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Europe's economies

Dangers ahead

Despite the gloating over America's troubles, the euro area looks increasingly fragile—and weakening domestic demand is largely responsible

THERE are few who truly believe any longer that Europe's economies can shrug off bad news from elsewhere. Jean-Claude Trichet, head of the European Central Bank (ECB), now concedes that gloom in America must darken the euro area's prospects. Exporters hit by the strength of the euro cannot but find it harder when their second-largest market (America) turns down, especially as the largest (Britain) is slowing too. Yet politicians and central bankers are reluctant to admit to home-grown frailties. Their ritual invocation of Europe's "sound fundamentals" and "lack of imbalances" seems like wishful thinking—or complacency.

The facts suggest that Europe is not weathering the global financial storms well. Figures released on February 14th reveal that the euro-area economy slowed abruptly at the end of 2007. GDP rose by only 1.6% at an annual rate in the fourth quarter-stronger than in America, admittedly, but still a lot slower than before. GDP growth in the two biggest economies, Germany and France, was weaker than the euro-area average. And though figures for Italy are not yet out, economists at Barclays Capital reckon its economy shrank. Economic activity across Europe seems to have slowed further at the start of the year.

What is worrying is that Europe's lost pep owes more to sagging demand at home than to crumbling exports. A full breakdown of the fourth quarter is not yet available, but it is expected to show that consumer spending was sluggish at best. Retail sales fell by 1% over the previous quarter. In Germany, where hopes of a consumer revival have often been dashed, sales crashed by 3%. Behind these grim figures stand increasingly nervous shoppers. The European Commission's gauge of consumer confidence has fallen by ten percentage points since July 2007, the sharpest drop since early 2003. Borrowing by households has slowed sharply, partly because of earlier interest-rate rises but partly also because troubled banks have become far fussier about their lending.

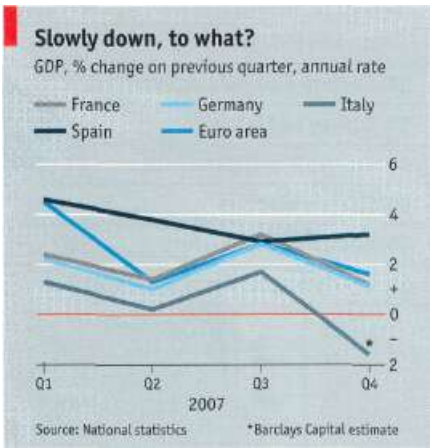
Such fragility is at odds with claims that Europe's economy has the domestic firepower to withstand a recession in America. Indeed, the parts of the economy that are most exposed to non-euro-zone demand are doing better than those that rely on domestic spending. An index of manufacturing based on a survey of purchasing managers edged up in January. But the gauge for service industries plunged to only just above 50, the point at which more managers report a fall than a rise in activity. Individual readings in Germany, Italy and Spain were all below that level. Much of the weakness, particularly in Spain, is down to struggling firms in property and finance, which suggests that the credit crunch and the deflating house-price bubble are taking a broader toll.

All this points to an economy that is faltering not because of slowing export demand but because European consumers are suddenly less willing to spend. Such caution may seem excessive. After all, the jobs market is still firm: euro-area unemployment recently dropped to 7.2%, the lowest for a generation. Europeans routinely save a larger share of their incomes than people in America or Britain, so household finances are less stretched in most euro-area countries. Yet consumers still have plenty of reasons for anxiety.

Foremost is stubborn inflation. Rising oil and food prices keep eroding consumers' spending power. Euro-area inflation picked up to 3.2% in January, its highest since the euro was launched in 1999. And although lots of jobs have been created in recent years, real wages have stood still. The OECD, a rich-country think-tank, reckons that average private-sector pay in the euro area rose by 2.4% last year. That was a small pick-up on 2006, but still barely enough to keep up with prices. The escalating cost of living has become a topic of widespread political debate.

Everywhere housing markets are slowing, even if prices are falling outright only in Ireland and Germany. This slowdown, along with recent volatility in stockmarkets, has made consumers jittery, believes Julian Callow at Barclays Capital. Wobbly asset values, high inflation and a buoyant jobs market are typical late in the business cycle, appearing just as economies slow down. "It's as if consumers can sense an earthquake coming," says Mr Callow.

The seismic warning has not gone unnoticed by the ECB. In interviews last



weekend, Mr Trichet confirmed that the ECB thinks the risks to the economy now "lie on the downside". It has stopped hinting about the possibility of an interest-rate increase. Yet concerns that inflation may persist well above the 2% upper limit of the ECB'S target range mean that it is not ready to ease monetary policy just yet.

