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International Economic Outlook

Europe Catches Pneumonia

By Desmond Lachman

The current global financial market crisis will claim its share of casualties. Prominent among them may be any further expansion of the European Monetary Union. It is also more than likely that today's global financial market crisis will mark the end of any serious challenge by the euro to the U.S. dollar as an alternate international reserve currency. Not only will a deep and long global economic recession put severe strain on the current fifteen-country euro area, it will also expose the acute external vulnerabilities of those twelve Eastern European countries that are aspiring to full euro area membership.

In 1998, when the euro was first launched, Milton Friedman famously warned that the euro would be truly tested by the first major global economic recession. He issued this warning in the belief that, lacking labor and product market flexibility, Europe was not an optimum currency area in the sense that was the case of the U.S. economy. In particular, he strongly believed that at a time of economic difficulty, there would be countries of significance in Europe that would have considerable trouble coping with the euro area's one-size-fits-all approach to monetary and exchange rate policy.

Judging by the unprecedented plunge in global equity prices and the virtual freezing up in global credit markets, there can be little doubt that Europe, along with the United States, is at the start of its worst economic recession in the postwar period. And judging by the bursting of Spain's outsized housing market bubble and by the precarious state of Italy's public finances, there can be little doubt that Spain and Italy will be the two major European economies that will be put to the severest of tests as the global recession deepens, for, in order to cope with their respective problems, Spain and Italy will need the lower interest rates and weaker currencies that continued euro membership clearly precludes. This *Outlook* reviews both the spreading cyclical crisis that has now swept over Europe as well as the structural issues it raises.

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The European Credit Crunch

At the beginning of the year, many observers believed that the global economic cycle would be different this time around. As signs proliferated that the U.S. economy was being hit by its worst housing market and credit market busts in the postwar period, many cherished the hope that the fundamental strength of the European and Asian economies would prevent those economies from catching the proverbial cold when the U.S. economy sneezed. It was also hoped that continued European and Asian economic strength would cushion the blow to the U.S. economy from its housing and credit market busts by allowing the United States to increase its exports to those economies.

In recent weeks, economic data coming out of Europe and Japan suggest that the hope of a decoupling of the rest of the world from the U.S. economic slowdown was nothing more than an idle pipe dream. It now appears that the French, German, Italian, Japanese, and UK economies all contracted in the second quarter of 2008, while there are now the clearest of indications that the

very large housing market bubbles in Ireland, Spain, and the United Kingdom have all finally burst. Worse still, there is now every indication that the European economy is experiencing a credit crunch as virulent as that in the United States.

A distinguishing feature of the current global credit crisis is its severe impact on the European economy. Much like their U.S. counterparts, European banks are being forced to deleverage their impaired balance sheets, while individual European governments are being forced to rescue failing banks. In the last week of September, as many as five European banks of significance failed, which necessitated individual rescue efforts by the governments of the Benelux countries, Germany, and the United Kingdom.

At the heart of the European banks' present credit problems is the fact that these banks in general, and those banks in Switzerland and the United Kingdom in particular, participated heavily in the purchase of U.S. asset-backed securities, including large amounts of subprime mortgages. This heavy participation is suggested by the Federal Reserve's estimates that almost 40 percent of U.S. asset-backed securities were purchased by foreigners. It is also underlined by International Monetary Fund estimates, which suggest that foreigners' mark-to-market losses from poor lending decisions could in the end exceed $500 billion.

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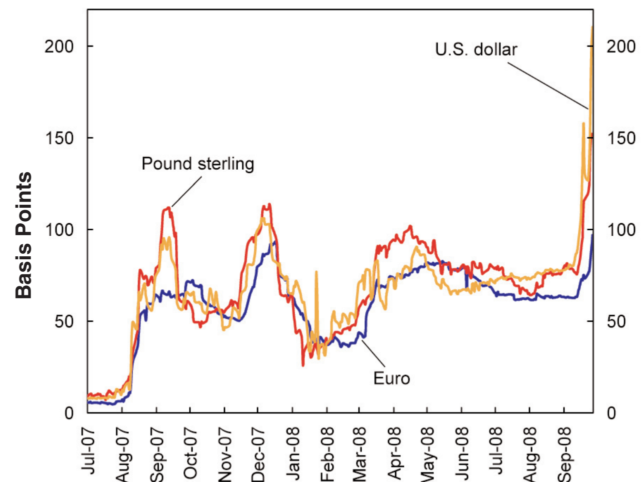
The dimension of the European credit problem is most vividly underlined by the fact that European banks have had to recognize $230 billion in loan losses since August 2007, when the European credit crisis was triggered by the failure of two investment funds at BNP, the large French commercial bank. The losses experienced by the European banks to date are not very different from the $250 billion in U.S. bank loan losses that have been recognized over the same period. And, as in the United States, the European banks' loan losses have not nearly been matched by the raising of an equivalent amount of new bank capital. This would suggest that, in the months ahead, the European banks, like their U.S. counterparts, must be expected to further tighten credit conditions as they try to repair their damaged balance sheets through selling assets and restricting lending.

