Fallout

Increasingly policy makers and investors are thinking about the consequences of the European financial crisis. The following focuses on two such consequences that are unlikely to appear on other lists. The attempt here is to be additive not exhaustive.

Europe: Re-writing the Social Contract

This year was supposed to be about the U.S. and U.K. exiting quantitative easing programs at the end of the first quarter and for the global economy to continue the recovery begun, albeit slowly, in 2009.

While this did indeed take place, it was obviously overshadowed by the European debt crisis and the strengthening of the deflationary grip in Japan. This resulted in both the European Central Bank and the Bank of Japan extending, and in the former's case, devising new, emergency facilities.

The European debt crisis will have far-reaching political and economic consequences. The politics contemplated here is not about partisanship but rather the balance of power between the state, business, and labor.

Over the years, European citizens have increased the basket of goods and services they receive from the state. These concessions mean that the state was subsidizing the true cost of labor and this generally bought social peace.

The financial crisis is bringing to an end that which was unsustainable in the first place. Given slow growth even in the best of times and demographic considerations, that basket of goods and services is no longer affordable. The basket of goods that citizens will get going forward from the European states will be less. Exactly how much less will be a function of the distribution of power within each country.

If the state is not going to be subsidizing labor as much, the distribution of productivity gains may be more fiercely fought over. The divergence between the return to capital in the form of profits and rents on one hand and the returns to labor in the form of wages and benefits on the other may re-emerge as a powerful political and social force. And this will likely take place at the same time as businesses realign themselves with new regulations and slower economic growth (see new normal).

United States: More and Less than Meets the Eye

As economists and investors consider the impact on the U.S. from the European crisis there is an understandable emphasis on the disruption to the U.S. financial system. This includes not only the rise in LIBOR, the TED spread (T-bills minus Eurodollars) and swaps curve, but also some disturbance to the U.S. commercial paper market and, of course, the negative wealth effect of the sharp drop in equity prices.

The erosion of household net worth from the fall in the stock market however is mitigated by two other considerations. The first is that American households have increased their holdings of fixed income products. They have lengthened maturities by shifting savings from money market funds to bond funds and Treasuries.

The second mitigating factor is the improvement in the labor market. More Americans are working a slightly longer work week and earning a little bit more. Look at the three-month moving average to smooth out this volatile series. In Q3 2009, the U.S. lost an average of 233k private sector jobs a month. In Q4, the loss slowed to 90k. In Q1 2010 it was a positive 84k and here in Q2, it is likely to be closer to 200k. The economy grew 231k private sector jobs in April and likely grew another 200k here in May.

The work week increased by 0.3% in the first four months of the year. This is the equivalent of more than 900k jobs, not in terms of the unemployment rate, of course, but in terms of income and output. And those jobs were paying a little more. Average hourly earnings rose 0.4% in both Q4 2009 and Q1 2010, although this pace is unlikely to be sustained this quarter.

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The Direct Investment Strategy

Outside of the financial impact, economists see U.S. exports as another channel for contagion. The European Union receives roughly 20% of U.S. exports. The fiscal austerity that many European countries are adopting will likely weaken aggregate domestic demand, which was not all that strong to begin with.

Jeffrey Lacker, the President of the Richmond Federal Reserve, suggested that the knock-on the US economy from the European crisis could shave this year's growth by 0.1-0.2%-- roughly $140-$280 billion dollars. Lacker, like other prudent observers recognizes that the crisis also raises some downside risks.

One of those downside risks may arise from a fact that few seem to really appreciate. Although the U.S. is among the world's largest exporters, exports are not the primary way U.S. companies service foreign demand.

While U.S. exports account for more than a trillion dollars a year in recent years, sales by US majority owned foreign affiliates eclipse that number dramatically. Over four trillion dollars of goods a year are sold by majority owned foreign affiliates using a 'build locally, sell locally' strategy. This strategy often not only reduces labor and transportation costs, it also insulates US companies from the effects of foreign exchange fluctuations.

Exports will be impacted by both the dollar-euro exchange rate and the strength of the euro zone economy. The price of money adjusts much quicker than the price of goods. This helps explain the phenomenon economists call the J-curve effect.

After a currency depreciates, the trade account may initially deteriorate as goods that were previously ordered work their way through the system. It might not show up in corporate earnings immediately. However, the sales by majority owned affiliates are hit immediately by the economic slowdown, resulting in a much quicker impact on corporate earnings.

There are other implications that arise from the direct investment strategy. The majority-owned non-bank foreign affiliates are not just selling goods abroad, they are also producing them. The most recent data is for 2007. That year the value-added of these affiliates of U.S. multinationals was about $1.12 trillion. The affiliates in Europe accounted for a little more than half of this.

The affiliates in Europe are a significant part of the direct investment strategy. The assets of these affiliates account for almost two-thirds of all US affiliate assets, and a little more than 50% of all affiliate sales and income. The affiliates based in Europe account for 40% of all the foreign employment by US multinationals (suggesting that low wages are not the main driver of the direct investment strategy, but rather being closer to one's customers may be a better explanatory variable).

To look at it from a slightly different angle, consider that the value-added these affiliates create contributes to the Europe's GDP in a more profound way than many suspect. For example, the majority-owned non-bank foreign affiliates of U.S. multinationals account for more than a fifth of Ireland's GDP, more than 6% of the UK's GDP, more than 5% of Belgium's output, and 4% of the Netherlands's output. They account for 3% of Germany and Sweden's GDP and 2.2% of France's and Portugal's GDP. They account for about 1.5% of the output in Austria, Italy, Spain, Finland, and Greece.

Slower growth in Europe and the dollar's appreciation may curb on the margins US exports to Europe. However, the deeper penetration through the production and sales of the affiliates of US multinationals warn of the risk of a greater potential negative impact. As the euro, which is still modestly over-valued according to the OECD's measure of purchasing power parity, moves below fair value in the medium term, these affiliates of U.S. multinational companies may find that rather than simply servicing local demand, its exports from Europe may become more attractive.

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