1015 15th Street, NW, 6th Floor, Washington, DC 20005
Telephone: 202-777-3000 – Fax: 202-777-3010

Irwin Stelzer
27 April 2012

Europe's Cold Win Cool's American Sentiment

"The world is too much with us," lamented Wordsworth over 200 years ago. Lately, American investors, businessmen, policymakers and workers agree inclined to agree. At least in the case of Europe. Just as our recovery from a deep recession seemed to be gaining momentum, strong headwinds blow over from Europe. France seems ready to elect a president who promises to impose a marginal tax rate of 75%, which most observers agree would reduce prospects for a quick recovery. The German economy, once the growth engine that could pull the eurozone out of recession, is slowing. The Dutch, until now Germany's biggest ally in the effort to impose austerity on wayward peripheral countries, have decided that austerity is for thee but not for me; the government fell in a dispute over spending cuts, prompting the Fitch rating agency to consider lowering the Netherlands' triple-A rating.

The eurozone's bailed-out periphery countries can't persuade their saviors of the validity of the first rule of holes -- when in one, stop digging. So although austerity is driving deficits up rather than down, shrinking economies (at an annual rate of 5% in Greece), and boosting unemployment (half of Spain's young workers are jobless), Germany insists that everyone dig faster.

The advocate of this austerity über alles, German chancellor Angela Merkel, now faces the possibility of death by three cuts: her voters won't tolerate sending more of their hard-earned wealth to southern profligates; her support from other countries is dropping, witness the Dutch decision to rethink the virtue of austerity; and her wish to avoid having Germany become the sole, visible master of the economic fate of Europe, all alone at the top, is unlikely to be realized if a new French president, François Hollande, withdraws his country from the Franco-German partnership.

With austerity far from a clear success, and political uncertainty rising, it is little wonder that a majority of economists surveyed by CNBC see a European recession as the greatest threat to America's recovery. Or that the Obama administration's economic team finds some joy in Europe's pain: it now blames the feeble nature of the US recovery on developments in Europe, although it has not made clear the precise nature of the mechanism that translates unemployment in Spain into slow job growth in America. Nor can it explain why, if Europe's woos are such a threat to the US, we declined to join the countries who recently beefed up the International Monetary Fund's bail-out capacity. Treasury Secretary Timothy Geithner told the Europeans they have sufficient resources to follow the advice of Voltaire and tend their own garden.

The reason Europe's problems cause gloom over here is Lehmanitis, a disease characterized by fear that the low resistance of financial bodies to contagion leaves them prone to complete collapse. When then-Treasury Secretary Hank Paulson decided against bailing out Lehman Brothers, he did not anticipate the extent to which even that relatively small firm was interconnected with the rest of the global financial system, and was not alone in getting a refresher course in the law of unintended consequences. Since then, there seems to be no cure for the disease and the fear it creates, the recurring worry that America is somehow interconnected with Spanish banks, Italian sovereign debt and who knows what else.

Never mind that the risk of financial contagion is far lower than it once was: US banks and money market funds have been steadily reducing their exposure to their European counterparts. Also, any reduction in exports to Europe, while unfortunate, must be weighed against that fact that the volume of US exports to Canada, Mexico and Asia “is much larger than the volume of exports to Europe - and growth in those three markets is much faster than in Europe,” according to Kevin Kliesen, an economist at the Federal Reserve Bank of St. Louis.

Meanwhile, there is considerable evidence that the recovery remains on course.

- Shipments of “core” capital goods (excluding volatile aircraft and defense figures) rose by 2.6% in March, well above expectations.
- Manufacturers are reporting surprisingly good earnings and sales figures for the first quarter, and are optimistic about the prospects for the rest of the year, despite high oil prices and bad news from Europe. The steel and auto industries are doing fine, and parts of the energy sector are booming.
- Consumer debt levels are dropping, so that financial obligations (credit card and mortgage payments), which sopped up 14% of consumer income in 2007, now claim only 10.9%, leaving more spending money in purses and wallets.
- Even the housing market seems ready to leave the intensive care unit, although not the hospital. Average prices are up a bit for the first time since July 2007 according to the Federal Housing Finance Agency, and in some cities are now above year-earlier levels. Sales of new homes in the first quarter exceeded last-year’s level, which it must be noted was nothing to shout about. The Federal Reserve Board’s monetary policy committee, considering all of the data from this important sector, cautiously acknowledges “some signs of improvement.” The Wall Street Journal is more enthusiastic, featuring a page one headline, “Stunned Homebuyers Find the Bidding Wars are Back,” and attributes that to “supply shortages”.

Then there is some cheery anecdotal evidence. Ford Motor Company’s securities have regained their investment grade status, something no one thought possible when it bravely hocked every asset to avoid following General Motors and Chrysler into bankruptcy and the embrace of the federal government. And investors, who had persuaded themselves to dump Apple shares because it couldn't possibly match recent results, were treated to what Wall Street calls "an upside surprise" when first quarter profits clocked in at 94% above last-year's figure on the back of booming sales of iPhones (up 88%) and IPads (up 151%). No tree grows to the sky, but this Apple tree is giving it a try.

The difficulty in digesting all of this positive evidence, and laying it against the bad news from Europe, is demonstrated by the fact that the report issued by Federal Reserve Board's monetary policy committee after last week's meeting was "a little vaguer than you'd like", according to Fed chairman Ben Bernanke. He attributed that to the need to reflect a consensus of committee members' disparate views. The committee increased its forecast of economic growth and lowered its projection of unemployment, but neither by enough to change current policy. It's steady as she goes, until incoming data suggest either tightening or loosening. No surprise there.