In any case, because consumers are anxious about rising prices, a cut in interest rates might not boost confidence. Some of today's inflation may be transitory—the "core" rate, which excludes energy, food, alcohol and tobacco, is only 1.9%—but the euro area's well-known rigidities mean that prices and wages are less responsive to a slowdown than in America and Britain. In recent years inflation in the euro area has been above 2% more often than below it. Still, the markets are betting that the ECB will cut rates soon, as it did in similar circumstances in 2001.

There is scope in some countries for a fiscal boost too. Spain and Ireland, where demand is likely to be hardest hit by the housing and credit slowdown, have the advantage of running budget surpluses of around 2% of GDP. Last year's VAT increase helped Germany balance its books and even make room for modest cuts in corporate and payroll taxes this year. But other big countries have less room for manoeuvre. France cut taxes sharply last year; its budget deficit, like Italy's (and Britain's), is already above 2% of GDP.

The euro area may also suffer from an imminent slowdown in eastern Europe, which has been a useful source of demand but where several economies look newly vulnerable (see box). One consolation may be that the euro seems to have stabilised against the dollar; fears of a dollar rout have eased, at least for now. It is the apparent fragility of the domestic economy that is the biggest headache now. Much will depend on whether traditionally thrifty German consumers, who were least affected by rising house prices and who shun credit, can make up for weaker demand elsewhere in the region. The signs so far are not encouraging. •

Eastern Europe's economies

Coming in to land

The east Europeans swap one economic problem for another

ORTHODOX economics suggests that big current-account deficits, high inflation and fixed exchange rates are a lethal combination. But after a scary year, the east European countries that looked most likely to tumble seem to be heading for a softish landing. In Estonia growth has dropped from double digits to a mere 4.5%. In Latvia retail sales, rising by as much as 25% last summer, are growing by only 10%. The foreign banks that own most of the financial system in both countries have tightened lending. Even if some housing borrowers default, the pain is manageable.

The European Commission continues to fret, particularly about Latvia. It gave warning this week of a "hard landing" if the government does not tighten fiscal policy again. But Neil Shearing of Capital Economics in London says that only the collapse of a big bank in the Baltics could prompt a crisis that would break the local currencies' peg to the euro.

Most other countries in the region have floating exchange rates. Many have raised interest rates recently—by a full percentage point in Romania—to head off inflation. Price rises endanger both competitiveness and their chances of adopting the euro. Hungary has the lowest growth and the highest inflation in central Europe; its currency, the forint, has been sliding. "If America has stagflation-lite, Hungary has stagflation-heavy," says Mr Shearing.

Markets are proving remarkably tolerant of the east Europeans' diminished zeal for reform after their rush to membership of the European Union. With labour costs still a small fraction of the euro area's, the prospects for growth look good on the surface. But worries about longer-term competitiveness are growing. Employment rates are still low—at 50%, Poland's is the second-lowest of any economy in the EU. But like its predecessor, the centre-right government in Warsaw shows little appetite for painful structural reforms.

The most solid prospect in the region now is Slovakia, thanks to the rigorous (and unpopular) policies of the previous government. Slovakia hopes to adopt the euro in 2009; the EU is scrutinising the figures now and will give its verdict in April. Soaring foreign investment and strong growth have stoked tax revenues, cutting the budget deficit. Slovakia's problem is inflation. It should fall to 2.7% this year, which is tiny by other countries' standards, and comfortably under the EU's target for euro membership—but it reflects artificial (and unsustainable) one-off controls on energy prices.

Countries that have pegged their currencies to the euro, or are shadowing it, lose their independence in monetary policy without gaining all the benefits. Willem Buiter, a former chief economist at the European Bank for Reconstruction and Development, thinks some would do better to adopt the euro unilaterally. The European Central Bank and European Commission would hate this, but they could not stop it, he argues.

Turkey and Islam

Veils of half-truth

ISTANBUL

What lies behind the row over lifting the headscarf ban in universities

TO TURKEY'S secular elite it is a step back to the dark ages; to its conservatives, an overdue right. Either way, the constitutional changes approved by parliament to ease the ban on the wearing of the Muslim headscarf in universities will trigger a new battle between the mildly Islamist prime minister, Recep Tayyip Erdogan, and his secular opponents.

Scores of university heads have declared they will ignore the changes, although they were approved by a big parliamentary majority on February 9th. Tens of thousands of Turks have taken to the streets in protest. The opposition leader, Deniz Baykal, promises to go to the constitutional court, arguing that the measures contravene constitutional guarantees of secularism. The court may rule in his favour, as it did in a dispute about the Turkish presidency last May. In any case, before the measures take effect the government has to change more specific rules about garb on campuses. Some doomsayers predict the sort of violence that flared between leftist students and nationalists and Islamists in the 1970s.

