Sword of Damocles Hanging Over Europe

Europe's financial affairs administrator, Olli Rehn (left), the European Commissioner for Economic and Financial Affairs, has recently warned that Portugal may need a bailout within a year. Rehn has tried to deflect calls from the President of the German Bundebank for an "exit strategy." In Greece, which is in even worse shape that the other "PIIGS," a man shot himself outside the Greek Parliament on account of his debts which seemed insurmountable. His suicide note likened the current Greek government to the collaborationist government under the Nazis.

Enda Kenny, the Prime Minister of Ireland, has very publicly stated that his government will not default on its debts, saying at his party's conference: "Ireland will not default. But we are determined to ease this burden on our people. That's why we are negotiating with our Troika partners [the EU, International Monetary Fund, and European Central Bank] to find a cheaper way of financing the cost of bank recapitalization."

So it ought to come as no surprise to learn that Spain is still in trouble. On April 3 the Spanish stock market dropped a chilling 2.6 percent in a single day. One consequence of this collapse is that the European stock market also dropped, declining 2.1 percent to close at its lowest price in a month. Koen De Leus, a financial strategist at KBC Securities, said:

> We had a strong rise this year already, and now markets are concerned that what is happening in Spain will spread to other countries. Austerity measures have already been taken in Belgium, Holland and Italy, and European economies won't grow. There will be a recession in Europe and markets will react to that. In this quarter and the second half of the year, it will be much harder for markets to rise strongly.

Spain's bond auction reflects the nervousness of investors. The nation's borrowing costs jumped in the first auction since the government announced its budget. Annalisa Piazza, a financial strategist for Newedge, tried to put the best possible face on the sale: "Market dealers seem to look at fundamentals now, with risks of a deep recession undermining the positive effects of the large ECB liquidity injection that led to a massive spread tightening since early this year." The rising rates which the Spanish government must pay bond investors to buy its sovereign debt, however, will increase the budgetary problems for Spain.

The rest of the European community is also performing poorly. Orders for manufactured goods in Germany, for example, grew only 0.3 percent, which was less than economic analysts had expected. The stress on such relatively "safe" economies is creating new pressures. The Bundesbank has become the first central bank in the European Union to use a rule which does not require it to accept bank bonds from those governments "whose credit assessment does not comply with the benchmark for establishing its minimum requirement for high credit standards."

The Austrian Central Bank has followed the lead of the Bundesbank, which means that the government bonds of Greece, Portugal, and Ireland can no longer be used to obtain funding through branches in either Germany or Austria. Thomas Costerg, an economist at Standard Chartered Bank in London, noted that countries other than Germany and Austria might also have reservations about accepting such collateral:

> Germany, the Netherlands, Luxembourg and Finland would be the countries most concerned about the quality of the collateral on the Eurosystem balance sheet. It comes amid an increasing debate about the decentralization of monetary policy. It does not involve huge amounts of collateral, but it's not a positive sign for the ECB [European Central Bank].

Finland, a nation whose solvency is proverbial, although the country itself is not very big, has already begun to face strong internal political pressures to not sacrifice its national creditworthiness to help nations in southern Europe.

A few months ago, economists thought that a boost of confidence, a new government in Italy, and some austerity measures in nations such as Spain and Greece might be enough to allow the European Union to avoid an economic meltdown. Today, however, that optimism seems far too rosy. The bad news out of Europe continues to be a "surprise" to those who ought not to be surprised at all.