FIGURE 1
SPREADS OF THREE-MONTH INTERBANK RATES OVER EXPECTED POLICY RATES, 2007–2008



SOURCE: Bloomberg LP.

A further illustration of the global dimension of the credit crisis is the very close correlation between financial market developments in the United States and Europe. Over the past year, the major European equity markets have lost more than 50 percent of their value in U.S. dollar terms, which closely parallels the corresponding decline in U.S. equity values. Similarly, there has been a rather close correlation between European and U.S. interest rate spreads between short-term bank borrowing and short-term official borrowing interest rates (see figure 1). These spreads remain unusually wide one year after the start of the credit crisis despite the massive amount of liquidity that has been made available to the European and U.S. financial systems by the European Central Bank (ECB) and the Fed. The persistence of these wide spreads despite massive liquidity injections suggests that the European and U.S. banks' problems are more ones of solvency rather than liquidity.

In response to the global equity market crash and the freezing up of credit markets in early October 2008, the fifteen European Union (EU) governments finally unveiled a comprehensive plan aimed at salvaging Europe's banking system from potential ruin. The steps outlined included the infusion of major new public capital into the banks, the guaranteeing of bank deposits and interbank lines, and the provision of increased liquidity.

If forcefully implemented, the new plan should in time restore European banks to normalcy. However, the plan appears to have come too late to prevent the

credit crisis from inflicting a real body blow to the European economy that will tip it deeper into recession. It would also appear likely that Europe's banks will experience further substantial loan losses as the recession deepens, which could very well require additional public sector support.

A Highly Restrictive Monetary Policy

A second negative economic shock that the European economy has shared with the United States has been the marked run-up in international oil and food prices in the first half of 2008. While the extent of this shock on the European economy has been softened to some degree by the relative strengthening of the euro with respect to the U.S. dollar, one should not minimize its severity. This shock has caused headline inflation (the most inclusive gauge of inflation) in Europe to accelerate to 3.8 percent over the past year, or to a level around double the ECB's inflation target of "close to but under 2 percent."

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While the European economy is presently experiencing less of an oil and food price shock than the United States and while oil prices have now declined markedly from their peaks, that shock is contributing to a much tighter monetary policy stance in Europe than in the United States. The reason for this asymmetry lies in the fact that the ECB has the single mandate of securing low domestic price inflation. In this respect, the ECB's mandate stands in sharp contrast to the dual mandate of the Federal Reserve, which is required by Congress to seek price stability and satisfactory growth in output and employment.

The Federal Reserve's dual mandate has permitted the Fed to respond to the U.S. housing and credit market busts by aggressively cutting the federal funds rate from 5.25 to 1 percent, despite the pickup in headline U.S. consumer price inflation to 5.5 percent. By contrast, the ECB has felt obliged to raise interest rates to 4.25 percent despite a weakening domestic economy and tighter credit market conditions. It has done so in reaction to European headline inflation being pushed up by higher international oil and food prices.

The relatively tight European monetary policy at a time of great financial market stress is already contributing to declining business and consumer confidence in France and Germany, the euro area's two largest economies. However, stubbornly high ECB interest rates are certain to be particularly problematic for Spain and Ireland, two of the euro area's hitherto fastest-growing economies, which are both now in the midst of full-scale housing market busts.

The severity of Spain's prospective housing bust is underlined by the fact that Spanish housing prices deviated much more from their long-term trend than did those of the United States between 2000 and 2006. It is also underscored by the fact that, whereas residential construction constituted only around 5 percent of the overall U.S. economy in 2006, in Spain, the corresponding figure reached almost 13 percent of GDP. The very likely movement of the Spanish economy into a prolonged housing-market-led recession over the next eighteen months is likely to weigh heavily on European growth. This would seem to be especially likely given the fact that the Spanish economy was responsible for generating around one-third of the euro area's economic growth between 2004 and 2007.

