The spectacle of insanely authoritarian policing in Ferguson, as well as media jitters over ISIS and ongoing reports of action in Gaza and Ukraine, has shifted attention a bit away from simply lousy economic results from Europe. A Financial Times overview:

This year was supposed to be the year the eurozone recovery took root – gathering enough pace to create jobs and spur investment.

Instead, growth stalled between April and June, leaving the currency area lagging behind other advanced economies and raising doubts about whether policy makers have done enough to stamp out the twin threats of stagnation and deflation.

The economy is still far smaller than six years ago, unemployment is in double figures and debt burdens in some areas are high.

Naked Capitalism readers will not be surprised at this outcome. We've said consistently that austerity would backfire and lead the contraction imposed on the periphery to infect the core. Indeed, Germany registered a small contraction in GDP in the second quarter and France was at stall speed. The results were so troubling that Bloomberg's editors cleared their throats:

All three of the euro area’s biggest economies — Germany, France and Italy — are failing. Germany’s output actually fell in the second quarter. So did Italy’s, for the second consecutive quarter. (Whether this is a new recession for Italy or a continuation of the old one is debatable.) The European Central Bank currently forecasts a rise in euro-area output of 1 percent this year. Expect that to be revised down next month.

With inflation in the euro area running at 0.4 percent — way below the ECB’s target of less than but close to 2 percent, and far too close to outright deflation — why isn’t the ECB trying harder to ease monetary policy? Its official answer is that it adopted new measures in June, including an expanded program of support for bank lending. These, it says, should be given time to work.

The problem is that the editors then call for more aggressive action by the ECB. Monetary stimulus is simply not remotely an adequate substitute for government spending. Even the austerian IMF has been forced to acknowledge that fact. Admittedly, they've done that in techno-speak, by stating that it has found that fiscal multipliers are almost always greater than one, meaning that government spending produces GDP growth greater than the spending rise. So even if on paper debt levels rise, the critical debt to GDP ratio falls because the increase in the denominator more than offsets the rise in the numerator.

So to the extent that European officials rouse themselves to address these alarming results, they will administer the wrong
And remember, these faltering results came in before the so called Tier Three economic sanctions against Russia went into effect. A new article in Project Syndicate argues that if they prove to be effective, as in they damage Russia in a meaningful way, the blowback to Europe will be even worse. The apparent assumption among Western policy-makers seems to be that Europe has enough fuel stockpiled that Russia will suffer from the loss of income before Europe feels the effect of higher energy prices due to any supply constraints Russia might impose. But the experts appear to have overlooked the fragility of Eurozone banks. From Marcel Fratzscher at Project Syndicate (https://www.project-syndicate.org/commentary/marcel-fratzscher-warns-that-western-financial-restrictions-imposed-on-russia-could-backfire):

The problem with financial sanctions is that no one knows precisely how they will unfold – especially in an economy as large as Russia's. If they prove to be more effective than intended, they will pose a serious threat to global financial stability.

The restrictions on Russian banks operating in Europe and the US appear modest. The banks can still access money markets, cover their short-term financing needs, and count on the central bank for support. But investors' risk appetite could easily shift, spurring them to withdraw large amounts of capital. Though Russia's public debt is modest, its foreign-exchange reserves large, and its economy much stronger than in 1998, once the herd is running, it is impossible to stop it.

Europe’s banks have extended almost €200 billion ($268 billion) in loans to Russian institutions and firms, and hold a significant share of Russia's euro-denominated assets, making them especially vulnerable. Moreover, the eurozone’s current stress tests may well reveal significant capital holes in major European banks in the coming months. Having just emerged from a deep recession, financial disruptions could easily cause Europe to slide back into recession, particularly given the eurozone economy’s close links to Russia via trade and energy.

Compounding the problem, no one truly understands the precise connections among Russian and European institutions and markets. The collapse of LTCM in 1998 was completely unexpected. Is Europe today prepared to deal with a similar failure of an important financial institution?

The financial sanctions on Russia are not targeted, temporary, or fully credible…Once these sanctions begin to bite, no one can say who will be hurt – or how badly. And, as Russia’s experience in 1998, and Argentina’s after 2002, demonstrated, the process of restoring confidence among market participants is a long and painful one…

In any case, US and European leaders must recognize that all sanctions will have costs – many of them unexpected – for both sides. If they are not willing to risk global financial stability in an unpredictable game of chicken with Putin, perhaps it would be wise to re-think the composition of the sanctions that they impose.

Yves again. I had dinner with Mark Ames earlier this week, and he remarked that the escalation of tensions in Ukraine has done the most to benefit the extremists west Ukraine in the part of the country that was never part of the USSR and Putin himself, as his opponents on the left have either gone silent or moved into support in the face of an existential threat from the US and Europe. So that means that so far, Putin has come out a winner from this battle of wills. American experts seem unduly confident that imposing economic costs on ordinary Russians will erode Putin’s record popularity, but Russia has had such a wild economic ride over the last two decades this seems like an optimistic assumption, particularly if it is seen as a cost imposed by clearly hostile foreign powers. So the upside scenario for the West is not all that likely to play out as hoped, and as Fratzscher stresses, the downside may be much greater than they envision.
This piece is cross-posted from Naked Capitalism (http://www.nakedcapitalism.com/2014/08/is-the-west-risking-financial-blowback-from-sanctions-on-russia.html) with permission.


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