Europe faces ever deepening recession

Chris Marsden
28 April 2009

Particularly revealing in the International Monetary Fund's World Economic Outlook issued last week is its estimation of the precarious state of the European economies.

The IMF described the United States as lying at the centre of the global economic crisis, but also predicted a worsening recession in Europe. It estimates that the euro zone's economy will contract by 4.2 percent this year, significantly worse than its January forecast of a 2 percent decline.

The EU states have incurred massive debts due to bank bailouts and stimulus packages, with a combined 2.3 trillion euros in financial guarantees, 300 billion euros in recapitalisation programmes and an additional 400 billion euros in various rescue and restructuring schemes.

The statistics agency Eurostat notes that Europe is in the midst of a deep economic recession, with industrial orders falling by 34.5 percent year-on-year. The euro zone's external current account deficit reached 57.3 billion euros in the final quarter of 2008, almost three times the figure for the same period in 2007. It is not just exports that are declining as a result of the global slump. Direct investment abroad by the EU amounted to just 23.9 billion euros for the last three months of 2008, compared to 171.9 billion in the fourth quarter of 2007. Foreign investors also disinvested in the EU.

The cost of bailouts and declining tax revenues due to the slump has led to a spiraling of government deficits, which collectively have hit 2.3 percent of GDP for the 27-nation EU. The government debt to GDP ratio increased from 66 percent at the end of 2007 to 69.3 percent in the euro zone and from 58.7 percent to 61.5 percent in the EU.

Europe's GDP is expected to fall by 1.2 percent, with the economy predicted to shrink by two percent, according to a report by the European Economic Advisory Group.

Unemployment is set to rise by an average rate of eight percent.

The IMF has said that the euro zone will face a worse recession than the United States, complaining that the European Central Bank was too slow to react to the impending recession and that Europe's financial policies were not being implemented in a "sufficiently comprehensive and coordinated" fashion.

There is particular concern over the state of Europe's banking system. While US banks have covered about half of their write-downs, Europe's banks have taken only a fifth so far. In a bleak warning, the IMF noted that total write-downs would wipe out the world's bank equity.

The *Financial Times* reported that Independent Credit View, the Swiss-based risk adviser, has warned of a "second wave" of debt stress hitting Europe under conditions in which its banks have much less in terms of reserve cushions than US banks.

Peter Jeggli, Credit View's founder, states, "The biggest risk is in Europe... The Americans are ahead of the curve. European banks are exposed to US commercial real estate and to problems in Eastern Europe and Spain, where the situation is turning dramatic. We think the Spanish savings banks are basically bust and will need a government bail-out."

The *Financial Times* comments, "Europe's banks are exposed to a hydra-headed set of bubbles. They not only face heavy losses from US property, they also face collapsing credit booms in their own backyard and fallout from high levels of corporate debt in the eurozone. It takes longer for damage to surface with Europe's traditional bank loans, which buckle later in the cycle as defaults rise. The ferocity of Europe's recession leaves no doubt that losses will be huge this time."

European banking is particularly exposed due to the collapse of the Eastern European economies.

Several countries have already gone cap-in-hand to the IMF, including Hungary, Serbia, Romania, Latvia and the Ukraine. In addition, the European Bank of Reconstruction and Development, the World Bank and the European Investment Bank have advanced a 24.5 billion euro support package for Eastern Europe's banks.

Even so, there is every possibility of a collapse of one or more of the eastern European economies, which would have a domino effect that may lead to the collapse of neighbouring states and west European banks.

According to figures compiled by Handelsblad, Italy's national debt is already well in excess of its GDP, Greece is approaching this figure and Belgium, France, Germany, Portugal and Austria all top 60 percent of GDP.

Germany

Numerous reports identify Germany as particularly vulnerable to the global recession due to its reliance on exports, which make up 40 percent of its GDP, and its exposure to east European debt.

