuto, I. (2017). An Analysis of the Recent Eurozone Recovery: is It Sustainable? *Journal of Governance & Regulation*, 6(3), 29-36. doi: 10.22495/jgr_v6_i3_p3

How to access this paper online:
http://dx.doi.org/10.22495/jgr_v6_i3_p3

Copyright © 2017 The Author

This work is licensed under the Creative Commons Attribution-NonCommercial 4.0 International License (CC BY-NC 4.0) <http://creativecommons.org/licenses/by-nc/4.0/>

ISSN Online: 2220-9352
ISSN Print: 2306-6784

Received: 08.08.2017
Accepted: 25.09.2017

JEL Classification: O52, H12, O1, E00
DOI: 10.22495/jgr_v6_i3_p3

This article addresses the topic of the surprise European Economy recovery in 2017 and its possible implications. The article aims to provide a broad and comprehensive understanding of the triggering factors that have contributed to this unexpected economic revival and to the slow and uneven economic recovery in Europe after the Global Financial Crisis of 2008 and the Great Recession. The article also aims to highlight the potential downside risks related to the still unsolved structural issues that caused the debt overhang and macroeconomic imbalances in Europe in the past decade. Thus, the European Union and the Eurozone seem to be on course for a potential brighter future in the years to come but internal and external risks might still undermine the path to sustained growth, full economic recovery, and stronger integration in the region unless proper political, economic, fiscal, and monetary governance and policies are assured to make the euro area more resilient to future systemic shocks.

Keywords: Eurozone, European Union, Economy Recovery, Financial Crisis, Great Recession, Monetary Governance

1. INTRODUCTION

Against all odds, and contrarily to a generalized gloomy scenario of the past years about the destiny of the European Union, the Euro area has surprisingly recorded a stronger than expected economic growth in the first semester of 2017 and a rather optimistic and reinvigorated political turnaround in favour of the EU.

During this crucial year for political elections in Europe (2017), a combination of key economic and geopolitical events (game changers) seem to have suddenly shifted voters' preferences towards more reassuring and realistic political options (i.e. pro-EU sentiment), in spite of new record levels reached by abstention in some important political elections and the rise of some radical parties.

Thus, apparently, a new political and economic mood is spreading across Europe re-energizing a strong interest in the integration process of the Euro area and strengthening the Union among the 27 member states. This sentiment of hope for the future of the EU seems to reflect a strong desire of many voters to pursue a more balanced and sustainable economic and social growth model in the region. A model that represents a better and more effective compromise among multiple goals, ideologies, interests, and visions such as, innovation-led growth; enhanced competitiveness; market liberalizations balanced with some protectionist measures for strategic industries; labour market

reforms to reduce high levels of unemployment and increase productivity, but also programs for social inclusion and the reduction of inequality and poverty. Furthermore, it also includes a EU defense spending program; an integrated common fight against terrorism, a strengthened cooperation on climate change and immigration; and a stronger long-term commitment in favour of free trade and sustainable globalization.

Thus, in spite of the gloomy outlook about the Euro zone and its possible break up scenario of the past years, which might have discouraged a large number of UK voters at the "Brexit" Referendum of 2016 to remain in what they perceived to be a "Dysfunctional Union" led by Eurocrats, it seems that the threat of a potential dissolution of the region has actually inspired (at least for the moment) a renewed passion for the Union, its identity, and shared values, and has led to the stunning victory of pro-EU leaders at the recent political elections of 2017.

Among some of the key economic, social, and geopolitical factors that have rapidly shifted the political preferences of many voters towards less extremist and Eurosceptic leaders and parties, noticeable ones are the following:

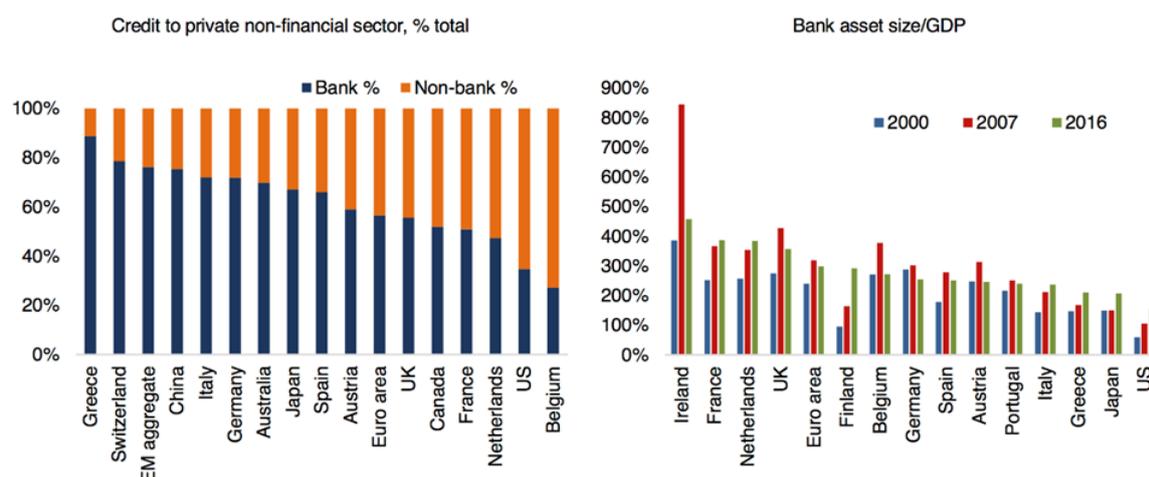
The sweeping victory of the reform-minded centrist candidate, Emmanuel Macron, at the French presidency election and the amazing success of his new party, La République en Marche; the British Prime Minister Theresa May's inability to win the

