

Economic Fault Lines Deepen in Europe

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Last week, the European Central Bank (ECB) raised its forecast for growth in the 16-nation Eurozone by just over half a percent, to an average rate of 1.6 percent for 2010. Earlier estimates had predicted growth of only 1.0 percent.

This predicted increase is largely due to the temporary performance of Europe's biggest single economy, Germany, and disguises the fact that growth rates are minimal for most European Union countries and negative for many others. Latvia, Romania, Bulgaria, Cyprus and Spain remain in recession and recent statistics for Greece suggest the country is actually plunging more deeply into recession.

New figures for the British economy reveal a slowdown in public sector activity leading to increased job losses. This has revived media speculation about a possible "double dip recession" in the near future when the drastic spending cuts announced by the new British coalition government come into force.

At the same time as it announced the Eurozone growth estimate, the ECB also declared on Thursday its intention to maintain its benchmark interest rate at a record low 1 percent, while extending measures to provide emergency funds for commercial banks until the end of this year. Originally the ECB had committed itself to providing banks virtually unlimited credit until mid-October. The decision on interest rates means the latter have now been pegged at this low level for the past 16 months.

The ECB statement on the state of the European economy acknowledged that the current improvement was "partly due to temporary factors". These "temporary factors" refer to the large stimulus programs introduced across Europe last year aimed at bailing out the banks and protecting big business from bankruptcy. These programs are now running out and successive European nations have adopted massive austerity programs. Huge spending cuts coupled with cuts to wages will inevitably shrink European economies and have pronounced deflationary consequences over the next months and years.

Commenting on the latest European figures ECB President Jean-Claude Trichet admitted to reporters in Frankfurt that the situation in Europe was still characterised by "uncertainty" and continued, "We have to remain cautious and prudent—we don't declare victory".

The extension of the ECB's interest-free credit to the banks demonstrates the continuing lack of liquidity and an ongoing lack of confidence on the part of investors in the European economy. Senior economist Carsten Brzeski at ING concluded, "The (ECB) liquidity program shows that the ECB still does not trust the recovery and the health of the financial system".

This remains the case despite the extraordinary measures European governments have

taken this year. In May the European Union (EU), in concert with the International Monetary Fund (IMF), agreed a €750 billion (US\$990 billion) bail-out package aimed at preventing the bankruptcy of the Greek economy and a collapse of the euro. Two months later European banks were subjected to so-called “stress tests” aimed at identifying their exposure to risky assets.

In spite of these measures, the price of government bonds in a number of Europe’s most exposed economies—Ireland, Portugal, Greece and Spain—is nearing the levels reached prior to the emergency May intervention by the EU and IMF.

Just a week ago the Standard & Poor’s rating agency cut the credit rating of Ireland to AA-, the country’s lowest rating in the past 15 years. The revised credit rating for Ireland means that the country will now have to pay increased interest rates to ensure the sales of its bonds.

The downgrade took place in the face of the Irish government having introduced what is acknowledged to be one of the most stringent and aggressive austerity programs in all of Europe. Indeed, ECB head Trichet, who has repeatedly insisted on the necessity for such drastic anti-working class measures, had personally held up Ireland as a role model to be followed by other struggling European economies.

Dublin finance analyst Alan McQuaid commented on the credit rating change: “The timing is awful. If the banks can’t refinance, then they become more reliant on the ECB, which hurts the perception of Ireland, which in turn drives sovereign spreads wider. It becomes a vicious circle”.

In a recent *New York Times* article entitled, “In Ireland, Dangers Still Loom”, authors Simon Johnson and Peter Boone warn of the consequences of the type of austerity programs being introduced across Europe—especially for those countries forced to pay off a growing burden of debt. They note that the finance markets remain unimpressed by the measures taken by the Irish government, which have sharply cut public sector wages and driven up unemployment to record levels.

They write, “Despite or perhaps because of this therapy, financial markets are beginning to see Ireland as Europe’s next Greece”. The authors estimate that the probability of Ireland defaulting on its debts “has shot up”, and that under the current government program every “Irish family of four will be liable for 200,000 euros in public debt by 2015”.

They conclude, “Ireland, simply put, appears insolvent under plausible scenarios with current policies. The idea that Ireland, Greece or Portugal can cut spending and grow out of overvalued exchange rates with still large budget deficits, while servicing all their debts and building more debt, is proving—not surprisingly—wrong”.

With concerns rising on international markets of a possible default by any one of a number of European states, the IMF intervened in the debate last week with its own statement in which it warned against panic reactions by the markets to the ballooning debt crisis.

The exception to the European rule and the only country with a decisive plus to its balance of trade in the second quarter of 2010 was Germany. Economic analysts, as well as France’s finance minister, have noted that the German figures appeared so favourable only because the country had recorded a record fall in production in 2009. Germany’s powerful export

industry was also able to profit from a temporary weakening of the euro against the dollar.

The latest economic data from the United States, which points towards an ongoing and possibly deepening recession, is once again pushing up the value of the euro against the dollar and will also lead to reduced demand from one of Germany's most important export partners. The biggest growth region for Germany's export industries—Asia, and in particular China—have also published figures that reveal a marked cooling off in their economies. As has been the case before in recent history, Germany's strength—its dynamic industrial base—is increasingly proving to be its Achilles' heel.

The response of European nations to the deepening economic crisis is inevitably "dog eat dog". The crisis is not only intensifying the fault lines between Europe and its main international rivals, but is also rapidly fuelling divisions inside Europe itself. This turn towards nationalism and self-interest on the continent will have explosive political consequences.

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