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As the eurozone's credit-less recovery continues, the threat of deflation is receding, says Rob Wood

The eurozone recovery is slowly moving into second gear. It is a credit-less recovery, but that is fine. There is plenty of deleveraging still to do. A credit-heavy recovery would be more worrying.

GDP grew 0.3% quarter-on-quarter in the fourth quarter of 2013 and leading indicators point to a modest acceleration of growth in the first quarter of 2014. In February, the European Commission's business climate indicator reached its highest level since August 2011.

Ever since Mario Draghi uttered those magic words about doing "whatever it takes" to save the euro in the summer of 2012, the economy has been improving. Not just in the eurozone, but in the UK, too, where bank funding costs fell in response to Draghi's commitment. What a long way we have come from regular discussion in the press of a likely eurozone break-up.

In any case, that discussion completely misread the strength of the political glue holding the eurozone countries together. The idea of Europe goes far beyond that of a mere common market or convenient currency. On the continent, the ideas of peace, prosperity and European integration often go hand-in-hand.

In the EU, the backlash against painful austerity and reforms will show up in a serious anti-EU protest vote at the EU parliamentary elections this May. But that is likely to fade as the positive results of the reforms at the euro periphery become visible over time.

Inflation, while low, is also not at serious risk of turning into deflation. With growth recovering, and German wage demands picking up in response to an extremely tight labour market, inflation is more likely to rise than fall over the next couple of years.

Low inflation can be a risk if it becomes engrained in people's expectations. But, equally, trying to quickly drive inflation up to the central bank's target comes with risks. Just ask the Federal Reserve or the Bank of England. In trying to offset the dot-com bust or falling import prices, respectively, they pumped up asset bubbles that later came back to haunt them. The tortoise may have a better strategy than the hare.

Aside from phantom concerns about deflation, one of the main hobby horses of eurozone worriers is the lack of a credit cycle. Loans to households and non-financial corporations continue to fall despite the recovery.

Of course, in some parts of the eurozone there is still plenty of deleveraging to do. Credit flows will be weak for some time to come. But that will not necessarily prevent a recovery. At the same time as credit has been weak, money growth has been strong.

The growth rate of the M1 money supply measure, which includes cash and overnight deposits, increased to 6.2% year-on-year in January. Adjusted for inflation, which stood at 0.8% year-on-year in the same month, real M1 growth is in line with its long-run average.

Money growth predicts economic growth well in the eurozone. If households and companies have more cash, they will eventually spend it. Indeed, it probably means that they do not need new loans. Companies, especially, have been squirrelling away cash for a long time now, so they can fund investment without needing credit.

There are also likely to continue to be marked differences by country. Those that are deleveraging will rely on strong exports rather than rampant domestic demand to drive the recovery. Others, like Germany, have and will see stronger domestic demand.

Ultimately, credit is not the be-all and end-all. In the UK, business investment just posted 8.5% year-on-year growth, while bank lending to companies continued to fall. The eurozone has come a long way in the past year and is likely to continue gradually improving as monetary policy increasingly gains traction.

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