party's parliamentary majority at the snap election in June 2017, which seems to have weakened her negotiating power in the Brexit negotiations with the EU, despite the support of the Northern Irish DUP, which might probably lead to a softer "Brexit" (a 'soft' withdrawal from the European Union). However, right now it is difficult to predict whether there will be a 'soft' Brexit deal or 'No Brexit' deal at all, since the UK Government may not get a great bargain from the negotiation with the EU, at least in the short-term. In the long-run a compromise is more likely. Other key economic, social, and geopolitical factors that have rapidly shifted the political preferences of many voters at the recent European elections include: the demise of a number of populist and Eurosceptic parties at the 2017 political elections in Europe (i.e. Austria, France, and Netherlands); the perceived increasing economic and political uncertainties about the future trade agreements and economic prospects of the UK and the U.S.A.; a great uncertainty surrounding Donald Trump's ability to timely and successfully deliver on all his "Trumponomics" policies and promises to the voters (i.e. 3% - 4% GDP growth); the sudden and

unexpected economic recovery of the euro area; and also the peculiar features of the European States' electoral systems which, somehow, do not favour the rise and victory of another Donald Trump case in Europe.

After all, many of the so-called populist and anti-establishment voters in Europe seem to be driven in their political preferences more by a spirit of protest and frustration with the current status quo and by the lack of satisfactory job/career opportunities than by real ideological convictions. Thus, as soon as they have realized, prior to the elections, that the promises of easy and quick fix, and painless solutions to long-lasting problems of their countries' economies were just pure illusions and unrealistic projects, they have immediately changed their political orientations towards "safer havens". Young European voters, in particular, are very eager for change and a real turnaround. They seem to have voted for a brighter future for themselves in their countries and in the European Union after a number of years of painful uncertainties (the lost decade).

Figure 1. Europe relies on banks for credit, and banks are recovering



Source: Algebris (UK) Limited, ECB, FRED, BoE, BoJ, BIS

2. EMBRACING CHANGE

Like Millennials living in other parts of the world, European Millennials appreciate change, are always connected, well informed, and digitally savvy. They naturally embrace the vision and benefits of disruptive business models, ideas, and technological innovations such as, industry 4.0, Big Data and business analytics, deep learning, A.I., machine learning, cognitive computing systems, digital apps and real-time data, robotics and IOTs, fintech and blockchain trade finance platforms, and the great possibilities these exciting innovations may bring to economic development. They appreciate change and innovation, and often times, even disruptive innovative models, however, they do not seem to appreciate a leap into the unknown when it comes to their future (i.e. EU dissolution and Eurozone break up), especially after having lived for most of their life in the middle of the slow growth and gloomy atmosphere that followed the Global Financial Crisis

of 2008 and the Great Recession. Thus, many Europeans voted accordingly at the 2017 political elections. They have realized that an anti-EU vote and a vote that would signal their desire to exit from the Euro zone would be just too risky and a real leap into the unknown, after the surprising events of the Brexit vote and Trump's victory at the election in the U.S.A. (i.e. the unthinkable that becomes a reality).

Young Europeans, like most Europeans, by and large, have positive feelings about Europe, the EU, and the Euro zone, and they wish to see a stronger and more stabilized European Union to succeed. A EU that can offer them a better future. A European Union that remains a key and relevant player in the world economy; a leading innovation-led growth environment; a solid center of democratic values and lifestyles; a place of social justice; and a leading global benchmark for environmental and sustainability projects (green economy, renewable energy economy, circular economy, biotech sector and bioeconomy, green bonds investments).

The disaffection and growing distrust towards the European Union and its institutions of the past years, which were driven by the severe crisis, the Great recession, tough austerity measures, limited capital investments, high unemployment and underemployment conditions, and growing inequality, now seem to be heavily scaled down, or at least for a while. We hope that this reverse and positive sentiment will last for years and that the EU will succeed in its long-term mission and vision towards growth and prosperity.

