Why Europe is Getting Less Bad in 2013

Despite the latest swing from euphoria to fear, including new political trouble in Italy and Spain, the bigger picture in Europe is that things are gradually getting less bad

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Investors spend their professional lives bouncing between the walls of fear and greed, but what Europe has experienced over the last few months is truly exceptional. The year began with 'Europhoria' gripping the financial markets, buoyed by relief that euro had survived. For much of 2012, the betting markets assigned more than a 50% probability to at least one country ditching the euro by the end of 2013, but by early January this year, only a small minority harboured that fear.

A few weeks later, fear is creeping back as political uncertainty returns in Italy and Spain — major economies that had taken important reform steps last year and seemed to be on the mend. Italy goes to the polls later this month and a hung parliament seems increasingly likely to halt further progress. In Spain, Prime Minister Mariano Rajoy is under pressure to resign following reports that he received illegal payments from a party slush fund. Adding to Europe's woes is the prospect of the Netherlands entering the eurozone hospital, with painful symptoms of excess debt in its banking system and a bust in its housing market.

But this kind of relapse is normal in a crisis-ridden region, and it is obscuring the bigger picture in Europe. The long view suggests that things are getting less bad. Economic surveys show a steady improvement in business conditions and it is likely that the stalled eurozone economy will grow again by the second quarter. Even traditionally inefficient southern economies are starting to liberalise rules that restrain competition in their labour, product and service markets, which will help raise Europe's growth potential. It remains highly improbable that any member state will leave the eurozone.

All of this is bringing some money back to Europe, including the crisis-hit nations of the periphery: Portugal, Ireland, Italy, Greece and Spain. In the last four months of 2012, investors poured more than $125 billion into the peripheral nations, reversing an outflow nearly four times that size in the first three months of 2012.

Watching the drama in Europe, I can't help but recall the drama that unfolded in Asia back in 1997 and 1998, when fear of insolvency seized Bangkok and spread to Jakarta, Seoul and Kuala Lumpur, chasing off investors and triggering fiery protests. The Thai stock market tumbled to a total value of $30 billion, or less than Chrysler. By last year, a similar cycle of fear and flight had seized Europe, dropping the Greek stock market to a total value of $41 billion, or less than Costco, the American warehouse discount store. The same arithmetic could have been applied across 'peripheral Europe'; in Italy and Spain, for a time, the stock markets were worth less than Apple.

The lesson of Asia was not that troubled Europe was hopeless and doomed to collapse — quite the opposite. At the bottom in Asia, the affected markets — Indonesia, Thailand, Malaysia and South Korea — were worth $250 billion, or less than General Electric. Since then, east Asian markets have surged 10-fold in dollar terms, marking 1998 as a rare buying opportunity.

Peripheral Europe appears to have hit a low typical of regions in crisis, going back to Latin America in the 1990s. On average, looking at the maximum peak-to-trough decline in the stock market, the country where the crisis started (like Mexico in 1994) saw a decline of 85%, while all the markets in the affected region fell by 65%. In peripheral Europe, the crisis started in Greece, where the market fell 90%, while the maximum decline for all the markets in the region averaged 70%.

By late last year, every tragic figure in the European drama had its alter ego in the Asian crisis; the main characters of Thailand and Greece had suffered nearly identical losses of output, as have the supporting characters. Indonesia was hard hit but pushed reform, like Ireland today, while Malaysia suffered less but also did less to reform, similar to Italy.

The European echoes of the Asian crisis go back a long way. To make themselves look like safer places to lend and invest, both regions had fixed exchange rates: Asia in the form of the dollar peg and peripheral Europe in the form of the euro. The plan worked almost too well, because as borrowing costs plummeted, locals borrowed to shop, build houses and erect factories. The debt binge drove current accounts into the red, stirring fears about whether these countries could pay their debts. When doubts peaked in one country — Thailand in Asia and Greece in Europe — the contagion ignited.

The big difference is that recovery came fast in Asia, which took just 3.5 years to surpass the pre-crisis peak output. Europe still hasn't recovered fully, five years after the crisis hit. The reasons are threefold: the collapse of national currencies in Asia quickly boosted exports, while the euro has not collapsed. Asia enjoyed the tailwind of a strong global economy, while Europe does not. Moreover, Asia's debt problem was confined largely to the corporate sector, while Europe has a twin problem of corporate and government debt.

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Asia began to recover when its economies started generating enough income to pay foreign debt. By the first quarter of 2008 — when pundits were still casting east Asia's troubles as a threat to the world — the end was in sight. In all the crisis-hit countries, the current account balance — a broad measure of foreign income that includes trade in goods and services, investment payments and cash transfers — was back in surplus.

Most of peripheral Europe is approaching that critical point. Spain, Portugal and Italy are on track to record surpluses this year. Ireland has recorded the first current account surplus in the region, at 9% of GDP, up sharply from an 8% deficit.

As Europe fights to regain competitive strength, its most politically-flammable task is reducing labour costs. Measured from recent peaks, unit labour costs have stagnated in Italy but have fallen by roughly 7% in Spain, Portugal and Greece, and by 18% in Ireland.

The star reformers tend to enjoy the sharpest recoveries, and in Europe, the stars are Ireland and emerging markets of the eastern regions — where governments were forced to push through sharp cuts in response to a dramatic decline in output. They suffered sharp recessions, but are now enjoying big rebounds: as of late last year, the market in Estonia was up 155% from its post-crisis low.

The recovery on most of the European periphery will be slower than in Asia, but it will come. The average ratio of stock market value-to-GDP in any given country is about 80%; in peripheral Europe, this ratio ranges from 23% in Greece to 38% in Portugal, close to where their Asian alter egos were in 1998, when they were poised for a rebound.

A sustained rebound in Europe will have important implications for the emerging world, including India. Much more than American banks, European banks have been major backers of growth in the emerging world, but they have also tended to pull back when they are under stress in their home countries. That trend peaked at the height of the European crisis, but now it is easing, according to the latest available data. After pulling back sharply in the second quarter of 2012, European banks increased their lending to emerging markets by $44 billion in the third quarter, including $2 billion to India, and analysts expect a continuation of that trend this year.

If Europe gets past this latest test of nerves and its economy starts growing again by the second quarter this year, as expected, that should generate positive ripple effects worldwide.

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