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THE DAILY JOURNAL OF COMMERCE, PORTLAND, OREGON

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What's up in Europe?

Published November 11, 2011

Previously, Europe was in the lurch, and U.S. markets were whipsawed by events in Athens. Turmoil ensued in Greece, one of the smaller economies in Europe, as the government called for a referendum on the European bailout, which may in fact turn out to be a referendum on the Greek role in the European Union.

At stake was whether Greece would continue to be part of the European Union. Markets throughout the world took a giant gasp as the future of the EU was called into question. U.S. markets tumbled. Could a country even leave the EU? What did this mean for the euro?

By the end of the week, the Greek government survived, barely. George Papandreou, the Greek prime minister, said he would form a new government and he might not be the leader. A vote on the future of the EU would not be held and for the moment, the euro would go on.

Italy was up next in the spotlight, and its failure would be a much more important event. Its economy is much larger than Greece's. By some indications, it is a stronger economy, but one-year bonds there now command a 6 percent interest rate. When compared to 32 percent for Greece, this is a strong indication that investors do not believe the Italian economy can long survive. The German bonds, of the same maturity, command about 0.25 percent to borrow. Investors pay the Germans to hold their money.

When Italy, Greece, Spain and Portugal joined the EU, they were allowed to borrow at the interest rate of countries in the EU. The rates were a fraction of what they would have to pay in their own currency. So there was a strong incentive to borrow, and borrow they did. But they borrowed in euros, and they had to repay in euros.

The trouble is that their economies did not keep pace. Workers' wages rose to uncompetitive levels during the boom years. The Greeks were unable to compete. It became more and more difficult for them to repay their debts. If they tried to raise taxes and cut spending, they would drive the country into recession, which meant fewer tax revenues, and more unemployment benefits to pay. The Greeks demonstrate the problems now facing Italy and Spain.

Further, the Greeks were unable to devalue their currency. In the old days, if a country could not pay its debts, it simply devalued its currency. Pensioners were worse off, but the country could sell goods to other countries at bargain prices. The economy would recover, tax revenues would recover, and life – for some people, at least – would go on.

For example, a country like England, which has its own currency, could devalue, pay back its loans to creditors in a devalued currency, collect more revenues as the economy recovered, and move on because the money owed would be owed largely to its own people.

But no more. Today, if someone sells Greek bonds, the prudent thing to do is buy German bonds, which only exacerbates capital dislocation in Europe.

The EU has a single currency, multiple countries and no single bond market. Plus, there is no single government. This made for a messy situation in which the euro became very vulnerable.

In fact, we are facing a crisis in Europe. The whole of European currencies are becoming dislocated. Italy has to pay 6 percent on its one-year debt while Germany pays 0.25 percent.

Germany takes pride in this circumstance, but the pride is misplaced. This means that German banks and institutions have money that they cannot lend at a profit, while Italian banks have money they cannot lend. As the German economy slows and banks find it difficult and unprofitable to loan, they cut back on their lending, which further slows the German and therefore European economy.

The German economy, the driver of Europe, will shrink. Greece will shrink. Italy will shrink. The whole process will lead to a circling of the drain.

So, does the European Union dissolve? Does the euro disappear?

U.S. banks have reduced their European lending according to the U.S. Federal Reserve. The recent senior-loan-officer survey of 51 U.S. banks and 22 foreign banks with U.S. branches shows that two-thirds of banks had tightened their lending standards for loans to European banks. Showing a heightened concern about economic uncertainty in Europe, the bank lending practices can ensure only a further slowing of the European economy, which is likely already in a recession.

What in the world is going on in Europe? We should care.

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