In France, in particular, there has been a polarization of vote and a large abstentionism at the recent political elections, reflecting a growing distrust for the mainstream candidates of traditional parties, due to unsolved issues concerning the stagnant economic growth of the past years, but also fears about terrorism; growing inequality; the aftermath of global financial crisis and the Great Recession; the impact on the labour market of globalization and manufacturing off-shoring and global value chains; disruptive technological changes and new business models ("Gig" economy, online shops, and online business models); austerity, and concerns about the potential loss of a good-quality and "generous" social welfare system and the highly cherished entitlements. Many young voters, in particular, have expressed their discontent for the inability of the traditional political parties to provide effective solutions to the social and economic divide, and fragmentation between overprotected and less protected and marginalized social groups and generations. Young people do not want to be marginalized in the job market, thus they have voted for a political change that might grant them in the future more opportunities in a more flexible, dynamic, and efficient labour market, which might better combine openness and protectiveness, pro-business reforms, and higher levels of competitiveness (i.e. removal of rigidities imposed on decisions about hiring and firing for permanent employment relationships, flexibility into new job contracts, cuts of unproductive public spending, and mostly, cuts on total tax on labour income - social charges, as well as, income taxes). These changes might probably improve the country's competitiveness and might help reduce inequality in the future, and prevent the resurgence of anti-establishment, populist and anti-EU nationalist movements.

However, the risk of a breakup in the EU has not completely disappeared. Downside risk due to political uncertainty will remain until unsolved structural problems, the incomplete framework of the eurozone governance and regulation, high unemployment, and the lack of adequate tools to fend off systemic risks, shocks, and economic imbalances in the Eurozone will continue to threaten the Euro zone stability in the future, despite the temporary truce in the region triggered by the victory of the pro-EU leaders at the 2017 political elections.

3. IS THE WORST OVER?

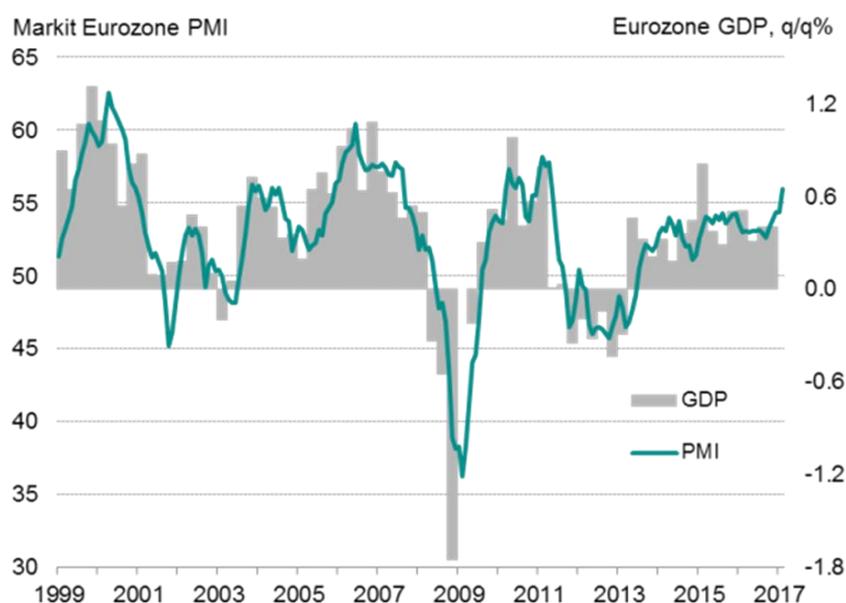
The latest economic data of the Euro area and its unexpected and robust uplift trajectory seems to suggest that probably the worst could be over now for Europe, and that a new positive trend will help spark optimism among investors, policy makers, and citizens, thus contributing to attract more investments and ensuring more trust in the EU and Eurozone and in the political stability of its members states. Such conditions are indeed critical to complete the necessary structural reforms; implement innovation-led growth plans; attract more foreign investments; and reassure global investors on the sustainability of the high public debts of its member states, and on the financial stability of its banking systems. Yet, Euro zone member states need to be fully aware of the fact that the more they head towards the direction of a more integrated and interdependent Union and Euro zone, the more they will be forced to play the game by the rules (European rules), with fewer exceptions. This might be a great opportunity to harmonize rules and disciplines in the Union and to strengthen solidarity and cooperation mechanisms but it might also turn out to be a tighter golden cage for those governments that aim to exercise a wide-ranging discretionary decision-making power (i.e. on bank crisis resolutions or on a leeway on budget deficits).

In order to strengthen the Euro zone's stability and sustainability and avoid future systemic risks, financial shocks, or severe economic imbalances, the European single-currency project should evolve towards a stronger fiscal union, banking union, and capital markets union; should consider the introduction of Eurobonds, eurozone budget, and a European unemployment insurance scheme. The region should also introduce harmonization of corporate tax bases; increase common resources for growth and capital investments in the region; and it should consider the creation of a European Monetary Fund (EMF), perhaps turning the ESM into the EMF. At least, the Euro zone should create a properly-sized cyclical shock absorber mechanism that should be immediately triggered in case of a sudden cyclical downturn in the region, and that it would not lead to permanent fiscal transfers or debt monetisation among countries (Pezzuto 2010; 2012; 2013; 2014)

4. NEW SAFE ASSETS

The Euro area and EU should not lose the opportunity to reform their missions and institutions now that there is a growing optimism and a renewed sense of pride in the euro area project and identity. The completion of the banking union, with a common deposit insurance scheme (EDIS), and the creation of a common backstop for future crisis resolutions are certainly critical components of a new architecture and governance of the region. Even the creation of new safe assets for European banks (i.e. sovereign-bond-backed securities such as "ESBies") (Brunnermeier et al., 2011; 2016a; 2016b) are important tools to help break the vicious circle between bank failures and sovereign risk (State insolvency).

