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European (dis)Union?

Lately, the European Union (EU), the world's largest economic bloc, and, within that, the euro zone, are facing major problems: the problems are both geopolitical and economic, critical enough to test European leadership and institutions. As for geopolitics, the issue is Ukraine and Russia (itself battered by the sharp fall in the price of oil and, consequently, the ruble). Russia has obviously not forgotten its once superpower status, and is trying to regain influence in its erstwhile "satellites", or its "near abroad" as it calls them, even as the west makes inroads there. At the time of writing the ceasefire in Ukraine, negotiated last week, seems to be holding, if only uneasily -- but a failure, and consequent stronger economic sanctions against Russia by the west, can hardly be ruled out.

There is also a question mark about UK's continuation as a member of the EU: the ruling Conservatives have promised a referendum on the issue in 2017, should they win the general election in May 2015. Perhaps UK has more to lose in both political economic terms by leaving: as it is, it had little role in the ceasefire negotiations between the EU and Russia. The dominant EU member in relation to both the economic and geopolitical issues is Germany, the country which lost both the major wars in the 20th century!

Turning now to economic problems, there are two major ones: continued Greek membership of the single currency, and the growth prospects in the euro zone.

Grexit: Averted or Postponed?

At the time of writing, it is not clear whether last Friday's agreement between the newly elected, anti-austerity Greek government and the euro zone finance ministers averts or merely postpones the possibility of Greece exiting the euro. It requires Greece to commit to economic reforms desired by its creditors: only then will Greece get funding for the next four months. If the reforms are not implemented and the earlier conditions regarding austerity are breached, funding comes to a halt at the end of June. In short, Greece still remains in the “debtors’ prison”, but may have got a “furlough” for the next few months. The Germans have perhaps forgotten that they themselves needed debt restructuring/write-offs in 1924, 1929, 1932 and 1953.

The crux of the problem is that, after five years of “fiscal austerity” imposed as part of its bailout, economic output has shrunk by a quarter, unemployment is 25%, and even those with jobs and pensioners have seen a sharp fall in wages: as John Maynard Keynes said in the 1920s “*there has never been in modern or ancient history a community that has been prepared to accept without immense struggle a reduction in the general level of money income.”* For the Greek government, reconciling its election promises with what its creditors may insist upon, is going to be a tough balancing act, at a time when most Greek banks are facing deposit withdrawals every day.

Several new books on fiscal austerity are echoing Keynes’ views. Mark Blyth in *Austerity: The History of a Dangerous Idea* sees the preference for austerity as a desire to shrink the state and to protect the comfortable lifestyles in the financial sector. Florian Schui in his *Austerity: The Great Failure* agrees with Keynes that “*austerity is self-defeating: one man’s expenditure is another man’s income”.* (One question: does our Finance Minister get time to read books?)

Deflation in the Eurozone

Despite monetary easing since the financial crisis of 2008 and a huge increase in the size of the balance sheet of the European Central Bank (ECB), as in Japan, the prospects of deflation (negative inflation) and slow/negative growth in the euro zone have not receded. If anything, the possibility of deflation has increased after the sharp fall in the oil price – prices in the euro zone fell by 0.2% in 2014. The money is not reaching the real economy as banks have little appetite for lending, partly because of the Basle III capital standards. The ECB recently announced yet another loosening of the monetary screw promising to pump € 60 bn a month in the economy for the next 18 months, at near zero interest rates: a few European countries outside the zone

(Switzerland, Sweden, and Denmark) have negative interest rates – and not only those administered by the respective central banks: even some corporate bonds maturing in a year or less are yielding negative returns! Meanwhile, the euro has slipped 10% against the dollar and the yuan, which should have helped economic recovery: but there are few signs so far. (Media commentators ascribe the fall to ECB's monetary easing, but more on that in a later article).

There are several major constraints on monetary easing and the fall of the currency pushing up prices and growth:

⇒ Demographics. Europe is the second oldest major economy after Japan;

⇒ Fiscal austerity, on which Germany will not relent;

⇒ The fall in the oil prices.

As for the first, the only long term solution perhaps lies in encouraging immigration as the US does. But in the short term, so long as unemployment and anti-immigrant sentiment persists, this is not a politically feasible proposition.

Given the series of economic and financial crises over the last five years, John Peet and Anton La Guardia wonder in *Unhappy Union* whether "*Monetary union* (should)*…have been the culmination of political union, not the means to achieve it*".

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