On Global Crisis

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The epicentre of the global economic crisis is now Europe. As the world watches each move in that continent with bated breath, it is evident that whatever happens, the current economic structure and trajectory in the region are no longer viable. But any change - whether in the form of a break-up of the currency union or a revision of its structure towards greater fiscal union or just a lingering slow motion death marked by massive social and political tension - will have huge implications not only for Europe but for all of global capitalism.

The combination of inflexibility, denial and lethargy that has characterised economic strategy in the European Union bodes ill for the prospects of any immediate resolution. The talk at present is all about Greece, and the uncertainty generated by the recent elections in which the Greek people comprehensively rejected the parties that have supported the severe and counterproductive austerity measures being imposed on them by the European Union in return for halting, niggardly and ineffective bailouts. No government could be formed, so new elections are slated for June 17, and already other European leaders (including Cameron of the UK whose own country stayed out of the monetary union) have been openly bullying the Greek electorate, threatening them with the most dire consequences if they vote for the parties that are demanding a revision of the austerity.

But this perception, that popular resistance to austerity measures is responsible for the current crisis, is wrong, because the drive for fiscal austerity is completely misplaced in the first place. The point that sensible economists have been making for a while - that fiscal tightening in this context is self-defeating because it reduces GDP growth and thereby fiscal revenues, and so makes the fiscal consolidation targets even harder to reach - is finally being accepted by many governments, even though Germany continues to resist.

Greece's national income is already nearly 30 per cent lower than it was four years ago, and it cannot hope to recover (and therefore be in a position to repay debts) with the current strategy that is only making output fall further. And Greece is just a small but extreme case of the strategy that is being imposed on all the "peripheral" countries in the Eurozone that have debt problems. Ireland, which was seen as a star performer because it has rigorously fulfilled all the draconian austerity measures, is still struggling to grow, as is Portugal. Spain's huge economy is being pushed into a downward spiral as the asset deflation of the collapse of the construction boom combines with reductions in public spending to throw more people out of employment and incomes to fall further. Italy is set to join that group, with massive implications for all of Europe.

Obviously, with this trajectory, it is only a matter of time before one or more of these countries have to default on at least part of its debt and then leave the currency union. This can only be averted if the Union itself becomes more like a real currency union, with a common bond across all countries, common deposit insurance for all banks within the zone, and fiscal transfers to assist regions in distress. This is being opposed to the teeth by Germany and some other North

European countries, so the question is who will blink first. At the moment, without significant policy change, it seems that we are headed for the endgame.

The idea that European policy makers are prepared or that financial markets have now "priced in" the possibility of Greek default and exit from the common currency, is laughable - not least because the full implications are impossible to predict. It is foolish to believe that the costs of exit are bad only (or dominantly) for Greece: they are actually likely to be even worse for the Eurozone, indeed for the European Union as a whole, including the non-euro member countries.

There is no formal mechanism for a member country to leave the Eurozone - there is no legal or procedural framework in the European Union treaties. So what exactly it involves in terms of legal issues and the continued membership of the country in the European Union is also unclear. In any case, even a limited exit of a single relatively small country from the currency union is unlikely to be orderly or manageable. Despite all claims to the contrary, it is impossible for the European Union to create an effective "firewall" between Greece and other peripheral economies of Europe that are currently under pressure. This is because the exit of any one member creates a fundamental uncertainty with respect to other members. Once it is revealed that membership of the Eurozone need not be permanent, financial markets will inevitably turn to other economies that may be next in line.

All money is essentially about trust, and once this trust is shaken, it has repercussions. Once the genie of possible exit from the currency union is out of the bottle, it cannot simply be shoved back into it. So other "weaker" economies will immediately face the pressure on their domestic banking systems, as investors both large and small begin to doubt whether their deposits will really continue to be denominated in Euros in future. Negative expectations very rapidly become self-fulfilling in such situations, as we know from the classic pattern of a run on a bank. Even Mervyn King, governor of the Bank of England, has accepted that while it may not be rational to start a bank run, it is rational to participate in one. Indeed, it would be individually stupid not to do so, in such conditions.

As it happens, bank runs in Europe have already started. So far they have been rather slow, but such processes can very quickly accelerate and precipitate a crisis. (All financial crises are usually associated with bank runs.) Deposits in Greek banks have fallen by more than one-third since the beginning of the crisis, and €1.2 billion was withdrawn in just two days after the inconclusive election. But banking systems in other countries that do not have such political instability are already experiencing similar slow runs. Deposits held in Spanish and Italian banks have also fallen by a total more than €300 billion since the start of 2012. The "flight to safety" of Europeans has led to increases in German bank deposits of approximately an equivalent amount. But since the banks of North European countries are also deeply implicated in lending to the peripheral countries, they are not really safe either. (Incidentally, US banks will also be affected.)