Figure 2. Markit Eurozone PMI and GDP



Source: HIS Markit, Eurostat.

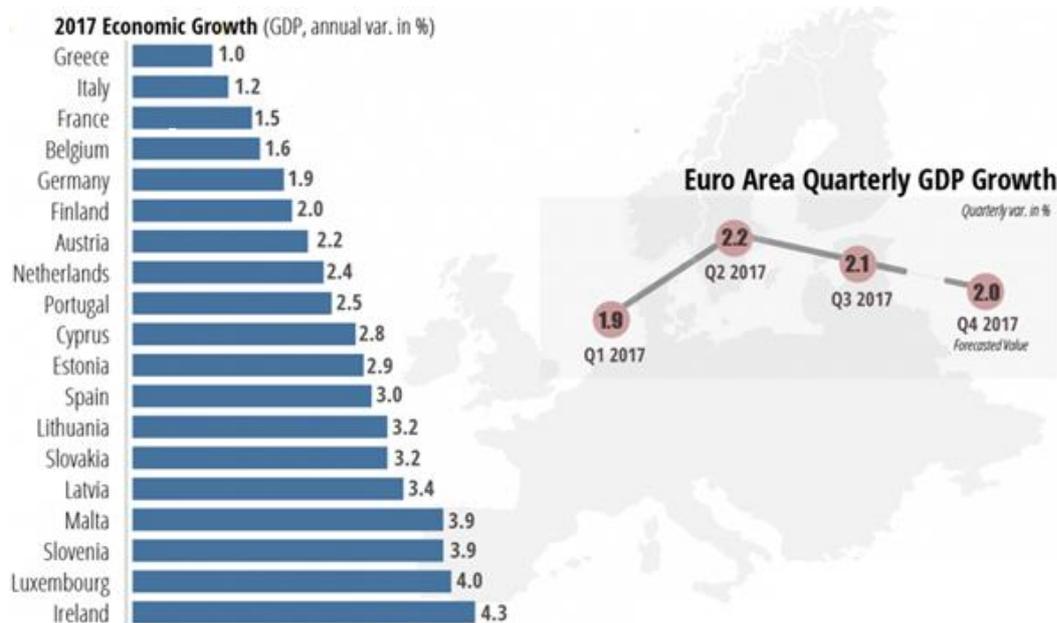
The use of the “ESBies” (European Safe Bonds), without joint liability (no risk mutualisation among Euro zone countries), could make Europe’s financial system safer in case of potential default of one of the member states or in case of a “haircut” on sovereign debt. As sovereign bonds tend to be always more concentrated in the portfolios of domestic investors and banks, the recourse to well-diversified European Safe Bonds in banks’ portfolios might reduce in the future concentration risks for banks investing in sovereign bonds. In other words, if one country defaults on its sovereign debt or it is forced to restructure its debt, the financial system will remain solvent. When Basel IV regulation will be introduced, it will probably impose a risk weight higher than zero (Rwa) on sovereign bonds held in banks’ portfolios (i.e. no longer a risk-free asset). Thus, at that point probably banks will have no choice but either to significantly increase their capital to comply with the minimum capital requirements or to substitute the domestic (national) sovereign bonds in their portfolios with other safer bonds (i.e. “ESBies”), if they do not want to penalize their profitability and dividend pay outs. Banks are also required to comply with Bank Recovery and Resolution Directive (BRRD), MREL, and TLAC requirements, and the new accounting and investment regulations (IFRS 9 and MiFID II), thus they have to plan in advance the compliance to the new rules. Even the retroactive enforcement of the “Burden-sharing” and “Bail-in” rules (BRRD) in Europe have added more complexity to the bank crisis resolution events. It seems that each country has been handling this challenge (BRRD regulation) in different ways, and with different timely solutions, either with stronger protections of senior bonds, or through the introduction of CoCo bonds (i.e. contingent convertible bonds) and Bail-in-able bonds, or through other solutions to protect investors, while most of the burden of bank failures generally remained on the holders of subordinated debentures and other stakeholders.

The Eurogroup and the European Commission have recently suggested national bank insolvency regimes to be harmonised in the region and a strengthening of the supervisory activity; the restructuring and modernization of the banking sector; their preference for a national solution to the long-lasting NPLs’ problems of banks in Europe; a state-backed asset protection scheme for risk-sharing and to limit further losses; the use of securitizations and synthetic securitizations for the transfer of NPL portfolios; the creation of national bad banks (i.e. Asset Management Companies - AMCs) with the ability to buy NPLs from banks at “economic value” rather than at “market value” in order to favour the repricing of the distressed assets (reducing the pricing gap between NPLs’ economic value and market value); the development of a secondary market of distressed debt (i.e. nonperforming loans); and the promotion of faster judicial and non-judicial debt recovery, collateral enforcement, insolvency procedures, out-of-court turnarounds, and restructurings’ solutions to help facilitating the repricing of the distressed debt.

