The Euro Narratives

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Do you remember the anxiety about the imminent breakup of the Euro? In May 2012, Nobel Prize winner, New York Times columnist, and self-declared “europessimist” Paul Krugman was announcing a mighty Eurodämmerung with great fanfare. His “end game” had Greece leaving the Eurozone in a month. Depositors would withdraw massive cash amounts from Spanish and Italian banks and move them to Germany. In short, it was the “end of the euro,” in “months, not years.” Krugman’s drama was actually accompanied by the doomsday finale from Wagner’s Götterdämmerung.

Krugman was not alone with such predictions. In 2012, Time Magazine said that Germany should be the one exiting the Eurozone. George Soros concurred. In August 2013, Krugman wrote a Pre-Mortem of the European currency, adding the lack of a banking union to “all the problems euroskeptics warned about.” Yet in January 2014, Krugman admitted that “it’s now possible to see how this [the Euro] could work.”

The European Central Bank issued for the first time in its history an outlook for the future. The projections through 2016 look positive (a real GDP increase of 1.2% in 2014, 1.5% in 2015, and 1.8% in 2016). ECB’s projected inflation will reach 1.6% by 2016.

Reality check

But not so fast. As the Harmonized Indices of Consumer Prices (HICP) continues to fall, the Euro is facing the specter of deflation. In March 2014, the IMF called for the ECB to cut interest rates and start a quantitative easing program. After ECB’s first meeting in March 2014, Mario Draghi shelved all corrective actions, saying that there was no danger of deflation, and dismissed comparisons with Japan. However, a week later, Draghi changed his narrative saying “the ECB has been preparing additional non-standard monetary policy measures to guard [against deflation] and it stands ready to take further decisive action if needed.”
Decreasing inflation rates raises deflation fears. Source: Eurostat.

While deflation might seem good for consumers who can buy more with their money, households expecting lower prices may put off purchases, thus not stimulating the economy. In addition, deflation increases the real burden of government debts, which normally causes governments to cut spending even further.

Rising Debt in Select Eurozone Countries and Japan. Source: Eurostat.

Japan had almost two decades of deflation. A real estate bubble in the late 1980s triggered a series of economic shocks. Similarities between today’s Eurozone and the conditions that caused Japan’s extended deflation problem have been pointed out by Reuter’s senior economic analyst Paul Carrel: weak bank lending, slow growth, a rising exchange rate, and the central bank’s denial of the deflation danger. But unlike Japan in the 1990s, the EU has managed to clean up some of its banks; and for now, European households are not deferring purchases.

EuroPoint: The Euro is still alive and well. Thanks to Draghi’s quick turnaround, the latest threat, that of “Japanization,” will most likely also be averted.