The Financial Perils of the Eurozone

By Vladimir Nesterov
Global Research, June 23, 2014
Strategic Culture Foundation

Region: Europe
Theme: Global Economy

Until recently European leaders were still making cheerful claims that the EU's economic recovery was finally at hand and that the euro zone was safely out of the woods. But no one's saying that anymore. In the first quarter of 2014, GDP in the eurozone averaged only 0.2% growth – only half as much as was expected. Germany has fared slightly better with a 0.8% increase in GDP, as have Belgium and Spain (which both gained 0.4% in the first quarter of this year). The situation in other eurozone countries looks far more grim. France recorded zero growth, GDP in the Netherlands shrank by 1.4%, in Greece by 1.1%, in Cyprus and Portugal by 0.7%, in Finland by 0.4%, and in Italy by 0.1%.

When analyzing the causes of this stagnation that threatens a new recession, economists point first and foremost to reduced levels of consumption. In France, for example, this decreased by 0.5%. In the countries most affected by the crisis (Greece, Portugal, and Cyprus), consumption is naturally quite low. Unemployment also takes its toll – affecting 27.5% of the employable population in Greece, for example, 16.7% in Cyprus, and 13% in Italy.

Economic woes are also prompting an escalation of sovereign debt, which equaled 85.5% of the eurozone's GDP in 2010 and 96.2% in 2013. The same trend can be seen throughout the EU – 79.9% in 2010 and 87.1% in 2013.

From inflation to deflation?

The World Bank has become alarmed at the recent developments in the European Union. A few days ago that institution released its Global Economic Prospects market forecast, in which it warned the European Union and the eurozone about the threat of deflation. "Inflation expectations remain anchored so far," the document claims, "but downward adjustments could unleash a pernicious debt-deflation cycle." Such a turn of events would sharply limit the ability of the European Central Bank (ECB) to sustain the economy.

Prices in the eurozone have now reached record lows – below levels in Japan, the US, or the UK, for example. Consumer prices rose by only half a percent in May. And the situation in Germany is not much better. The Federal Statistical Office reported on June 13 that the price for goods and services in Germany grew by 0.9% in May compared with the previous month. Such a low inflation rate has not been recorded since June 2010. In April the inflation rate was still only 1.3%. Prices of many foods, vegetables in particular, declined. Compared with the previous year, the cost of gasoline and diesel fuel also fell. Thus, the rate of inflation in Germany remains below the optimal level recommended by the European Central Bank. The goal of the ECB is to maintain annual price growth at a level just below 2%.

If prices stop climbing, or if they begin to recede, this could trigger a dangerous spiral:

consumers might hold off on major purchases in anticipation of further price cuts, while businesses, in turn, could postpone investment, and the economy could ultimately find itself at risk of collapse.

This would again strengthen the deflationary trend, creating a vicious circle. Economists can already see this happening in the countries in Southern Europe that have been stricken by economic crises. In Greece for example, prices have been falling for the past few months. Goods and services this past May were two percent cheaper than in May 2013. On average, prices in Europe have tumbled by as much as 2.1 percent. Contributing factors are declining wages, high unemployment, and the business community's aversion to investment. In turn, the unfortunate economic plight of the countries still in crisis is having a negative impact on demand.

The ECB's inconsistent moves

Given this situation, the European Central Bank (ECB) decided to slash its refinancing rate to a record low of 0.15%. At the same time there were plans to pump 400 billion euros into banks in Southern Europe, the area most affected by the crisis, so those countries could offer loans to businesses. In addition, the ECB imposed a negative interest rate of -0.1% per annum on the commercial banks that hold its funds. The penalty was imposed in order to encourage the banks to do their primary job, which is to lend money to the non-financial sector of the economy. After a prolonged recession, European entrepreneurs are in dire need of fresh capital, but credit and financial institutions have been spooked by the crisis and either prefer to invest in securities or have decided to play it safe and keep many billions of euros in the Central Bank.

The reactions to these measures by the ECB have been mixed. For example, in Germany the heads of banking and savings-bank organizations, as well as the entire insurance industry and most economic institutions, spoke out against the new policy of the European Central Bank. All of them claimed it was unacceptable to further reduce the benchmark interest rate because that would entail an expropriation of depositors' savings. As a result, in the near future the public will be faced with major shortfalls in the funded components of their pensions, and insurance companies will not be able to provide their customers with the interest that they had been promised when they signed their life insurance contracts.

The clamorous protests in Germany did not come out of nowhere. Germans are conservative when it comes to financial matters and still prefer to keep their savings in savings banks, although they currently receive only a very meager interest rate on their deposits – significantly lower than the rate of inflation, which amounted to 1.1% per year in April.

But the ECB decided on June 5 to cut its benchmark interest rate from 0.25 to 0.15%, forced to focus less on German sentiments and more on the situation in the eurozone countries that are experiencing zero or negative economic growth.

The ECB has no universal remedy in its toolkit.

Most experts believe that reducing the benchmark rate to a historic low will not have a galvanizing effect. There is no uniform credit and monetary policy that can be applicable to the entire eurozone, replacing national programs to brace the economy.

Nor is a negative interest rate a panacea. After all, the ECB's client banks can reduce the liquidity in their accounts to the minimum reserve required by law. And this in turn could result in a shortage of liquidity in the interbank market. This could bring about a reappearance of the credit paralysis that hit during the global financial crisis in 2008. After all, even if only one out of a hundred medium-sized businesses in Germany is complaining about the reluctance of banks to lend, a quarter of all companies in Spain, and as many as a third in Portugal, are also experiencing problems with financing.

Thus, the ECB has a limited toolkit, and no universal remedies that can simultaneously assist all the eurozone countries. This results in an exchange rate for the euro that is an extremely poor guide to the needs of the eurozone's member countries in their varied economic straits. Were it not for this unified currency, we would have seen a strong rise in the exchange rate of the German mark set against a sharp devaluation of the drachma, peseta, lira, and escudo.

And the worst aspect of this story is that it is getting harder and harder for banks, which accept deposits from the public and extend credit to their customers, to make any profit at all. A lengthy period of low profitability could prompt banks to engage in riskier operations, which could easily generate new bubbles and a new financial crisis. Perhaps one that is even more dangerous than the upheaval of 2008.