5. TOWARDS MORE STABILIZED UNION

This seems to be a turning point for Europe, thanks to the recent results of the political elections. A unique opportunity to be brave and to make those additional and critical reforms to the EU framework and Eurozone institutions and rules that might assure a more stabilized Union in the years to come. The new Merkel-Macron axis might be just the missing piece of the puzzle to allow the successful completion of the necessary reforms to relaunch Europe and its stronger integration and Union. Chancellor Angela Merkel seems to be open to discuss some of the proposals of President Macron to relaunch Europe such as, the creation of a eurozone budget; investing in the European defense industry; facilitating a greater regulatory standardisation across many fragmented markets; and perhaps even introducing the Eurobonds.

Figure 3. Top performers among Euro Area economies in 2017



Source: FocusEconomics

Currently, Germany is running an astonishing current account surplus of approximately 8.3% of the GDP, while some Eurozone countries are still experiencing Macroeconomic Imbalances. In particular, Target2 net balances (Trans-European Automated Real-time Gross Settlement Express Transfer System) reveal that imbalances are sharply widening again after the Euro zone debt crisis, or more precisely, the balance of payments crisis. However, now apparently it seems that the imbalances are linked to the implementation of the ECB Asset Purchase Program (APP) rather than to an indicator of financial fragmentation or financial stress in the markets, or in other words, to difficulties in the access to funding markets for peripheral countries' financial institutions or governments.

Despite its impressive, globally competitive, and strong economic and social model, Germany maintains its commitment on trade surpluses and balanced budgets; a more favourable real exchange rate versus other euro zone currencies (amplified by the effects of the QE); and the benefit of the "salary moderation" reforms, introduced in the Country soon after joining the euro (thus increasing productivity proportionally more than wage growth per employee). Furthermore, Germans traditionally spend less and save more than they produce, and more recently the Country has been accumulating a high savings rate, in particular in the corporate sector, in spite of the record-low interest rates available in the market for additional investments.

Since the post-crisis period, Germany has been advocating in favor of tough austerity measures for the other member states of the euro area. Consequently, low investments in capital-starved and debt-laden nations such as Italy, Greece, and Spain, in spite of some degree of flexibility on budget deficits in more recent times, have contributed to slow growth and a jobless recovery in the latter countries (but the late introduction of

labour reforms in a number of peripheral European economies did not help either).

The German view for reducing economic imbalances and achieving stabilization within the Eurozone in the past years, following the crisis, has been to progress with tough austerity and internal devaluations on prices and salaries, higher levels of primary surpluses, and other national adjustments, but this approach has also led to deflationary trends in some peripheral economies. Furthermore, national adjustments alone have proved not to be so effective so far in order to spur equally strong reflationary trends in all countries. Probably, some levels of fiscal transfers (temporary or permanent) in the Euro zone will be necessary in the long run in order to improve the adjustments, reduce imbalances, and achieve a better harmonization of the labour market regulation and corporate tax bases.

In the years after the global financial crisis, countries like the USA and UK have almost doubled their public debts as a percentage of the GDP in order to rescue their economies. In addition to the massive monetary stimuli from their central banks and the various runs of QE programs, these countries have also reached astonishing levels of budget deficits to revamp economic growth and to fight recession and deflationary pressures (USA reached budget deficit in excess of 12% in 2009 whereas the UK reached a budget deficit above 10% in the same year). The Eurozone rules impose a budget deficit limit at 3% of the GDP.

The prolonged European crisis of the past years and the "Great Recession" that followed were due to a number of structural weaknesses of the peripheral European economies and to the "vices" of a number of local governments (i.e. lack of structural reforms, lower productivity levels, limited and unproductive investments, lack of liberalizations, lack of true competition, high taxation, high tax evasion, bureaucracy, corruption) which increased the divergence among the economies. But the crisis was

also due to the devastating impact of the global financial crisis of 2008 and its aftermath such as: the sudden and disruptive freeze in the financial markets and liquidity markets; the sudden capital flight from the peripheral countries, when the crisis peaked; the severe and prolonged credit crunch that followed the financial crisis due also to undercapitalized banks, and a tougher prudential regulation. But most of all, it was due to the lack of an immediate access to a single European crisis resolution mechanism, a backstop fund that would have helped stabilize the weaker economies after the crisis. The ECB, somehow, has made possible the impossible, after the crisis with the Troika, playing the role of the central bank but also a "political" role, and providing conventional and non-conventional policies (i.e. LTROs, OMT - Outright Monetary Transactions) and support to states and banks (the only game in town!).

6. HISTORICAL BACKGROUND

When the peripheral European countries joined the euro in the late 1990s (the European Monetary Union), the interest rates they paid fell sharply as market participants judged that the value of investments in these countries would no longer be vulnerable to erosion through currency depreciation (competitive devaluations aimed at boosting exports). Thus, since the interest rates in the peripheral countries were still higher and more attractive than those of the core European countries, massive inflow of funds arrived in these countries from the core ones (Pezzuto, 2013; Higgins, Klitgaard, 2011).

