ECONOMIC NEWS UPDATE

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Can the European Contagion Infect America?

Greece is a far away country about which we know very little, as Neville Chamberlain described Czechoslovakia -- right before developments there brought the world closer to World War II. France has never been a great friend of America’s -- remember Freedom Fries? -- so its travails aren’t causing Americans to lose any sleep. Germany seems to the casual observer to be in good shape, so no worries there. Italy, of course, is of concern, and not only to some 18 million Americans who claim Italian ancestry, but with the resignation of Berlusconi surely his successors will find a solution to a country running a smaller deficit relative to its size than is America. So no need to worry about the failure of eurozone politicians to come up with a solution to its problems.

Yet, and yet…. We Americans are spending more time on Europe’s problems than on our own, if the press and television coverage is any guide. Of course, this might be due to political overload -- repeated debates among
Republicans seeking the opportunity to take on what they see as a wounded Barack Obama, daily television appearances by the President, charge and counter-charge about everything from who is responsible for the deficit to the private life of Herman Cain. More likely, however, attention to eurozone problems stems from concerns about their possible impact on the American economy.

For one thing, exports to Europe, although small, are not of zero significance. Sales to the EU account for about $240 billion, less than 3% of GDP and 19% of total exports. Eurozone countries account for about $180 billion of the EU total. Not a lot in the $15 trillion American economy, but not to be sneezed at in a period when the economy is struggling to record a bit of growth, especially when emerging markets for American goods also seem to be entering troubled times. And as always, the aggregate figures conceal important facts: GM profits were hit hard by eurozone weakness.

More important, Americans increasingly see Europe as the canary in the coal mine -- the fate of America if its politicians can’t agree on a plan to stop the nation’s descent into insolvency. “We don’t want to become Greece” is a chant increasingly heard from pundits, much easier to understand than complicated statistics about debt:GDP ratios. But so long as Democrats refuse meaningful cuts in entitlement programs, and Republicans hold out against increases in tax rates, Greece is what we are about to become. Unless, of course, we use our one advantage -- the ability to print money to reduce the value of outstanding debts -- in which case inflation is in our future.

Then there are the lingering memories of Lehman Brothers, the 2008
collapse of a not-very-large investment bank that almost brought down the global financial system by drying up the flow of credit. Assurances that America’s financial institutions are not susceptible to a collapse of the European banking system -- undercapitalized and still loaded down with risky mortgage products in addition to the sovereign bonds of countries that can never repay them in full--ring hollow because such a collapse would cause U.S. banks to tighten lending criteria. Indeed, the latest report of senior bank lending officers suggests that such a tightening process has already begun.

That concern was magnified when Jon Corzine’s MF Global went bust because of his huge, highly leveraged bet that eurozone bonds would recover. They didn’t. For those who do not follow the details, the take-away is: something is wrong in Europe, and whatever it is it took down an American investment bank. So far that event has had no effect on other banks, but you don’t have to be a worry wart to believe it is early days yet. Unfair, and likely a case of fear replacing reason, but American consumers and investors are already sufficiently nervous, sufficiently suspicious of official assurances, to think the worst.

With some reason. Some still remember when the last financial upheaval threatened the survival of supposedly super-safe money-market funds. Well, now we find that those funds are important lenders to foreign banks, positions
they are attempting to bring down in a hurry even if it means putting their funds in U.S. Treasury securities that yield almost no interest. They are also less interested in making cash available to U.S. banks, since those banks have close relations with their foreign counterparts.

Finally, there is that great intangible, confidence, or what John Maynard Keynes called the “animal spirits” of entrepreneurs. It is difficult to keep one’s spirits animal-like when news of defaults and haircuts accompany morning coffee and workouts in corporate gyms, when pictures of feckless eurozone politicians flash across screens as they decide that the solution to their problems is a hand-out from China, which has no present intention of filling their begging bowls, and when American politicians do their best to emulate their European counterparts. Better to sit on $2 trillion of cash than to risk it in an unpredictable world.

All of these are low probability events. But the low probability of a catastrophe is enough to make consumers and investors take notice. Which is especially unfortunate just now. The economy is struggling, but all signs are that a double-dip recession has been avoided, replaced by what Federal Reserve Board chairman Ben Bernanke calls “frustratingly” slow growth. There are some signs, too, that the both Democrats and Republicans have looked into the Grecian abyss and stepped back. Democrats say they are willing to consider some reductions in entitlement programs, and Republicans say their opposition to increases in tax rates does not mean they are opposed to “revenue enhancements” that might be obtained by reforming the tax structure. The odds against a deficit-
reducing deal of any magnitude remain high, but they are a trifle lower than they were last week. For which we can thank the trilling of the canary in the European coal mine.

Meanwhile, as it becomes clearer that the collapse of MF Global is a tragedy only for Jon Corzine and his investors, and that U.S. money funds and banks have reduced their exposure to the eurozone to minor levels, fear might ease. Not to be replaced by a revival of animal spirits, but at least by less fear.