Monetary shyness in Europe

By Mauro Guillen and Emilio Ontiveros

GLOBAL ECONOMY

Mauro Guillen
Wharton School professor of management
Emilio Ontiveros
Universidad Autónoma de Madrid professor

The eurozone economy is again in recession. Four of the largest economies—France, Italy, Spain and Holland—plus two convalescent ones are still recovering from a bailout, Greece and Portugal, will see their GDP contract this year. European unemployment is at an all-time high.

In some countries, such as Spain, more than 27 percent of the active population is jobless, more than 50 percent among young people.

At the same time, there is no inflation. Still, the European Central Bank (ECB) did not cut interest rates until the first week in May, after more than 10 months without any significant action other than standing ready to buy government bonds if conditions deteriorate and affected countries request it.

Meanwhile, the Federal Reserve, the Bank of England, and the Bank of Japan have deployed an array of unconventional monetary weapons to deal with deflation and stagnation.

The real economies of the U.S., Britain and Japan are actually in better shape than those of most European countries. European leaders seemed to have forgotten the lessons learned in the 1930s during the Great Depression when deflation devastated economies on both sides of the Atlantic.

Since the 1970s even moderate inflation has been portrayed as an economic sin.

Without modest inflation, however, companies put investments on hold and consumers postpone making purchases. Most importantly, inflation helps governments under budgetary duress pay down their debts without increasing taxes.

The call for stronger and more decisive ECB action is not only based on arguments related to anemic growth, unemployment, and low or no inflation.

An even bigger problem has to do with the transmission of monetary policy, that is, with its actual effects on the real economy. In the European southern periphery liquidity offered to banks has not translated into lending to companies, especially small ones.

Moreover, the cost of borrowing is far from uniform across the eurozone. Italian, Spanish or Portuguese small and medium firms borrow at rates 3-4 points above those enjoyed by German firms.

It is important to note that European companies rely on bank credit to a much larger extent than American firms, which have a deeper and more developed capital market at their disposal.

The ECB must be more proactive. One possibility is to expand the market for asset-backed securities collateralized by loans to non-financial corporations.

It is somewhat reasonable for it to be cautious, given the recent history with similar products in the mortgage market.

The ECB has suggested that the European Investment Bank should take a more active role.

The European economy continues to wait for a more decisive approach to addressing the monetary problems that beset the Eurozone.

The global economy, especially big exporting countries such as China, South Korea or Brazil, need the European market to recover quickly. Otherwise, growth around the world will stall.