If the crisis has not yet exploded, it is because Greek and other banks are being propped up by funds transferred in the form of "emergency liquidity assistance" from the European Central Bank (ECB). The terms and amount of such funds are kept secret, but are estimated to be around €500 billion so far, with €100 billion going to Greece alone. This is happening even as the ECB has officially excluded four Greek banks from ordinary liquidity operations because of the

ongoing political uncertainty - forcing them to rely on such secret emergency liquidity. Ireland has also been the recipient of fairly prolonged "emergency" assistance of this nature. But such quiet transfers, which have been critical in allowing the monetary system to continue at all, would have to reach stratospheric proportions if the bank runs intensify. Without explicit fiscal transfers or immediate creation for Eurobonds that transfer the burden, disorderly defaults are inevitable.

The doomsday scenario has been summarised by Martin Wolf of the Financial Times (17 May 2012): "The mechanisms at work would be powerful: runs; the imposition of (illegal) exchange controls; legal uncertainties; asset price collapses; unpredictable shifts in balance sheets; freezing of the financial system; disruption of central banking; collapse in spending and trade; and enormous shifts in the exchange rates of new currencies. Further government bailouts of financial systems would surely be needed, at great cost. Big recessions would also worsen already damaged fiscal positions."

There is no doubt that Europe has more to lose than Greece from such a disorderly default. Europe is now facing a banking crisis of potentially enormous proportions. The only way to prevent havoc is to create a common deposit insurance and bank resolution regime that covers the entire Eurozone, as well as the issue of jointly held Eurozone bonds. These are now seen as more acceptable: France under Hollande has already declared its support, but there is continued (though increasingly inexplicable) German opposition.

It is still not clear how this will play out, but the prognosis is not encouraging. Part of the problem is the lack of recognition in surplus countries that they have been huge beneficiaries of the monetary union. Far from subsidising the profligacy of the periphery at their own cost, they have been able to preserve employment through export surpluses and then used these to finance investments (mostly in private non-tradable activities like real estate and some public spending like arms purchases in Greece) that provided their banks high returns for a while and also further benefited their own industries. In such a context, non-symmetric adjustment, by making only the debtors suffer and pay, is not just unfair - in Europe today it is also simply not possible.

Without greater, more forceful and immediate expressions of political solidarity and will to preserve the monetary union on the part of surplus countries like Germany, the Euro is unlikely to survive for long in its current form.

So the trigger of this latest round of fierce instability in the ongoing global crisis is likely to be Europe. But that does not mean that other regions of the capitalist world order are in good shape economically. The perception of successful "decoupling" was at first interrogated and then somehow reinforced by the Great Recession of 2008-09 and its aftermath. The latter was because several emerging economies - notably China, but also India, Brazil, Argentina and a number of other economies - not only experienced less severe downswings but also recovered faster and more strongly to exhibit GDP growth rates similar to those of the previous decade. But the past year has suggested that both internal trends within regions and the closer integration of regions will make it harder to reproduce such differential performance in the coming recession.

The world's largest economy, the United States, is currently perceived to be on a path of recovery. There is much talk of the slight increase in output in the past year, the fall in the unemployment rate, and that fact that some industries are beginning to relocate factories back in the US. But this is a halting, uncertain and easily reversible recovery. Indeed, reverse is almost inevitable, because the basic forces underlying the crisis have not been addressed or dealt with.

The current rate of growth of US output - at 2.2 per cent per annum - is sluggish at best. The unemployment rate has fallen only because more people are leaving the labour force (the "discouraged worker" effect) since the number of unemployed remains high at more than 5 million and job creation is slowing down. Businesses are cutting back on investment, which will affect future growth. Worse, previous legislation means that at the end of 2012 the government will automatically be forced to implement sweeping spending cuts and tax increases that are estimated to reduce consumer spending by at least 4 per cent. Headwinds from Europe will intensify the likely downswing. So, despite very loose monetary policy and the most expansionary fiscal policy of all the large economies other than Japan, prospects for the US economy are brittle at best.

In China, the authorities had sought to slow growth because of fears of "overheating" as evidenced by high inflation rates. But the slowdown has been sharper than expected, already leading to calls for renewed state stimulation of the economy. However, there are problems in trying to recreate the real estate and construction boom that has already spiralled out of control, while falls in real estate prices continue to have unpleasant implications for bad loans of the banking sector and for employment in construction, which had been an important part of the increased employment since 2008. There are growing fears that further slowdown in exports can create a "hard landing" for China's economy. The political instability generated by the power struggle within the elite after the fall of Bo Xilai is also likely to have economic implications, though these can still only be guessed at.

In general, given the uncertainties and negative outlook of these major economies, there is no doubt that the world must brace itself for another recession, possibly greater than the recent one - Act II of the ongoing drama. The performance of individual countries in this will depend on the extent to which they are able to insulate themselves by boosting domestic demand in sustainable ways, without further reliance on financial mechanisms that are already too fragile and volatile to last for long.

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