

[Comment] Could the credit crunch destroy the Eurozone?

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EUOBSERVER / COMMENT - Anybody who believes the Eurozone is immune to the havoc created in the Anglo-Saxon economies by the credit crunch would do well to look again. Recent figures suggest the outlook for the EU-15 is poor - and if one factors in weakness of the Eurozone's economic governance, the outlook is positively grim.

This week marks the first anniversary of the credit crunch, the moment when it dawned on bankers that the US\$12 trillion mortgage market was in meltdown and that an unknown fraction of the securitised mortgage bonds held by banks and funds was toxic.



Since nobody knew quite how much toxicity was in the system, banks started writing off bad debts and calling in loans while highly leveraged hedge funds found themselves in dire straits: last August, two of Bear Stearns' hedge funds collapsed, America's largest mortgage bank (Countrywide) announced itself in distress while in France, BNB Paribas blocked withdrawals of US\$2.2 billion in funds.

The US Fed and the European ECB quickly (and correctly) poured massive amounts of liquidity into the markets to prevent them seizing up altogether: US\$70bn and US\$ 140bn respectively. Moreover, the Fed cut interest rates drastically: whereas its rate stood at 5.25% in early 2007, it is now down to 2 percent. Still, the crunch has deepened in 2008. In the US this week, mortgage approvals hit a record low while the fall in US house prices continued to accelerate. In Britain, retailers were reporting that sales in July 2008 were at their lowest level in a quarter of a century. Both Britain and the US are headed towards recession, and there is no end in sight.

While it is widely recognised that property markets in Spain and Ireland are tumbling and that in France the market has softened dramatically, what is less known is that business sentiment is deteriorating everywhere in the Eurozone. Last week's Purchasing Managers Survey of the EU-15 revealed the worse outlook since November 2001.

In Germany, until recently thought to be bouncing back, corporate sentiment surveyed by Munich's Ifo Institute for Economic Research is at its lowest in three years, while the recent INSEE survey in France suggests the outlook there is worse. To add to the gloom, the IMF's latest Global Financial Stability Report says there is no sign of recovery from the credit crunch. In the words of Jaime Caruana, one of the IMF directors, 'As economies slow, credit deterioration is widening and deepening, and as banks deleverage [cease lending] and rebuild capital, lending is beginning to be squeezed, restricting household spending and clouding the outlook for the real economy.'

Key lessons from the crunch

Until early 2008, the orthodox view in the financial community was that the crunch was a short term affair; the real economy would soon bounce back, all the healthier for having purged the bad debt from the books.

But there were many possible triggers for recession besides toxic mortgages; one had merely to look at America's treble deficit - on current, government and household accounts - to realise that the US economy was in for a great unravelling, almost certainly taking the EU with it. As the financial journalist Larry Elliot has argued, coming to grips with the crisis requires at least four things.

First, the denial has to stop - this is not a short term crisis, nor even the beginning of a 2001 style recession - it is far more serious. Secondly, the financial system needs regulating. It is in deep trouble, largely of its own making. Yes, governments will need to pour billions of taxpayers' dollars and euros into the system if confidence is to be restored, but the quid pro quo is that the financial services sector must accept serious government intervention, minimally of the sort which existed prior to Reagan-Thatcher style 'deregulation'. Franklin Roosevelt saw this clearly in the 1930s when he pledged that government must become an effective counterweight to Wall Street's financial oligarchy.

Thirdly, the historical precedent is not the Great Crash of 1929. Rather, it is the Japanese property bubble of 1989 and the deflation and long-term stagnation which followed. Some readers will recall a time in 1988 when it was claimed that the value of a few square kilometres of real estate in Tokyo exceeded the assets of the US state of California.

The bursting of the Japanese property bubble brought with it a similar credit crunch, and fearing the worst, Japanese households cut their spending thus sending the economy deeper into recession. The Bank of Japan initially did the right thing, flooding the market with liquidity and holding nominal interest rates close to zero. But in the early 1990s, price levels started to fall - causing consumers' nominal debt to rise in real terms and leading them to postpone consumption even more. The result was nearly two decades of stagnation. As Keynes recognised, there comes a point when the use of monetary policy alone is as ineffective as 'pushing on a string'.

The fourth point - following logically from the third - is that Keynesian fiscal policy is very relevant today. Ultimately, when nobody else is willing to spend and when credit is tight, it is government which must spend its way out of the crisis. This was the lesson of the 1930s and 40s, the lesson in Europe of Marshall and the the trente glorieuses, the lesson of Japan, and it is still the lesson today. But Europe has been vulnerable to stagnation for the past decade.

Why Europe is vulnerable

Lest Europeans should think themselves smugly superior to America in terms of economics (we after all have not engaged in sub-prime lending), the reader might ponder the ECB's current obsession with inflation.

True, oil prices are rising and food is dearer (particularly in the world's poorest countries), but to raise interest rates in the face of impending recession as the ECB has recently done is little short of economic madness. Oil prices are high because of growing uncertainty about the future of the Middle East; food prices are high in good measure because of switching agricultural land to biofuel crops. Tighter money in Europe may squeeze household demand, but it will not help resolve the underlying causes of inflation.

More ominously, the Eurozone is vulnerable to crisis because of the lop-sided nature of its economic governance - a powerful central bank, but a tiny, non-adjustable EU budget, with fiscal spending at member-state level constrained by the SGP.

In this sense, the US is far better equipped to combat recession; its Central Bank is required to treat inflation as only one of three criteria, while Congress has discretionary power to use the federal budget counter-cyclically; eg, it accepted George Bush's reflationary package worth 1% of GDP, however poorly targeted the package may have been. The EU has no such discretion, but instead is bound by rules-driven automatic stabilisers inspired by bankers' notions of 'sound money'.

True, when the downswing really starts to hurt the ECB still retains plenty of scope to cut interest rates. But what happens when monetary policy becomes ineffective? In truth, Brussels will need to reconsider Keynes and the Eurozone's economic architecture will need to alter drastically, or else the very existence of the Eurozone will be in peril. For pro-Europeans like myself, that is perhaps the harshest lesson of the present crisis.

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