The Burden of a Strong Euro

Among the more striking international currency market developments since 2002 has been the steady depreciation of the U.S. dollar under the weight of its largest external current account deficit on record. The pace of the dollar's depreciation picked up considerably following the start of the credit crisis in August 2007, and, in the immediate aftermath of the Bear Stearns crisis in March 2008, the dollar reached an all-time low since the start of floating in 1971.

Over the past five years, the brunt of the dollar's depreciation has been borne by the euro as most Asian countries actively intervened in their currency markets with the explicit objective of preventing any undue strengthening of their currencies. Indeed, between the beginning of 2002 and March 2008, the euro approximately doubled in value from $0.82 to the euro to almost $1.60 to the euro (see figure 2).

Since March 2008, as signs of recession in Europe have proliferated, there has been a significant strengthening of

FIGURE 2
THE EURO VERSUS THE U.S. DOLLAR

SOURCE: Bloomberg LP.

the U.S. dollar. Even at its present level, however, the euro remains substantially stronger than the $1.18 to the euro, at which exchange rate the euro was launched in 1998. The euro's substantial strength over the past year, coupled with the slowing in the U.S. economy, is now being reflected in a marked slowing in export growth across the major European economies and in Germany in particular.

The challenge that a continued strong euro and any further weakening in the U.S. economy pose for the European economy is underscored by the fact that Europe's export sector has been the primary engine of European economic growth over the past five years. It is also underscored by the fact that Europe's strained public finances do not leave much room for fiscal stimulus, while the continued elevated headline inflation rate is presently constraining the ECB from cutting interest rates. The challenge of a strong euro will be particularly acute for countries like Greece, Portugal, and Spain, which are Europe's high inflation countries and which have lost 30–40 percent in unit labor competitiveness to Germany over the past five years.

A Major Challenge to the Euro

Until very recently, there was a lively debate in academic and financial market circles as to whether the euro might pose a challenge to the U.S. dollar's dominant position as an international reserve currency. Fueling that debate were the persistence of a very large U.S. external current account deficit and the emergence of acute problems in the U.S. asset-backed securities market. Over the past few months, that debate has subsided as markets have begun to focus on the pronounced weaknesses within the European economy that have been reflected in a significant weakening in the euro since the second quarter of 2008.

The prospect of a marked deepening in the European recession over the next year would pose the largest challenge to the idea of the euro as a currency since its 1998 launch. In particular, it will test the idea of whether Europe is an optimum currency area in the same way as is the United States. It will also test the notion of whether a one-size-fits-all monetary policy that a single currency entails can be sustained in as diverse an economy as Europe, where individual member countries are affected differently by the recession and where they lack the requisite product and labor market flexibility.

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The Spanish and Italian economies are likely to be the two main European economies that will determine whether the euro can be sustained in its present form. In the context of a global economic recession and in the absence of an independent monetary and exchange rate policy, Spain's ongoing housing market bust is likely to plunge the Spanish economy into a prolonged and deep recession that could make continued euro membership politically difficult to sustain. By the same token, one must expect a global recession to aggravate Italy's already highly compromised public finances, which could invite market speculation as to whether Italy can restore its public finances to a sustainable path while continuing membership in the euro.

Eastern European Vulnerability

At the same time that financial market doubts intensify about Spain's and Italy's ability to resolve their problems within the constraints of continued euro area membership, market attention is now focusing on Eastern Europe's present acute external vulnerabilities. These vulnerabilities are most vividly underlined by the unusually wide external current account deficits that characterize the

region. External current account deficits in Bulgaria and Romania now exceed 20 percent of GDP, while in Estonia, Latvia, and Romania they exceed 10 percent of GDP.

Even in Hungary, Poland, and Slovakia, external current account deficits are now in excess of 5 percent of GDP, and these deficits are far from fully financed by foreign direct investment inflows. Making matters worse, until the present crisis, these countries had allowed their currencies to appreciate significantly against a strong euro, and they had become highly dependent on European export markets for generating domestic growth. Exports to Europe account for as much as 20–40 percent of those countries' GDP, making those countries highly sensitive to any slowing in euro area economic growth.