The IMF has predicted that Germany's economy will contract by 5.6 percent this year, while a group of German financial institutions predicts a 6 percent decline.

Germany may face an "especially persistent" recession and see a 23 percent decline in exports this year, pushing unemployment to close to 11 percent. Germany's budget deficit will swell to 132.5 billion euros, or 5.5 percent of GDP in 2010, from 3.7 percent this year, the German institutes state.

Germany accounted for nearly a quarter of European bank write-downs last year. Its investments in eastern Europe ($450 billion, or four percent of German banking assets) raise further dangers. And not just for Germany.

Germany remains the engine of Europe's economy. An ever worsening recession there will pull the rest of the continent in its wake.

Britain

The parlous state of the UK economy is the second major cause for concern, due primarily to the role of London as a finance centre.

The IMF has predicted that Britain's GDP will contract by 4.1 percent this year, much greater than admitted by the government of Prime Minister Gordon Brown, and that Britain will suffer an ongoing recession.

In last week's budget, Chancellor Alistair Darling predicted a 3.5 percent fall this year and a return to growth by 2010.

Commenting on the disparity, IMF head Dominique Strauss-Kahn said, "Part of the recovery relies on confidence and it is absolutely normal that governments all over the world will try to rebuild confidence in looking at the upper part of the range rather than the lower bound."

"I would certainly have more pessimistic forecasts than most governments. Last year we were proven right," he added.

The April 25 *Wall Street Journal* was deeply skeptical regarding Britain's prospects, noting that "The UK, with a capital city that serves as one of the world's premier financial hubs, has depended on financial services for one in five jobs and more than a quarter of its tax revenues... the plunge in first-quarter gross domestic product—[1.9%] the biggest since the 2.4% drop posted in the third quarter of 1979—presents a challenge for the UK government, which is taking on debt at a rate not seen since World War II, as it spends money to cushion the downturn and salvage its banking system. Over the next three years the government's net borrowing requirement will be £488 billion ($718 billion)."

The IMF predicts that government debt in Britain will reach more than 80 percent of GDP.

Some measure of the extent of the slump is provided by the rise in unemployment to over two million, with predictions that it will top three million by 2010. In addition the latest British Chambers of Commerce monthly business survey found that 70 percent of companies plan to freeze or cut wages this year and half are thinking of making staff redundant in the next six months.

The IMF has warned that Britain's housing market has still further to fall. With house prices having declined by 20 percent, the IMF stated that, as with Spain and Ireland, there was "a considerable distance left to run".

David Cameron, leader of the opposition Conservatives, who are predicted to win next year's general election, has spoken of creating a new "age of austerity", vowing even deeper cuts than those pledged by the Labour government.

Spain

Spain is amongst the western European nations worst hit by the recession.

The IMF has predicted a prolonged slump in Spain's economy as a result of the collapse in its housing market. It expects the economy to contract by 3 percent in 2009, as against government predictions of 1.6 percent. This month, unemployment topped four million, having doubled in the past year. Now standing at 17.4 percent, it is widely expected to top 20 percent fairly shortly.

The Socialist Party government of Jose Luis Rodriguez Zapatero has responded with a 70 billion euro fiscal stimulus programme and has pledged more to come. But The IMF has issued a strong warning that a worsening budget deficit expected to rise to 8 percent of GDP raises dangers of economic collapse.

France

In France, the Sarkozy government has estimated that the economy will shrink by 2.5 percent this year. Prime Minister Francois Fillon said, "What is certain is that 2009 will be a year of severe recession."

This estimate is contradicted by the OECD, which predicts a contraction of 3.3 percent. France's budget deficit stands at six percent.

Last month, unemployment rose by between 60,000 and 70,000, following 79,900 job losses in February. The unemployment rate presently stands at 8.2 percent, but is expected to top 10 percent by the end of the year. Unemployment is already a massive 21.2 percent and rising amongst those in France who are under 25.