European economy slowed by sovereign debt, banking crises

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Speaking to reporters at the end of last week, the head of the European Central Bank (ECB), Jean-Claude Trichet, sought to play down speculation on the possibility of the euro-zone entering a new recession.

"We are in a situation," he said, "where a number of facts and figures and data are not, I would say, confirming that we would have stagnation or a double-dip [recession]… I see perhaps a tendency [...] from outside to be excessively pessimistic [...] and I think that the figures that we have are not confirming this pessimism."

Trichet was speaking after a meeting of the ECB governing council decided to maintain its core interest rate at an all-time low of one percent for the 15th successive month. His attempt to calm the markets followed a number of international reports that made precisely such pessimistic predictions for the economies of the European Union and the euro-zone.

In a report issued last Thursday, the International Monetary Fund (IMF) forecast that growth in the euro-zone would be the world's lowest in 2010 and 2011. According to the new IMF estimates, the world economy will grow by 4.6 percent in 2010 and by 4.3 in 2011. The euro-zone, however, will grow by only one percent in 2010 and 1.3 percent for the following year.

The IMF forecast of stagnation for the European economy was supported by figures released last Wednesday by the EU statistical office, Eurostat, which put economic growth in the first quarter of 2010 at just 0.2 percent.

The Eurostat figure applies to the gross domestic product of both the 27-member European Union and the 16-member euro-zone. Should the Eurostat estimate of 0.2 growth be replicated for the remaining three quarters of this year, the annual rate of 0.8 percent would lag behind even the IMF's projected figure of just one percent.

The Eurostat figures reveal substantial variations between individual countries. Having implemented one of the most ferocious austerity programs in all of Europe, the economy of Ireland registered the most growth (2.7 percent), followed by Sweden (1.4 percent) and Portugal (1.1 percent).

At the bottom end, Lithuania's economy shrank by 3.9 percent compared to the last quarter of 2009. Other economies with a shrinkage in economic activity included Austria, Finland, Estonia, Romania, Slovenia and Greece.

In Britain, the latest report by the Office for National Statistics (ONS) increased the estimate for the economic damage suffered since the eruption of the financial crisis in the autumn of 2008. The ONS now says the British economy contracted by 6.4 percent, instead of its initial estimate of 6.2 percent, from its peak in the first three months of 2008 to its trough in the final three months of 2009.

The economics editor of the *Guardian*, Larry Elliott, concluded his summary of the report: "Exports are struggling, the consumer sector is depressed, and the prop from the public sector is about to be kicked away. The second half of 2010 will be dominated by talk of double-dip recession."

With economies across the continent either in the doldrums or shrinking, the IMF noted that there are significant dangers for the world economy from the continued existence of high levels of toxic assets on the balance sheets of European banks. The IMF report declared that the European banking system is plagued by a "legacy of unfinished cleansing" which has left "pockets of vulnerability, overcapacity, and poor profitability."

Despite the fact that the ECB has kept its interest rates at record low levels to encourage banks to lend, the IMF report noted that banks have pulled back from lending to one another, leaving many European banks to rely on short-term loans from the ECB to stay afloat.

Europe's weakest economies—Greece, Spain, Portugal and others—have seen a steady rise in the interest they must pay to those who invest in their government bonds.

According to an article in the *Wall Street Journal*, a total of $1.7 trillion in euro-zone government bonds must be redeemed in 2010-2011. This is far higher than the levels of refinancing for the US, the UK or elsewhere.

In response to the relentless pressure of the financial markets, virtually all of the countries of Europe have announced austerity measures which threaten to further depress economies already suffering from rising unemployment and slumping consumer demand.

Jose Vinals, director of the IMF's monetary and capital markets department, said last week that Europe's debt and banking problems "could spill over to other regions and stall the global recovery."

The IMF called upon the euro-zone governments to make the EU's emergency €500 billion rescue fund for European economies "fully operational" and appealed to the ECB to prepare to make new purchases of government bonds. It also called on the EU to explain how it intends to shore up banks that fail stress tests.

The stress tests of European banks, the results of which are due to be published on July 23, are modeled after the tests carried out last year on US banks, and are just as worthless. Although presented by Trichet last week as a means of forcing banks to "open their books," the European stress tests are utterly anodyne.

Under the headline "Banal Findings," the *Financial Times Deutschland* summed up the opinion of the financial world, commenting caustically: "[T]he question is how long investors will let themselves be treated as stupid… the investigation will hardly bring something to light that isn't already known […] The reason for this farce is obvious: European governments had to decide to publish results in order to calm the markets [...] But in case something really disturbing does emerge about the situation of the banks, they don't have a plan. In any event, the tests are designed so that, in the end, no bank will fail them."

Anton Hemerijck, professor of institutional policy analysis at VU University Amsterdam, warned recently: "In a panic move, Northern Europe could adopt stringent austerity policies that would snuff out any prospects for growth. The countries of southern Europe are depending on their northern European neighbours to provide the impetus for their economic recovery. If this does not happen, we may well be in a period of calm before the storm."