Low real interest rates spurred heavy foreign borrowing by both the public and private sectors in the countries and triggered bubbles and severe imbalances/debt crises. The problem was that foreign capital was used to support domestic consumption or housing booms rather than productivity enhancing investments. Thus, these countries engaged in substantial foreign borrowing for a number of years (high public and/or private debt overhang). In other words, in spite of the fact that the economic fundamentals and business environment were not particularly brilliant (e.g. moderate GDP growth rates in some countries, or higher ones, but driven mainly by the housing and lending bubbles; high sovereign debts, and in some countries also high budget deficits; low productivity/higher unit labour costs in manufacturing, low investments in innovation, and decreasing competitiveness; current accounts imbalances and stronger exchange rates which eroded competitiveness; bureaucracy, red tape, and local elites defending their status quo), these Euro zone states had a wide availability of very cheap interest rates for long time, closer to the ones of the "core" Central and Northern European countries, since investors and financial markets had limited perception of a potential underlying higher sovereign risk (risk premium), which could be triggered by severe and prolonged financial and economic shocks (e.g. the global financial crisis), without a lender of last resort (ECB), or without a fiscal and banking union, and solidarity mechanisms among member states. (Pezzuto, 2013; Higgins, Klitgaard, 2011)

This has led in a number of peripheral countries to the "Easy Credit" euphoria and to heavy borrowing engagements from foreign private investors, which have ultimately allowed domestic spending to outpace incomes. Then, as it is well known, there was the perceived debt crisis/imbalance (e.g. "Grexit") which reflected a loss of investor confidence in the sustainability of these countries' finances and caused a spike in domestic interest rates, and capital flight towards "safer havens" (i.e. AAA rated bonds - German Bunds/cheaper funding costs). (Pezzuto, 2013; Higgins, Klitgaard, 2011).

Furthermore, German daily newspaper, *Süddeutsche Zeitung*, recently reported that the German government has earned more than €1.3 billion from the hundreds of billions in aid given to Greece since the massive debt crisis emerged in 2009, which include loans and bonds purchased in support of Greece's bailouts and various financial support programs (i.e. Securities Market Program - SMP and loans by the development bank KfW, which is owned by the German government) in order to keep the economy afloat. (Brössler, 2017).

Nevertheless, however, the lower real interest rates available in the peripheral European countries, unwisely, have not been used by local governments to improve their countries' competitiveness; to increase productive investments, repay their huge public debts, or to encourage structural reforms. Joining the single currency (the euro), these countries have been forced to a stricter fiscal and monetary rectitude. They have lost the opportunity to use the exchange rate as a critical cushion against unexpected shocks or to benefit of temporary competitive devaluations of the currency in order to boost export and growth.

Yet, they have had the benefit of a much stronger currency (euro) to purchase commodities and energy products (oil) but also cheaper interest rates to increase capital investment and improve firms' profitability, or to reduce the high public debts. In many circumstances, however, these more favorable conditions were not used wisely to invest in innovative sectors but rather used to support domestic consumption or to invest in old economy activities (i.e. real estate), as it has happened in the U.S.A prior to the global financial crisis through the massive growth of the subprime mortgage segment and housing market.

7. THE ROLE OF EURO

The euro has not been the root cause of the demise of the weaker Euro zone countries, since a number of these economies were not growing significantly even prior to joining the euro and their level of productivity has actually decreased after joining the euro (i.e. unit labor cost increases).

The access to cheaper interest rates and the availability of abundant capital inflows from abroad has eventually led to real estate bubbles in some countries (Spain and Ireland); to an excess of unproductive public spending in others, and to "easy lending" (corporate and retail lending) in other countries, which eventually have contributed significantly to the massive NPL problems in the Euro zone. A number of countries who were no longer able to rely on their national fiscal and

monetary policies after joining the euro, due to limited space in their budget and to the change of ownership of the monetary policy mandate from the local central bank to the European Central Bank (ECB), began to “use” the cheap real interest rates and their political influence in the attempt to boost consumption and economic growth through the national banking system.