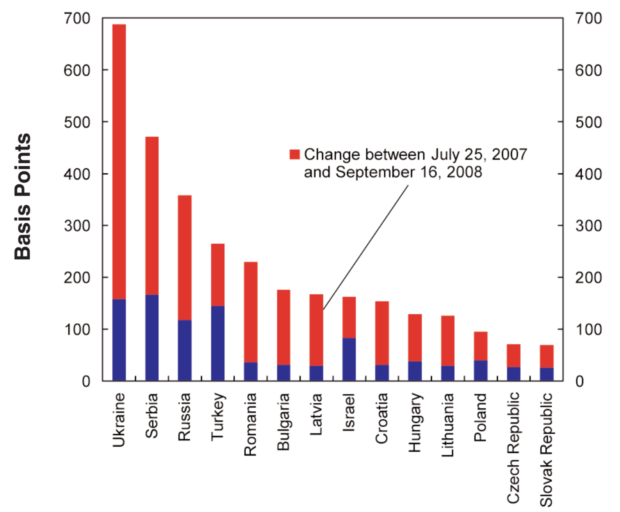
A further dimension of Eastern Europe's acute external vulnerability is the very high degree of financial market risk in the Baltic countries, Bulgaria, Hungary, and Romania. All of those countries have very high shares of foreign-exchange-denominated loans in their economies, which implies heightened vulnerability in the event of any substantial depreciation of their currencies.

In the context of a severe global recession, market participants must be expected to start worrying that substantial currency weakness in Eastern Europe will make it very difficult for those countries to meet the Maastricht criteria for full euro area membership anytime soon. And those doubts will be reflected in yet a further widening in Eastern European credit spreads that will make it all the more difficult for Eastern Europe to unite with the rest of Europe.

Eastern European countries would be making a grave mistake in assuming that the present global economic financial market crisis is but a passing phenomenon. With global credit markets having frozen and global equity prices having declined by more than 30 percent since the start of this year, Eastern Europe should be bracing itself for a prolonged period of pronounced global economic weakness.

The more than probable stress that the global economic crisis will have on Eastern European financial and exchange markets could have a material impact on those countries' economic growth and inflation prospects. If the Eastern European countries are to weather this storm in a manner that allows them to keep alive their hopes of eventual EU membership, they will need to resist the pressures that will inevitably arise for populist fiscal measures that might cushion the crisis but that could put attainment of the Maastricht criteria out of reach for an inordinately long time.

FIGURE 3
SOVEREIGN SPREADS,
JULY 25, 2007–SEPTEMBER 16, 2008



SOURCE: Bloomberg LP.

Policy Implications

In the months ahead, the European economy will experience strong headwinds. This will be the direct result of the continuation of the global credit crisis, a less robust international economy, the continuation of relatively high domestic interest rates, and the further unwinding of large housing price bubbles in a number of key European economies. The very likely deepening of Europe's recession in the second half of 2008 will be occurring at the same time that the U.S. and Japanese economies will also be moving deeply into recession.

The anticipated global recession will have the benefit of attenuating the inflationary pressures that are in evidence in a number of major economies. In particular, one should expect a further decline in international oil and food prices on top of the 40 percent decline from their peaks already experienced in recent months. At the same time, one has to expect the intensification in global protectionist pressures that could very well turn the tide against any further trade liberalization.

Three policy implications would seem to flow from the economic scenario outlined above. First, European policymakers should be more sensitive than they currently appear to be to the very real downside risks to the European and global economic outlook, especially in light of the beneficial effect that lower international oil and food prices will have on the European inflation

outlook. In particular, the ECB should now be adopting a less hawkish approach to monetary policy, and it should stand ready to cut interest rates as needed to support a flagging European economy. In addition, Europe must make every effort to forge a common approach to the credit crisis presently afflicting its member countries.

Second, in light of the weakening European economy and against the backdrop of the prospective fading of the second quarter U.S. tax rebate program, U.S. policymakers should not be counting on continued rapid export growth to provide the same sort of support to the U.S. economy as it has done to date. This heightens the need for additional policy measures in the United States to arrest the downward spiral in U.S. house prices, which threatens to intensify the ongoing global credit crisis.

Finally, policymakers in both the United States and Europe should be alert to the rising tide of protectionism. In that respect, they should make every effort to heighten the public's awareness of the dangers of a renewed global lapse to protectionist policies.