Brace for European Financial Armageddon

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The Euro was heading for a crisis wrote Oliver Hartwich in the August 2019 of the IPA Review, and now it's here, as he details in a new article (reprinted below) on what Europe now faces as a result of the Euro's inherent flaws and subsequent mismanagement.
Dr Hartwich is Executive Director of the New Zealand Initiative and a German born economist who knows what he's talking about. I was honoured when he agreed to review for the *IPA Review* former IMF official Ashoka Mody's book on the failures of the Euro, *EuroTragedy: A Drama in Nine Acts.*
His latest article, published at *newsroom* and republished here with kind permission of the author, quotes Mody's current take on the crisis engulfing Europe in real time. It is sobering reading and a reminder why policy makers must remain focussed on the social and economic impacts of the pandemic, not just the immediate health impacts.

Brace for European financial Armageddon

An almighty economic earthquake is in the making, and it is going to hit Europe hard, says Oliver Hartwich

Milton Friedman was wrong about the euro currency.

Before its introduction, the godfather of monetarism predicted Europe's monetary union would not survive its first recession. Well, with the combined alchemy of European governments and the European Central Bank (ECB) the euro muddled through the 2008 Global Financial Crisis (GFC). Just.

But maybe Friedman only got the timing wrong? Perhaps the euro will fail in its second recession?

Because that scenario is looking increasingly likely, thanks to the Covid-19 crisis.

In this column a couple of weeks ago, I explained why Covid-19 will wreck the Italian economy. A few days later, Ashoka Mody, a former International Monetary Fund director and author of the most comprehensive history of European Monetary Union, estimated that Italy would need a bailout of between US$500 billion to US$700 billion. But that was a week before the Italian Prime Minister closed all non-essential business in his country.

And of course, it is not just Italy. The German federal government has put together measures worth up to €600 billion. The European Central Bank announced a €750b "Pandemic Emergency Purchase Programme" which calmed markets for about half a day. The European Commission has just abolished the EU's fiscal rules for the crisis, allowing countries unlimited debt and deficits.

The coronavirus started as a global health challenge, which will test national hospital systems to their limits over the coming months and perhaps years. We are not even at the end of the initial stage yet.

However, the financial fallout from this crisis will last even longer, much longer. And it will be catastrophic. Let me explain why by putting the current crisis into perspective. For that we need to think back twelve years.

> .. The euro crisis was tough. It was an economic and political nightmare … Yet by comparison, the implications of Covid-19 may be several times worse.

In September 2008, financial services company Lehman Brothers collapsed, triggering the early stages of the brewing GFC. In the wake of Lehman, the world's financial system was on the brink and a string of companies either failed or were bailed out.

A year later, in 2009, the financial contagion had moved to Europe. When Greek Prime Minister George Papandreou revealed a much higher budget deficit than previously estimated, the news spooked markets. Fearing a repeat of the Lehman disaster, Greece was effectively cut off from capital markets.

The rest is history. Portugal, Ireland, Italy, Cyprus, Spain and of course Greece all needed assistance for their governments or banking systems.

To deal with the crisis, Greece had to be bailed out not once but three times. The EU introduced a European Stability Mechanism with €500 billion lending power. When in July 2012 the ECB's then-President Mario Draghi said he would do “whatever it takes” to save the euro, this was what he meant. The bank's balance sheet ballooned as it pumped in several trillion euros to stabilise the financial system.

That late last year the ECB's bank rates were still about zero percent ten years after the debt crisis began, shows the crisis is still not over. It was only on hold. Though some European economies like Ireland and Spain recovered substantially, others like Italy, France and Greece never went back to a proper growth path.

No doubt, the euro crisis was tough. It was an economic and political nightmare. It took countless long night summits in Brussels to get it under control. Yet by comparison, the implications of Covid-19 may be several times worse.

Think about it this way: Even at the worst moment of the Euro crisis, Greek GDP “only” contracted by around 10 percent, Italy by 7 percent and Spain by 4 percent.

The size of economic corrections due to Covid-19 are likely to be larger. Tourism has ground to a halt in Europe – and even when the crisis is over, it will take a long time until tourists dare leave their countries again. It means you can write off tourism for this year and perhaps the next.

Tourism constitutes a large chunk of Southern Europe's economy. In Greece, it is 12 percent of GDP, in Italy 14 percent and in Spain 15 percent. The collapse of this sector alone is enough to drive these countries into recessions far more severe than the euro crisis. And of course, it is no just tourism. It is every other sector now too.

To make matters worse, the Euro countries are all much more indebted today than during the last crisis. In 2010, Greek debt was 146 percent of its GDP. It is more than 180 percent today. It is the same picture for Italy: up from 115 percent in 2010 to 135 percent now. And for Spain: 60 percent then, 95 percent today.

Also, there are fewer options for somehow stimulating European economies out of a crisis. Back in 2010, monetary policy still had some room to manoeuvre and governments embarked on fiscal stimulus. This time, the ECB cannot simply lower its cash rate. There are natural limits to negative interest rates. It will even struggle to revamp quantitative easing because it will run out of non-junk bonds it could buy.

As for fiscal stimulus, it is hard to convince consumers to buy and companies to invest when whole countries are in lockdown and the economy is tanking.

Finally, at least back in the early 2010s, some countries were doing relatively well. Germany, for example, massively benefited from the lower euro exchange rate and low interest rates thanks to its export-oriented economy.

Today, not a single European country is doing well which means there is limited willingness for European countries to come to each other's aid. They are busy dealing with their own crises. Just witness how Italy has been left alone with its crisis by Europe and now rather gets its medical support from China.

Covid-19 is causing enormous problems, but it is also catalysing existing foibles. Germany's car industry was already struggling last year after an emissions scandal and the move to electric vehicles. Deutsche Bank has been struggling for years. Covid-19 is not the cause of these problems, but it exacerbates them. Just look at Volkswagen's or Deutsche Bank's share prices.

An almighty economic earthquake is in the making. In a few weeks or months, several large European economies will require bailout and assistance packages. These will be several times larger than anything Europe has seen. Yet no country, central bank or institution will be eager or even able to provide them. Even the gargantuan sums on the table now will not be enough.

Incidentally, forget about the International Monetary Fund. It was already stretched when it got involved with Greece last time. It cannot bail out all of Europe when the euro collapses.

That's why Milton Friedman predicted the euro would not last. He had good reasons because he regarded the eurozone members as too different. In 1997, he wrote that monetary union "would exacerbate political tensions by converting divergent shocks that could have been readily accommodated by exchange rate changes into divisive political issues."

Not even Friedman could have foreseen a systemic, multi-layered crisis as the one we are witnessing today. And though he predicted the euro's eventual failure, he did not tell us what would happen afterwards.

We still do not know the answer to that. But we will soon find out. Brace yourself.

Image Credit: A deserted street in Brussels due to the Covid-19 pandemic. Photo: Flickr/Miguel Discart

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