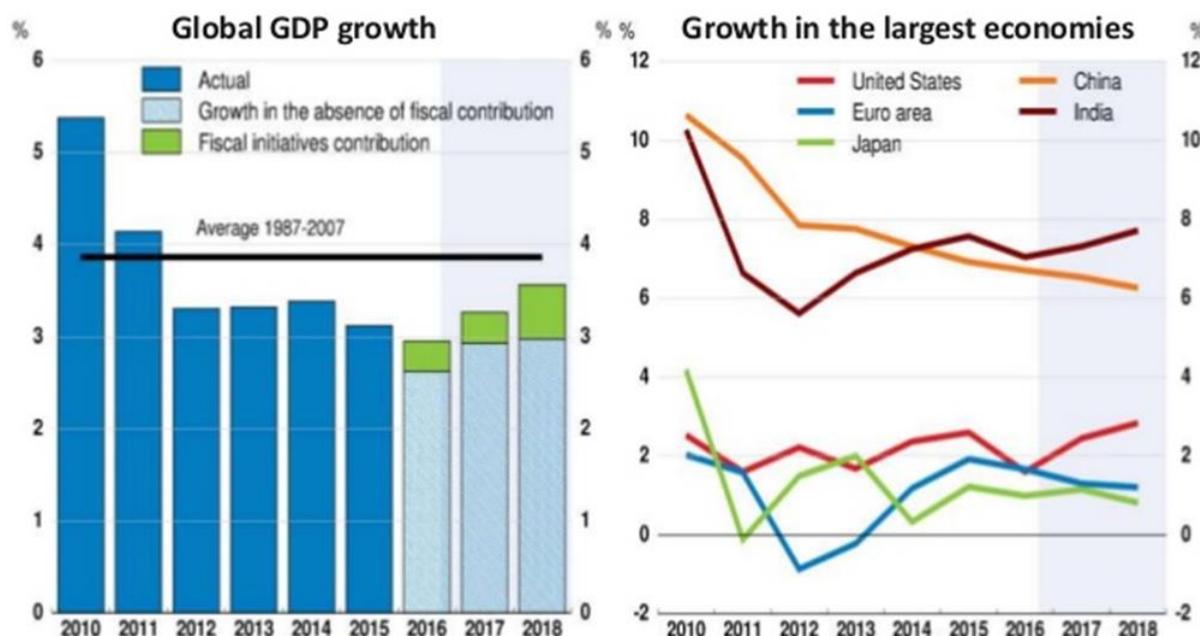
Then, the financial crisis of 2008 abruptly sparked a systemic risk in the markets and caused a sudden and severe collapse in the financial markets, the freeze of the liquidity markets, and a severe slump in the real economy, thus ultimately accelerating the busting of the asset bubbles in Europe, liquidity problems, credit crunch, and the fall in global demand and trade of products and services. This dramatic and systemic event was almost the missing piece necessary to complete the process of divergence and imbalances that started in the Euro zone when the weaker economies failed to take advantage of the stronger euro, cheaper interest rates and optimal market conditions to boost productivity enhancement policies in the early days of the euro and to close the gap with the more productive and competitive countries. The real missing piece that completed the crisis in Europe were the tough austerity measures, the dramatic fall in capital investments, and the persistent credit crunch which eventually contributed to drag the weaker economies into a prolonged recession. Only when the ECB began to provide massive cheap liquidity, when they have introduced the QE program, and when they have helped bail-out ailing banks with the Troika (i.e. Spain, Ireland), or have promised to protect countries from high spreads/high bond yields (speculation), and to avoid

a potential exit scenario from the euro area with the famous “Whatever it takes” statement - offering the Outright Monetary Transactions (“OMT”), or creating with the European institutions the European Stability Mechanism (ESM) and the Single Resolution Mechanism (SRM), then these weaker economies started to recover.

8. FORECASTS AND CONCLUDING REMARKS

The current scenario is much better. The economy is growing quite strongly in Europe, exports are increasing, and firms’ confidence levels are improving (PMI indicators). Yet analysts and investors should not forget that the ECB’s unconventional monetary policies and cheap interest rates will not last forever. Similarly, they should not forget that the massive liquidity offered by the ECB’s QE (sovereign and corporate bonds purchases) will not be available forever too. As it is today, the ECB’s nominal exchange rate has already risen to the highest level since December 2014, thus proving that the ECB’s QE effect on the exchange rate seems to be ending. In fact, currently, the faster recovery of the Euro zone economy, the uncertainty about Trump’s policies, and the Brexit deal are strengthening the euro versus the US dollar and other currencies. Yet, a faster than expected monetary policy normalization by the US Federal Reserve, with rising interest rates and the unwinding of its huge Balance Sheet, and the introduction of ambitious and unprecedented fiscal policies and deregulations in the US, might change the course of the US dollar trajectory versus other leading global currencies.

Figure 4. Global GDP growth and biggest economies



Note: Estimated fiscal initiatives contribution based on fiscal stimulus in China as the euro area for 2016-18 and in the United States for 2017-2018. Fiscal years starting in April for India.

Source: OECD March 2017 Interim Economic Outlook; OECD November 2016 Economic Outlook database; and OECD calculations.

Nevertheless, Europe seems to remain on solid path to stronger recovery. A number of favorable economic conditions of the current economic cycle such as, lower crude oil prices and energy prices; improving manufacturing activities, the perception of greater political stability in Europe; the forward guidance of the ECB; and a gradual stabilization of the banking system in the region (except, in case of Black Swans), are contributing to increase confidence in the EU and Eurozone governance and to attract more foreign investments and capitals. The financial crisis, the Great Recession, and the slow recovery have created a number of investment opportunities in Europe in specific sectors and countries due to a number of undervalued equities (alpha and beta opportunities). Thus, it looks like Europe is heading for a very exciting future scenario, unless trade wars, international geopolitical tensions, and unexpected internal and external shocks may undermine the current favorable political climate.

European countries with high public debt and moderate GDP growth have to progress in their structural reforms programs, innovation and modernization of their economies (labor market, PA sector, internal competition, welfare systems, retirement plan systems, digital transformation, and so on) and should increase their levels of productivity and competitiveness, while also progressively reducing public debt and maintaining higher level of investments on innovation, education, R&D, and infrastructures, thanks also to support of the EU investment plans.

