IMF and OECD: Europe will be hit hard by US recession

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Reports issued by the International Monetary Fund (IMF) and the Organization for Economic Cooperation and Development (OECD) warn that the United States is entering into a recession and reject all claims that Europe will be able to avoid severe economic dislocations as a result of America's worsening situation.

The OECD meeting in Paris this week estimated that global losses from the US subprime mortgage crisis would surpass $440 billion. This was a sharp upward revision of its previous estimate of $200-300 billion.

Europe was more vulnerable than many thought to the global financial markets crisis, and would be especially so if trouble spread to the equity derivatives markets, officials said on April 15.

The OECD's estimate of likely bank losses ranges from $350 billion to $420 billion, based on different assumptions as to the amount of distressed assets the banks will be able to recover. Assuming a 40 percent recovery rate, the OECD estimated losses in excess of $422 billion, of which $87 billion would be borne by US banks—$60 billion by commercial banks and the rest by investment banks.

These losses would ripple throughout the world. A third of the collateralised debt obligations (CDOs) and other financial instruments based on US residential mortgage-backed securities (RMBS) that are tied to sub-prime markets have moved offshore, mainly to Europe, the OECD said.

Forbes magazine, commenting on the OECD report, noted: "More dangerous still, it said, was another area so far not hit by the crisis that spilled out of the subprime market last August—capital-guaranteed financial products with exposure to equities and based on complex operations-replication programmes."

The OECD stated that a $1 trillion equity derivatives market based on these products had developed between 2003 and the start of this year.

These instruments are the basis for many of the savings products offered by scores of retail banks and building societies. Europe is the dominant force in these Constant Proportion Portfolio Insurance (CPPI) products.

Thomas Weiser of the OECD said one of the big risks now was that economic growth could be hit by loss of capital at banks which played a key role in the wider economy. He called for massive injections of cash by the world's central banks.

The IMF described last summer's crisis in the financial markets as "the largest financial shock since the Great Depression." It stated that the world's bankers have created a pool of $1 trillion in toxic debt, twice the sum estimated in earlier projections.

The IMF's conclusions are conservative, given such a description. It predicts that the US will go into a "mild recession" this year, with growth of around 0.5 percent, even after the economic stimulus package from the Bush administration and sweeping cuts in interest rates. It warns that there is a one-in-four chance of a full-blown global recession over the next 12 months. At best, it forecasts that world economic growth will fall to 3.7 percent for the next two years.

The IMF issued particular warnings that house price inflation in several European countries, including Britain and the Netherlands, where housing was said to be 30 percent overvalued, would make them more susceptible to the global downturn.

Britain has long been recognised as the European country most exposed to the economic turmoil unleashed in the United States and most heavily dependent on world financial markets. The IMF downwardly revised UK growth figures from the Treasury's estimate of 2 percent this year and 2.5 percent next to 1.6 percent for both 2008 and 2009, the worst performance since the last recession ended in 1992.

After nationalising Northern Rock and injecting £50 billion of liquidity into the markets, the Brown government and the Bank of England plan to risk billions more, emulating the US Federal Reserve by taking over bad mortgage debts from banks in return for secure government bonds.

House prices in Britain already fell by 2.5 percent last month and are expected to decline by as much as 10 percent this year. Britain's Royal Institution of Chartered Surveyors reports that the number of residential property agents saying prices declined exceeded those reporting gains by 78.5 percentage points in March, the worst since records began in 1978.

Britain is also labouring under staggering levels of personal, unsecured debt.

Total UK unsecured debt is £1.3 trillion—more than the rest of the European Union put together. Lorna Bourke, writing in *Citywire*, rejects claims that the present housing crisis is not as bad as that in the 1990s, when there were 78,000 repossessions a year, because unemployment is lower. She notes that "In the early nineties high unemployment created by the collapse of the debt market in 1987 and rising inflation meant homebuyers could not meet their mortgage obligations. Does that sound familiar?"

Credit card debt is much greater than it was in 1990. Financial analysts Mintel have reported that mortgage costs in Britain trebled during the past 10 years and now account for 25 percent of consumer spending, compared to 14 percent a decade earlier. The debt management company TDX Group estimates that the number of people struggling with debt is set to double during 2008. Around one million people have unsecured debts totalling £25 billion, averaging a staggering £25,000 each. Some 60 percent is owed on credit cards, with the rest mainly in personal loans.

London's role as a financial centre will translate into a massive and relatively immediate impact from a global economic downturn. JPMorgan Chase analysts estimate that 40,000 City of London jobs could be lost as a result of the credit crunch, doubling the forecast by the Centre for Economics and Business Research.

Amongst the cuts already announced are 900 jobs at UBS, the European bank worst hit by the credit crunch, representing 10 percent of its London workforce. Merrill Lynch has warned of 450 imminent job losses in London.

