Europe digs its economic grave while the ECB answers to no one

The European Central Bank preens as the last guardian of virtue in a sinful world, yet its actions are devastating the public finances of almost every country under its care.

By Ambrose Evans-Pritchard
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Without a radical change of strategy, the ECB risks pushing the weakest states into a debt-compound spiral that can only end in bond crises and/or the disintegration of Europe's monetary union – whichever comes first.

The International Monetary Fund says the eurozone will contract by 4.8pc this year, worse than the UK (-4.2pc) or the US (-2.6pc). The deepest damage will occur next year as Europe remains mired in slump, even as the rest of the world recovers. It is the length of recession that matters most for jobs, social stability, and public finances. I am not easily shocked any longer but I did sit up when Spain's budget chief Luis Espadas said the economic collapse could "easily" push Spanish public debt to 90pc of GDP by 2011. This is up from 36pc in 2007.

Nobody knows where the tipping point lies on public debt, though anything above 100pc of GDP in a currency union is courting fate. Some are already there. The European Commission says Italian debt will jump to 116pc in 2010. Greece is vaulting back to 109pc, Belgium to 101pc, France to 86pc.

Even German finances are falling apart. After screwing down spending to balance the books, discipline has broken down. Berlin says the deficit is heading for 6pc next year, taking debt to 82pc. This is happening all over the world, of course. But the ECB is compounding the effect, whether for reasons of politics, Bundesbank fetishism, or misjudgment. By refusing to join the US, Japan, Canada, Britain, and Switzerland in quantitative easing (QE) the ECB has allowed a contraction of private credit this summer. The M3 "broad" money supply has shrunk since February.

Ignore M3 at your peril. It flashed awarning signal in the US months before the collapse of Lehman Brothers last September; it is flashing the similar warning signals in Europe now.

Professor Tim Congdon from International Monetary Research said the eurozone money figures are "horrifying" and portend a serious crunch ahead. "My verdict is that the senior people in the ECB [and the Fed] have little organised understanding of the debt-deflationary processes initiated in late 2008," he said.

Ireland's M3 contracted at a 30pc annual rate last month, a death sentence for a hyper-indebted economy. The wreckage will be evident just in time for the Irish to vote again – under extreme duress – on the EU's Enabling Act in October. This should make for interesting political chemistry.

In Germany, the *Mittlestand* lobby (BVMW) says half its members are facing a liquidity squeeze, while the strutting finance minister, Peer Steinbrück, has assumed a ghostly pallor. "We must take seriously the threat of a credit crunch in the second half of this year," he said.

Mr Steinbrück has called for a suspension of the Basel II accounting rules in order to rescue banks, and even suggested that the German government undertake direct lending to boost credit. The regulator BaFin has already told us that bad debts are set to "blow like a grenade" this year. A leaked BaFin memo said "problematic" assets have reached €816bn (£700bn), led by Hypo Real with €268bn.

ECB experts think eurozone banks will have to write down a further €203bn by the end of next year. Yet ECB policy-makers seem unwilling to face the implications. Yes, they have injected €442bn in a one-year tender, but the money is not reaching the economy. Simon Ward from Henderson New Star said the ECB is repeating errors made in Japan when it first trifled with QE, relying on banks to pass on credit rather going for massive bond purchases.

Inevitably, Europe's politicians are taking matters into their own hands. They will not sit idly by as millions lose their jobs. If the ECB deflates, budgets must bear the strain, and that is exactly what Europe cannot afford with a birthrate of 1.53 per woman and the onset of demographic decline. The commission says the number of workers per pensioner over 65 will halve from four to two by 2040. Age-related costs will explode by 15pc of GDP in Greece, 9pc in Ireland, Spain and Holland. The populations of Germany and Italy will soon be shrinking.

Viewed strategically, Europe's mix of monetary deflation and rampant deficit spending by the states is nothing short of lunatic.

Needless to say, Britain faces it own colossal mess, but of a different kind. It is the Prime Minister who is taking the country over a cliff, not the Bank of the England. Voters will soon have the joy of sacking him. How do Europe's voters sack the ECB?

http://www.telegraph.co.uk/finance/comment/ambroseevans_pritchard/5811343/Europe-digs-its-economic-grave-while-the-ECB-answers-to-no-one.html