Spectre of ‘lost decade’ haunting Europe

By Claire Jones in Lindau

When Nobel Prize-winner Joseph Stiglitz was asked in Germany this week if the country and its neighbours would suffer a lost decade, his response was unequivocal.

"Is Europe going the same way as Japan? Yes," Mr Stiglitz said in Lindau at a meeting for Nobel Laureates and economics students. "The only way to describe what is going on in some European countries is depression."

Dire gross domestic product figures, which showed the eurozone’s recovery had stuttered to a halt in the second quarter, and inflation at a four-and-a-half year low of just 0.4 per cent in July have been a stark reminder of the problems befalling the world’s second-largest economic bloc.

Hopes of a meaningful recovery this year have faded, overtaken by concerns that a rise in geopolitical tensions could worsen conditions in the months ahead.

Beyond the latest figures, the big picture is bleaker still. Despite hopes that the worst ravages of the region’s sovereign and banking crises are behind it, the eurozone’s economy remains smaller than it was before the collapse of Lehman Brothers in the autumn of 2008.

With debt burdens worryingly high in parts of the currency area, low inflation and little growth risk causing another crisis. That has bolstered calls for the European Central Bank, facing price pressures of less than a quarter of its target, to embark on broad-based asset purchases immediately.

The ECB has signalled it will not embark on quantitative easing until at least the end of the year, preferring instead to gauge the impact of the package of measures announced in June, which include up to €1tn in cheap loans for the eurozone banks. The central bank further believes its health check of the bloc’s biggest lenders, whose results will be announced in October, will help to boost investor confidence.

The governing council will also hope that signs the Bank of England and the US Federal Reserve are beginning to consider raising rates will weaken the single currency, boosting exports and lifting inflation.

But waiting carries risks.

John Llewellyn, of Llewellyn Consulting, said: “QE by the ECB looks almost an inevitability. But it would probably have to be massive. And having left it so late, with low-growth expectations now embedded; with deflation an increasing spectre; and with only a limited availability of financial instruments to buy, the ECB may well have missed the boat.”

Ken Wattret, economist at BNP Paribas, said: “The longer the inflation rate is allowed to stay so low, and continually approach zero, the smaller the cushion against deflation. Inflation expectations can also suddenly turn into something much more destabilising. The experience in Japan is a warning in both respects.”

Mario Draghi will speak at the Kansas City Federal Reserve’s Jackson Hole’s symposium on Friday. But the ECB president has already insisted that the fate of the currency bloc’s recovery lies in the hands of governments; more monetary stimulus would be of little use unless national politicians make commitments to reform business practices, he said earlier this month.

Though Germany’s downturn is viewed by many as a blip, economists believe the problems in France and Italy, the region’s second and third largest economies, are more persistent.
Neither country has grown at all this year and a tense time in Brussels looks likely in the weeks ahead as leaders ask for leniency on budget deficit target. Berlin has already signalled it will resist their efforts, with Angela Merkel, Germany's chancellor, saying on Wednesday in Lindau that it was possible to achieve economic growth and cut spending.

Analysts warn political intransigence and lack of leadership have undermined confidence.

“Policy makers, and most economists, have forgotten the powerful self-fulfilling nature of expectations,” Mr Llewellyn said. “If businesses expect little or no growth in demand, they do not invest in new capacity. Demand remains weak; business expectations are thereby fulfilled; and stagnation results.”

The latest figures on GDP and inflation have also renewed arguments that the structure of monetary union is flawed. While neither the US nor the UK are back to full strength, both of their economies have surpassed their pre-crisis peak. Rather than mirroring its counterparts to the west, the eurozone has begun resembling Japan, which has faced a decade-long struggle to eliminate deflation and stagnant growth.

Unlike Asia’s second-largest economy, however, where joblessness remained under 5.5 per cent, unemployment in the currency area is 11.6 per cent. If it does come, growth in the months ahead looks set to remain too weak to dent joblessness.

“Europe has very talented people and [if] country after country is not working, it has to be a systemic problem. The basic problem was that it’s not an optimal currency area,” Mr Stiglitz said. “Combining flawed structure with flawed policies has been devastating.”

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