Mr Erdogan's Justice and Development (AK) party has been under pressure from its base to scrap the headscarf restriction, which was imposed only in the 1990s, ever since it came to power in 2002. Polls show that most Turks favour lifting the ban for university students. Even the country's

generals have remained silent, for a change. So what is all the fuss about?

One answer is that the battle over headscarves is not really about religion at all. Rather it is a power struggle between a rising class of observant Turks from the Anatolian hinterland and an entrenched elite of secular "white" Turks, backed by the generals and the judiciary. "Women with scarves used to be our maids, now they have become our neighbours," sniffs one Istanbul socialite.

But snobbery and power are only part of the story. The headscarf debate reflects a clash between tradition and modernity as much as one between Islam and democracy. Many Westernised, middle-class Turks, especially women, fear for their lifestyle. They cite government plans to ban the showing of alcohol on television as another example of creeping conservatism. It did not help when one AK member of parliament crowed that, after getting the headscarf into universities, government offices would be next.

Even headscarf campaigners complain that they knew nothing about the government's plans. Some believe they were designed merely to win votes in the local elections due next year. If the AK were serious about bolstering equality between the sexes, "there would be more than one woman in the cabinet," says one AK-supporting lady. And if letting women cover their heads were a matter of rights, as Mr Erdogan claims, why has the government not scrapped Article 301 of the penal code, which criminalises free speech? (Its most recent victim is Atilla Yayla, a liberal academic, given a suspended three-year jail sentence for calling Ataturk "that man".) The government is also dragging its feet on European Union demands to make it easier for non-Muslim minorities to reclaim properties confiscated by the state.

One reason for this, some suggest, is that the AK government needed to placate a small far-right party whose support it needed in parliament to secure a two-thirds majority on the headscarf. At all events, Mr Erdogan's waning interest in joining the EU has led to growing disenchantment among his liberal supporters. Their problem is that they have nowhere else to turn. Mr Baykal, who purports to stand for Ataturk and modernity, is among the country's most strident opponents of Eu-imposed reforms. Despite losing three elections within the space of a decade, he remains firmly in position.

The bigger worry is that Turkey has not yet devised a system of checks and balances that can protect the rights of all individuals, be they secular or pious, Turks or Kurds. As Abdullah Gul, the pro-European Turkish president, argued this week, EU membership could offer a panacea for Turkey's ills. If only Mr Erdogan (and existing EU members) would agree. •

Kosovo's independence

A state is born. Or so say some

PRISTINA

Neither Russia nor Serbia will recognise the new Kosovo

ACROSS Kosovo few can believe that they are on the brink of independence. This is the moment most Kosovars have longed for ever since the break-up of Yugoslavia in the early 1990s. Some 90% of Kosovo's 2m people are ethnic Albanians. Agron Bajrami, editor of the newspaper *Koha* Ditore, says there have been so many disappointments that they will celebrate independence only when it happens.

Ever since the end of NATO'S war in 1999 Kosovo has been under the jurisdiction of the United Nations, although formally remaining part of Serbia. Now it is preparing to declare independence on either February 17th or 18th. A huge new European Union mission is ready to move in to help run the place. So far Ban Ki-moon, the UN secretary-general, who is under pressure from Russia to resist independence, has adopted a strategy of doing nothing. But UN officials in Kosovo have been told that once independence is declared, Mr Ban will decree that the situation on the ground has changed and that their mission has outlived its usefulness. They will then be withdrawn, to be replaced by an EU mission.

Russia will make sure that Kosovo cannot join the UN. Serbia too will be furious and take as yet unspecified measures to undermine the new country. An assembly is planned in the Serbian-controlled north of Kosovo, in which parallel Serbian institutions will be formalised to run Serb bits of the country. For years Serbia's leaders have warned the West that Kosovo's independence would mean there would be two Albanian states in Europe. Now, scoffs one diplomat in Pristina, "we are going to get two Kosovos instead."

It's the real thing this time

The fall-out from the declaration will be huge. Serbia will declare it null and void. Russia may table a UN Security Council resolution to the same effect, although America, Britain and France will block it. On the ground, violence is not expected but cannot be ruled out. The Serb-controlled north of Kosovo is already run as part of Serbia, as are bigger enclaves elsewhere. But fear is palpable in smaller Serb-inhabited villages.

Bratislav Kostic, leader of one such place, Gojbulja, complains that he has received no instructions from Serbian officials about what to do. He fears that if protests get out of hand in northern Kosovo and ethnic Albanians have to flee, Gojbulja's Serbs may be the first to be expelled by Albanians in revenge. With America and most EU countries lining up to recognise a new Kosovo, the last thing its leaders will want is to see their moment of glory marred by scenes of Serbs in flight. ■

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