Initial signs have emerged of a rise in unemployment from its present 1.6 million. Although the claimant count rate fell by 1,200 in March, the previous month's 2,800 decline was revised to show a 600 increase—the first since September 2006.

Sterling has hit repeated all-time lows against the euro, which is presently worth more than 80 pence. The Bank of England has cut interest rates to 5 percent in an attempt to stimulate the release of credit by banks and building societies.

Europe's economic powerhouse, Germany, does not at first appear to be in such a precarious position. Its exports continue to rise, even though the euro has dramatically risen in relation to the dollar.

But there are clear signs of troubles ahead, of which the €4.3 billion losses incurred by the Bavarian State Bank (BayernLB) from its dealings on the US subprime mortgage market, as well as the billions lost by SaxonyLB and WestLB, are only a foretaste. These banks, partly owned by the federal government and various German states, are to be bailed out to the tune of €30 billion—at taxpayer expense.

According to *Der Spiegel*, this is only the tip of the iceberg. It wrote on April 2, "The end of the crisis is not in sight: According to one study (by business advisory group Ernst and Young) German banks have hidden away rotten credits in their books—amounting to a total sum of €200 billion."

This week, four leading German economic think tanks cut their forecasts for growth this year to 1.8 percent, down from the 2.2 percent they predicted last October, and projected even slower growth of 1.4 percent next year. The German government is less confident still, predicting growth of just 1.7 percent this year.

The *Financial Times* reported April 14 the views of several leading European industrialists that the worst effects of the credit crunch will not be felt for six months.

Peter Löscher, chief executive of Siemens, said, "I don't see any impact at the moment. But I have no doubt it is coming, probably in 6 to 12 months' time." Wolfgang Reitzle, chief executive of the Linde industrial gases group, added, "It will happen with a time lag ... of maybe a year.... We are in the most critical business environment in decades."

Gareth Williams of ING Financial Markets stated, "This [financial] quarter is going to be pretty horrible. But the worst will come in the fourth quarter." Teun Draaisma of Morgan Stanley is forecasting a 16 percent drop in earnings over the year and an "earnings recession in Europe."

Germany and Europe, with a monetary system based on stability and spending targets, are particularly fearful of the impact of runaway inflation and angry over how the US Federal Reserve is pumping money into the economy.

An article in *Der Spiegel* from April 14, entitled "The Madness of Ben Bernanke," gave full vent to these tensions. Comparing Alan Greenspan and Ben Bernanke, the former and current heads of the Federal Reserve, to Siegfried and Roy, it described their "pumping easy credit into the system" as "a crazy policy that will worsen the crisis.... The aim is to keep on financing consumer spending and even to stimulate it further—for reasons of patriotism. There's a word for this policy—madness."

The strong euro has not so far done major damage to the European economy, particularly because it has reduced the cost of dollar-priced oil imports. But companies reliant on dollar sales such as Airbus have been hit and a "pain threshold" will eventually be breached.

More long term, the divergence of policy between the Fed and the European Central Bank (ECB), which has kept interest rates steady, cannot but destabilise the global economy. The dollar's decline also means that its repayment of debts has less value, punishing US creditors in Europe and elsewhere.

Inflation is a major problem for Europe, now running at a record 3.6 percent in the euro zone. The ECB has set its main policy rate at 4 percent, but fears that inflation will make this unsustainable. Food and energy price rises alone added 1.6 percentage points to March's inflation figures.

Jorg Kramer, chief economist at Commerzbank AG in Frankfurt, told the *International Herald Tribune*, "The Fed is not so interested in inflation, currently. They have a bigger problem: recession." But he warned that "someday, this crisis will be over" and inflation will necessitate drastic action.

The Fed's benchmark rate is currently at 2.25 percent and a further cut is expected. Krämer said he expected Bernanke to cut the fed funds rate to 1.25 percent by June.

The "fight against inflation" is always a codeword for moves to cut the wages of the working class. German government and bank officials are complaining of recent high wage settlements being unsustainable, including a meagre 8 percent agreement in Germany's chemical sector that is staged over two years and barely matches the official inflation rate.

In Britain, Prime Minister Gordon Brown has imposed a 2.5 percent pay ceiling throughout the public sector, already provoking strikes involving hundreds of thousands of civil servants and teachers.

Draconian attacks are being prepared in France, where dissatisfaction with the country's economic performance in ruling circles is most pronounced. Prime Minister Francois Fillon has cut the official forecast for gross domestic product (GDP) growth in France in 2008 to 1.7-2.0 percent from a previous estimate of "around 2.0 percent." The right-wing administration of Nicolas Sarkozy has announced public spending cuts of €6-7 billion annually to run for a three-year period in 2009-2011. But with a public deficit running at €1.2 trillion in 2007, far greater attacks must be anticipated.