Stimulus versus Austerity: The Crisis of Europe's Economic and Financial System

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Global Research, June 17, 2012
17 June 2012

Region: Europe
Theme: Global Economy

Four and a half years after crisis conditions erupted, nothing's been done to resolve them. The smartest guys around haven't fixed things.

On June 14, rumors circulated about coordinated central bank intervention. European banks are especially troubled. Recapitalizing them hasn't worked.

Expecting more of the same to accomplish what hasn't so far worked is another way of defining failure.

Along with talk of more stimulus, Egan-Jones Ratings, an independent NRSRO (Nationally Recognized Statistical Rating Organization), downgraded French sovereign debt from A- to BBB+ with a negative outlook. Doing so shows core European weakness.

Dutch banks were also downgraded. So were Spanish ones and sovereign Spanish and Cyprus debt. Both countries approach junk status.

Germany shows weakness. Its 10-year sovereign debt jumped over 30 basis points from recent lows. It's troubled by having to fund more bailouts or face euro dissolution issues. It's also pressured by having to shore up the ECB in case it's threatened.

The average Eurozone country has a 500% debt/GDP ratio. Expects more defaults, write-downs, and frantic steps to shore up sovereign debt.

Spanish bonds touched 7% before settling slightly lower. Liquidity isn't the problem. Markets are awash with it. At issue is sovereign and banking sector solvency.

Multiple intervention rounds solved nothing. Neither will more of the same. Structural problems remain unresolved. More time alone is bought. It doesn't come cheap. The price is greater debt, higher service costs, and eventual crisis conditions too grave to fix.

Bad policies don't change basic economic fundamentals. Non-performing European bank loans are increasing. Italy may be the next Spain. Its sovereign yields top 6%. More on what's bad there getting worse below.

Economic growth forecasts are increasing. Europe's recession deepens. Next year looks worse, not better. Synchronized global slowing is occurring with ammunition running out to address it.

Five years ago, OECD countries sovereign debt/GDP ratios were 70%. Today it's 106% and rising. Governments are less able to stimulate growth. Failing to assures greater trouble. Rising debt + higher service costs + falling growth = eventual house of cards collapse.

Germany is Europe's backstop. Bailouts are wearing thin. Over two-thirds of Germans want Greece out of the Eurozone. They're tired of paying for its problems.

People thought the ECB would be Europe's Bundesbank proxy. They were also told Maastricht had no bailout provision. In fact, "risk mutualization" was part of the treaty. Two trillion euros were created to deal with crisis conditions. German taxpayers bore one-third of the cost. At issue is for how much longer?

If it's unable or balks, what then? On the eve of Greece's election, it's unclear who'll win. Will a third run-off be needed? Does it matter either way?

Whatever the outcome, Greece is bankrupt. Its debt is impossible to repay. Increasing it makes things worse. Ordinary people face harder than ever hard times, not relief no matter who's president or controls parliament.

They have three choices – starve, leave, or rebel.

Greece must choose between austerity or default and restructuring, whether in or outside the Eurozone. Leaving is no minor matter. Global economies will manage. Adjustments will be made. They'll take time.

Lorenzo Bini-Smaghi calls Grexit a political and economic nightmare. Leaving the euro, he believes, requires also exiting the EU. Greece could also be sued. He sees a lose-lose situation. Either choice assures trouble.

Citigroup economist Michael Saunders believes Grexit is virtually certain. Perhaps by New Year's day 2013 it'll come.

He "assume(s) that Greece will leave EMU in early 2013, followed by a sharp currency devaluation" and economic contraction. He also thinks contagion will be limited, June 17 election results will be inconclusive, and the Troika will ride to the rescue.

Leaving may be another Lehman moment. Expect painful readjustments, geopolitical tensions, market turmoil, trade frictions, greater crisis, and eventual stability provided counterproductive policies are reversed.

Nothing so far suggests it. Austerity exacerbates hard times. Jobs are destroyed, not created. People are running out of money and patience. Continental unraveling is increasing.

Suicides are rising. Garbage isn't collected. Other public services are eroding. Vital ones like healthcare and education are affected. Greece faces collapse. Spain is close behind.

Public heath crises loom. Serious illnesses aren't treated. Lifesaving drugs are in short supply. Hospitals aren't operating properly. An Athens one said basic items are running out. They include cotton wool, catheters, gloves and examining table paper covering.

Greece was ordered to cut healthcare spending from 10 – 6% of GDP. Imagine any country reducing medical spending by 40%. Imagine desperate people needing care unable to get it. Imagine disease and death tolls rising. Imagine public anger exploding.

Italy potentially is Europe's biggest problem. If it goes, so does the continent. It's troubled. It's too big to bail out. No one's sure how much times remains to shore up its economy and other EU ones. George Soros and IMF head Christine Lagarde say less than three months.

Italian debt auctions aren't encouraging. One year paper went for 3.972%. A month ago it was 2.34%. Longer dated debt yields are rising. Italy is where Spain was weeks ago.

Appointed Prime Minister Mario (three card) Monte's tax increases are backfiring. Value-added receipts are down. Economic conditions are troubled.

Harvard Professor Alberto Alesina said:

"This government has raised taxes too much. It would be much, much better to lower spending."

How that will help when stimulus is needed he didn't explain. Economic deterioration is increasing. Q I results show 0.8% contraction after slipping 0.7% in Q IV, 2011.

Italy is Europe's third biggest economy after Germany and France.

It's in serious trouble. It's problems are severe. Its sovereign debt burden is huge. It's currently at around 120% of GDP and rising. It's about two trillion euros. When economic growth is needed, it's declining.

Its industrial production dropped for nearly two years. It's about one-fourth lower than when 2008 crisis conditions erupted.

Unemployment is growing. It approaches 10%. For youths it exceeds 30%. Business confidence is down. Consumer confidence is at record lows.

According to Bloomberg, Spain and Italy "appealed to European policy makers to step up their response to the financial crisis after a 100 billion euro ($125 billion) lifeline for Spanish banks failed to calm markets."

Societe Generale chief European economist James Nixon calls Italy the "next domino" to fall. "The southern European economies are effectively in free-fall and market appetite for southern European debt is rapidly drying up. I can't see anything to turn that dynamic around," he said.

At the same time, Germany's parliament hasn't approved the European Stability Mechanism (ESM) bailout fund. Internal wrangling continues.

ESM is supposed to be operating by July 1. German approval is required. Chancellor Angela Merkel wants two issues passed together. Opposition Social Democrats (SPD) and Greens want a financial transaction tax, as well as measures to stimulate growth.

A June 21 meeting is planned. Unresolved issues separate both sides. Some SPD members threaten to delay the bill until fall. Eurozone countries have until yearend to ratify it.

Parliamentary elections are over a year away, but political posturing affects policy.

Germany also prioritizes fiscal/political union ahead of resolving other problems. It wants European countries bound under one size fits all rules it controls. They include austerity and debt reduction. These measures haven't worked and won't now.

With Germany calling the shots, Gordian knot diplomacy remains unresolved.

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