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French, Germany Consumer Confidence Holding Up -- A Dangerous Sign of Euro Zone Crisis Fatigue?

By Moran Zhang

French and German consumer confidence showed unexpected strength, reports showed Friday. While the market is cheering about the "good news," some economists view this as a warning sign of a euro zone crisis fatigue -- something that is as dangerous, if not more so, than the crisis itself.

"This is like hearing the cry of 'wolf' too many times and people will no longer, in some sense, be scared of what's happening," said Srinivas Thiruvadanthai, an economist with the Jerome Levy Forecasting Center.

"The risk is, there is real danger and it's not that there no wolf, there is a real wolf here," Thiruvadanthai said.

A survey of consumers by the GfK institute in Germany showed sentiment holding up at 5.7 in June, the same level as in May. GfK's gauge of economic expectations jumped to 19.6 in May from 8.5 in April and an index of consumers' willingness to spend rose to 32 from 27.6.

"Despite recessionary trends in Europe and rising uncertainty as a consequence of the debt crisis, Germans feel that the national economy is continuing its upswing," GfK said.

A separate report from the French national statistical institute Insee showed consumer confidence in France rose for a third consecutive month in May to the highest level since November 2010.

However, Thiruvadanthai said the increase in consumer confidence is not sustainable.

The new statistics from France do not tell the real story and are most likely skewed from the recent election, said Guido Lombardi, executive director of the North Atlantic League and a former executive director of the International Council for Economic Development.

"For the last three months the French people have been fed rhetoric from an election where the candidate who won promised the French people no cuts in spending, no economic hardship, and no pain," Lombardi said. "With that type of message for an economically embattled nation, who wouldn't have a sense of optimism?"

That's largely why the Insee has reported higher numbers.

Lombardi warned that "once the honeymoon is over from the (President Francois) Hollande campaign and the reality of a difficult economic environment sets in, look for that number to go down."

Since the onset of the European sovereign debt crisis, policymakers have always managed to get things together every time they reached the brink.

Europe's finance ministers approved the first rescue package worth €750 billion ($938 billion) in May 2010, aimed at ensuring financial stability across Europe by creating the European Financial Stability Facility.

Yet, the situation slipped further, prompting euro zone leaders to approve on more measures to prevent the collapse of member economies. These include: an agreement whereby banks would accept a 53.5 percent write-off of Greek debt owed to private creditors, increasing the EFSF to about €1 trillion and requiring European banks to achieve 9 percent capitalization.

"The risk is that perpetually, there is bigger and bigger demand being put on the policymakers, especially the ECB, for them to come and do something in the euro zone," Thiruvadanthai said.

"Each time, whatever they have to do is far bigger than the previous one and if policymakers make a mistake and fail to rescue the situation, the consequences are catastrophic," Thiruvadanthai added.

However, people can't and shouldn't always depend on the policymakers to come to the rescue.

"So great are the pressures on European leadership that there is hope for another such rescue, perhaps before panic grows to match that of last December," David Levy, chairman of Jerome Levy Forecasting Center, wrote in a May 18 note. "However, it would be foolhardy to count on such a rescue.'

A case in point would be the fall of Lehman Brothers during the 2008 financial crisis.

Before Lehman Brothers collapsed, the U.S. Federal reserve came to the rescue and arranged the buyout of Bear Sterns by JPMorgan Chase & Co. (NYSE: JPM), Bank of America Corp (NYSE: BAC) bought failing subprime mortgage lender Countrywide Financial and Merrill Lynch. Meanwhile, the U.S. Treasury took over Fannie Mae and Freddie Mac.

"They did a lot of things before they let Lehman go," Thiruvadanthai said. "So somebody on the eve of Lehman's collapse could have said 'Yeah, yeah, you know, there's going to be no crisis because every time things look like they are going to be bad, they'll come to the rescue."

This is exactly why Henry Paulson, who was the U.S. Treasury Secretary at the time, declared his firm commitment against the danger of "moral hazard" and decided to let Lehman go bankrupt. Moral hazard describes the tendency of bankers to make bad loans based on an expectation that the lender of last resort, either the Federal Reserve domestically or the International Monetary Fund globally, will bail out troubled banks.

Economists say the fatigue about the crisis is natural, but it doesn't mean that there is no problem.

If they got used to being scared about something really bad happening and that really bad thing has not happened, they'll figure that things are OK. And that's what's happening in Europe.

"The point is the dangers are severe and most people don't fully appreciate it," Thiruvadanthai said. "The economy is worsening (in Europe) and there's little improvement there."

Levy warned that investors should beware of the euro zone crisis fatigue.

We all know the pattern, Levy noted. A crisis begins to erupt in the euro zone. The crisis gets bigger, and it sinks stock markets, the euro, the more suspect sovereign bonds, and risk assets worldwide.

Many consumers and businesses become sufficiently worried to hold off on some major purchases, and the economy deteriorates. Finally, European leaders take concrete policy actions or make promises that ease the markets' fears and relieve bank liquidity concerns. Markets rally, fear ebbs, and economies benefit from a little catch-up spending.

"Watching yet another euro zone crisis unfold may evoke a muted reaction as people's capacity to become worked up about Europe has been tapped too often," Levy wrote.