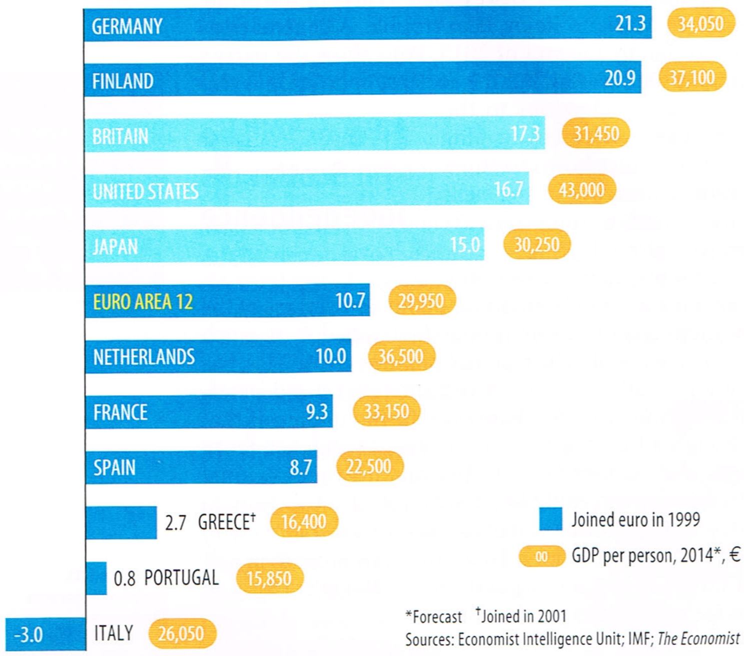
Southern discomfort

GDP per person, % change, 1999–2014*



*Forecast †Joined in 2001

Sources: Economist Intelligence Unit; IMF; *The Economist*

Teenage sulks

Paul Wallace

Aged 15, the euro will remain a difficult adolescent

After four years of crisis-fighting, European leaders have the chance to build more solid foundations for their shaky currency zone by sorting out its wobbly banks in 2014. They are more likely to fumble this opportunity than to seize it wholeheartedly. As before, they will do enough to keep the single currency intact but not enough to make it work properly.

The year will begin on a high note as Latvia becomes the 18th state to join a currency union that started in 1999 with just 11 members (see our obituary of the lat). The decision of this small Baltic country is as much political as economic, as it seeks to curb Russian influence by embedding itself more deeply in Europe. But after all the fears about a "Grexit", Eurocrats will still hail the expansion as a vote of confidence in the euro. And it will come after an earlier boost at the end of 2013, as Ireland becomes the first economy to leave its bail-out programme and return to market financing (though it may still require help through a credit line).

Euro-zone GDP is expected to expand in 2014 by only a modest 1%

In contrast with these northern lights, the outlook for the bailed-out economies of Greece, Portugal and Cyprus will remain a southern cross. Greece will be lucky to escape a seventh year of recession, and will require extra loans to meet its financing needs in 2014 and 2015: a third bail-out. And, even though Greece has defaulted on a record amount of sovereign bonds, its public debt will be oppressively high, at 175% of GDP. Further debt relief will come to the fore in 2014. Since most of the debt is now owed to other euro-zone countries, that will pose tricky questions, especially for Germany, the biggest creditor, which will do its utmost to avoid outright forgiveness for fear that other rescued countries will clamour for similar treatment.

Portugal for its part is heading for a second bail-out. A deep recession caused a political crisis in 2013, which undermined investor confidence, causing hopes for a return to market financing in mid-2014 to recede. But it is Cyprus that will suffer the most. Output will decline cumulatively in 2013 and 2014 by over 12%, according to the IMF, which notes that the fall could exceed 20% in "adverse" circumstances. The main worry is that the recapitalisation of the Bank of Cyprus using uninsured deposits will prove to be inadequate as bad debts surge.

A chance to grow up

These setbacks in small southern countries will be manageable if the euro zone can sustain and strengthen the recovery that started in the spring of 2013, with the upswing spreading from Germany to include the big Mediterranean economies of Italy and Spain. One worry is that the German export machine may run slow if Chinese growth falters. Another is that a dearth of credit will hold back smaller Italian and Spanish firms. Even if these risks can be averted, euro-zone GDP is expected to expand in 2014 by only a modest 1%, leaving output still below its peak in 2008. That overall figure disguises how badly some economies like Italy and Portugal have done since the introduction of the euro in 1999 (see chart).

There is an opportunity nonetheless for European leaders to build a basis for stronger sustained growth. The European Central Bank will become the supervisor of the zone's biggest banks in late 2014. Before that, in the first half of the year, it will conduct a searching investigation of their books. This asset-quality review is a chance to deal once and for all with the banking weaknesses that have interacted with unsustainable sovereign-debt burdens to make the euro crisis so intractable. The review could restore investors' faith in euro-zone banks, lowering their funding rates and enabling them to lend more freely to companies.

But if the review is to carry conviction (see "Show me the money", in the Finance section), it will prompt tough and potentially costly decisions: closing down banks that are no longer viable and injecting funds to plug capital gaps. That requires recourse if necessary to taxpayers, but Germany has blocked efforts to make this possible at the euro-area level; instead banks will have to rely upon the public purses in their home countries. Yet the weakest banking industries are in the countries with the weakest public finances, such as Italy. The danger is that the asset review becomes another euro-fudge, which does not sever the link between shaky banks and shaky sovereigns.

If Europe fails to seize the opportunity to sort out its banks, then it will fit into a disappointing yet familiar pattern. The euro area may no longer be in mortal danger of breaking up. But it will increasingly resemble a joyless union whose members stay together only for fear of a more painful separation. ■

2014 IN BRIEF

Riga, in Latvia, and **Umea**, in Sweden, are the European **capitals of culture**

Paul Wallace: Europe economics editor, *The Economist*