European Trade Union Confederation (ETUC)
Confédération européenne des syndicats (CES)

From recession to depression? – Downwards spirals European policymakers should take care to avoid

The Commission Spring forecasts are devastating. The economy is expected to shrink by about 4% this year with growth positive but still close to zero in 2010. Meanwhile, unemployment will be soaring to levels we have not seen in a long time.

Faced with these dismal forecasts, the ruling consensus among European policymakers seems to be that this is just a temporary, although serious, blip in the business cycle and that Europe has already taken the short-term stimulus action to get the economy back on its feet. The 2% of gross domestic product (GDP) European recovery initiative along with the fiscal policy automatic stabilisers are seen to be sufficient to address the 2009 downturn. In return, many policy makers are already preparing the 'post crisis' situation. So called 'exit strategies' are focussing on how to return to the agenda of 'business as usual': Consolidation of public finances, continuing wage moderation, more flexibility and easy firing are some of the main pillars of this.

However, these attempts to 'return to a business as usual' agenda do not take into account the structural nature of this crisis. This is not just a temporary weakness of the business cycle, this is a structural crisis of the model of 'casino capitalism' itself: Households, banks and companies in many countries are now focused on driving down their high debt burdens. This process will take several years and during this period investing and spending behaviour from the private sector will be depressed. So, even if the recovery shows up next year, demand dynamics and overall growth will not be brilliant.

If policymakers make the mistake of reverting to a 'business as usual' policy agenda while the economy is still suffering the consequences of debt deleveraging, then they risk turning the recession into a long and deep depression. There are at least seven downwards spirals able to prolong the downwards tailspin of the economy.

- **Mass redundancies of the core work force**

Up until now, the crisis has mainly hit the workers on fixed-term employment contracts, while workers on open-ended contracts have been put on short-time working schemes in combination with unemployment benefits. There are, however, time limits: Businesses will not put their workers on short-time working arrangements indefinitely. Restructuring of the core workforce is to be expected in the coming months. When this happens, massive job loss will feed back in the economy and strike another blow to demand and economic activity. And while it is correct that unemployment benefit systems in Europe may cushion somewhat the blow on household income and demand, it also should be reminded that these systems have been hollowed out systematically after a decade of 'making work pay' policies. Moreover, with unemployment and deficits in the social security system rising, a return to this 'make-work-pay' approach and a further weakening of social safety nets can not be ruled out. If this were to happen, insecurity will rise further and economic prospects will get another blow.

- **2. A second wave of financial meltdown**

The economic recession will lead to an increase in default rates on mortgages and corporate loans. International accounting standards will force banks to adjust downwards the rating of these loans in their books. As a result, a new imbalance between banking assets and banking capital will appear. Banks squeeze credit even further and finance to support economic activity will become even more rare: The scenario of Autumn 2008, where banks squeezed credit in reaction to the losses on securitised bonds, is about to repeat itself.

- **3. The Stability Pact all over again**

Public deficits are exploding, even reaching the double of the 3% Maastricht threshold will be breached. If from 2010 on fiscal consolidation strategies are set up to return to the 3% deficit, public deficits would be cut at the exact moment the economy is in this still in the doldrums and cooping with the fall out from the second wave of credit contraction (see above). The consequences of fiscal contraction for an economy that is already weakened will be disastrous.

- **4. Europe being torn apart by financial markets…**

Many central and eastern European countries face difficulties in accessing capital markets. In the process of rebalancing assets with capital, western European bank headquarters are cutting credit flows to their bank subsidiaries in central and eastern Europe at a time the region is estimated to renew finance at a rate of 200 billion a year. On top of this, financial markets are specifically targeting government bond markets and even euro area members are now confronted with soaring interest rate spreads with German bonds. The perverse self fulfilling prophecy of financial markets is back at work: High interest rates undermine public finances, thereby seriously limiting member states' leeway to stabilise the economy and in the end actually triggering the default the market fears.

- **5. …with the IMF, being backed by European funds, destroying the social model in eastern Europe**

If Europe leaves more vulnerable member states outside the euro area exposed to the vagaries of financial markets, then those member states will have no other choice but to turn to international financial institutions, in particular the IMF. However, the track record of the IMF is well known: In exchange for foreign currency loans, countries are forced to cut anything that is social: wages, social spending, workers' rights, public services. Moreover, access to the Commission's €50 billion balance of payment fund is conditional on respecting the IMF adjustment programme. European funds are being used to help the IMF to cut down the social dimension in Europe. For the moment, IMF lending to European member states is limited to Hungary, Latvia and Romania (with a non conditional loan arrangement with Poland) but the risk is that the usual herd behaviour of financial markets would spread contagion throughout the region.

- **6. Wage cuts: Be careful what you wish for**

A collapse of wage dynamics would be another step contributing to the making of the New Depression. Contrary to the idea that wage formation in Europe is rigid, the risk is that wages actually react too forcefully and in too flexible way. A recession of minus 2% will seriously weaken the bargaining position of workers and drag wage dynamics down. If the relationship of the past between wage dynamics and economic crisis holds, a collapse of wage dynamics to a rate of growth close to zero can not be excluded. The danger is that this would tip over low inflation into zero inflation or even deflation, thereby causing a rise in real interest rates. Rising real interest rates in the midst of a recession and against a background of excessive private sector debt loads will trigger yet another round of the spiral going downwards. Debt deflation, similar to the 1930s, is on the cards, especially if some policymakers continue to believe that wages formation processes, trade unions and collective bargaining need to be weakened and use the crisis as an alibi to do so.

- **7. Reform of public pensions systems**

In exchange for allowing short-term fiscal stimulus measures to be implemented, several economic institutions are calling for governments to reform pension systems, for example, by raising the retirement age. The aim is to maintain or improve the credibility in the long-term sustainability of public finances. However, reforms such as these add to the uncertainty and insecurity of workers' at a time when such insecurity is already at peak levels. Workers are very likely to respond to this by doing the opposite and raising savings ratios even further. If this happens, demand dynamics will again be weakened, making it more difficult for the economy to recover.