Things now seem to be much better than before, and there are good reasons to cheer about the recent positive development in Europe, yet investors should remain aware of a number of potential externalities that might affect the economic region such as: Donald Trump's protectionist policies and potential tensions in the trade agreements, and the impact on the European economy of market deregulations and liberalizations in the U.S.; Other key relevant emerging factors to consider include: the "Brexit" and "Grexit" scenarios; asset bubbles (low interest rates for long, abundant liquidity, and credit-led growth); the sustainability of the welfare state and public pension systems in multiple countries; China's corporate debt and shadow banking; the rising debt and rising concerns about the bond market liquidity in the emerging markets; tensions in the Middle East (Saudi Arabia, Qatar, Syria, Iraq, Iran); the complex issue of North Korea; Venezuela, Brazil, terrorism, cyberattacks and bitcoin, and the potential 'taper tantrum' of central banks that might lead to dramatic sell-off in markets. Last but not least, also the risk of a potential correction in the US stock market. It is almost ten years since the US had a strong correction in the financial markets, and according to many analysts and commentators, many valuations in the market are already a bit stretched to say the least. Furthermore, the massive recourse to passive investment strategies and the heavy use of highly leveraged ETF's intraday trading activities are likely to amplify potential risk in case of a sell-off and strong correction. The inflation rate in the U.S. is still below target, the yield curve is flattening, and at the time of writing this article (early July 2017), the Federal Reserve seem to be fearlessly committed to progress with its policy normalization process and the unwinding of its huge balance sheet. Yet, one should also remember that probably by the beginning of next year the majority of its board members and the chairwoman of the Federal Reserve will probably retire or pursue a new career (Mauldin, 2017).

Well, to conclude this long article, there are many good reasons to be cheerful about the future of Europe and about the new political cohesion and economic integration in the region, but analysts and investors should also remain watchful about how the future scenarios will actually unfold since the reform process can be quite long and challenging (sustained growth and inflation are required over the years to reduce excessive public debt and to absorb imbalances) and, most of all, since meanwhile, a number of externalities in the global macro-environment and potential tensions among Euro zone states concerning fiscal policies, budget deficits, and public debt reduction, directly or indirectly, might somehow affect the inspiring vision and project that President Macron and Chancellor Merkel are bravely planning to undertake to "make the EU great again."

REFERENCES

1. Brössler, D. (2017). "Germany is Making Huge Profits with Greece" [Deutschland macht mit Hilfen für Griechenland Milliarden Gewinn], *Süddeutsche Zeitung*, Retrieved from <https://tinyurl.com/y8uztesw>
2. Brunnermeier, M, L Garicano, P Lane, M Pagano, R Reis, T Santos, D Thesmar, S Van Nieuwerburgh, and D Vayanos (2011). "European Safe Bonds", The Euronomics Group, Summary available at VoxEU.org.
3. Brunnermeier, M, L Garicano, P Lane, M Pagano, R Reis, T Santos, D Thesmar, S Van Nieuwerburgh, and D Vayanos (2016a). "The Sovereign-Bank Diabolic Loop and ESBies", *American Economic Review Papers and Proceedings*, 106 (5), 508-512. <https://doi.org/10.1257/aer.p20161107>
4. Brunnermeier, M, S Langfield, M Pagano, R Reis, S Van Nieuwerburgh, and D Vayanos (2016b). "ESBies: Safety in the Tranches", *European Systemic Risk Board Working Paper No. 21*. Retrieved from <https://ssrn.com/abstract=2848283>
5. Higgins, M.; Klitgaard, T. (2011). *Saving Imbalances and the Euro Area Sovereign Debt Crisis*. Federal Reserve Bank of New York. *Current Issues in Economics and Finance*. Volume 17, Number 5. <https://doi.org/10.2139/ssrn.1925018>
6. Mauldin, J. (2017). "Prepare for Turbulence" from *Thoughts from the Frontline*. Retrieved from <https://tinyurl.com/ycjeof7k>
7. Pezzuto, I. (2008). "Miraculous Financial Engineering or Toxic Finance? The Genesis of the U.S. Subprime Mortgage Loans Crisis and its Consequences on the Global Financial Markets and Real Economy," *Journal of Governance and Regulation*, Volume 1, Issue 3, 2012. Retrieved from SSRN: <https://ssrn.com/abstract=2196577>
8. Pezzuto, I. (2010). *Miraculous Financial Engineering or Legacy Assets* (Chapter 16) in Kolb, R.W. *Lessons from the Financial Crisis. Causes, Consequences, and Our Economic Future*. John Wiley & Sons, Inc
9. Pezzuto, I. (2013). "Predictable and Avoidable: Repairing Economic Dislocation and Preventing the Recurrence of Crisis." *Routledge*.
10. Pezzuto, I. (2014). *Predictable and avoidable: What's next?* *Journal of Governance and Regulation*, 3(3-1), 134-150. http://doi.org/10.22495/jgr_v3_i3_c1_p7