Spain’s Troubles - - Ours, Too?

One need only look at the periodic gyrations in the stock market to find evidence that the adventures of the euro have a substantial effect on the health of our own economy. Whenever one of the weaker Eurozone countries runs into problems in issuing debt obligations, the Dow Jones is likely to feel the pain as well.

Greece has become the poster boy for the euro’s problems. It has been easy to fault how the Greek government falsified its economic data to evade the Eurozone rules, how the Greeks enjoy(ed) lavish retirement programs and other expensive perks, how they neglected to pay their taxes and how they misbehaved regarding so many other economic issues. It seems just that that country should be subject to austerity measures that might put things aright.

Unfortunately, other troubled Eurozone countries have been tagged with the Greek example, even though their situations are quite different. Take Spain as an example.

Spain is no Greece. In 2007, the country had a budget surplus and its debt was only 27% of its gross domestic product. (By comparison, at that time, Germany’s debt was 50% of its GDP.) Spain’s banking regulations were quite conservative, much more restrictive than those in the U.S. What did in Spain was the bursting of a real estate bubble, whose existence was due in no small part to profligate lending by German banks. The same ocean of money looking for higher returns, which created the subprime crisis in the U.S., caused a similar tsunami in Spain. Today, Spanish unemployment is almost 24%, about three times the rate in the U.S. For workers under 25, the rate exceeds 50%.

The standard prescription offered to Spain by its Eurozone partners has been austerity, austerity and more austerity. Until recently, the Spanish government has gone along, cutting spending to the bone and raising taxes in hopes that it can convince lenders that it will be able to pay its debts. These measures reduced the 2012 budget by 27 billion euros. What the Eurozone partners (read Germany) have not done is to assist Spain by having the European Central Bank make serious purchases of Spanish debt or to issue Eurozone debt, backed by the credit of all the zone’s members, to help finance member countries’ obligations.
Recently, Spain has been living virtually day to day with the executioner’s axe menacing overhead. The government has been obliged to offer interest of around 6% in order to market its 10 year debt securities, dangerously close to the 7% that many experts believe could cause a default as lenders flee. The most recent interest rates on shorter term obligations have increased by over 80% compared with last month.

So the story of Spain seems to be a country that had pretty responsible fiscal and regulatory policies, but was caught in the same kind of real estate excess that we have experienced here. What are its chances to escape from the crisis?

On the surface, it is hard to see how Spain’s 24% unemployment rate will be improved under a regime of decreased spending and higher taxes. This problem will be exacerbated, if borrowings become more expensive and further sap any growth in the economy. A failure to break out of this “death spiral” may well require Spain to return to the peseta, essentially devaluing its currency.

The Germans seem prepared to run that risk. They ask why they, who have behaved themselves, should be asked to bail out their less prudent neighbors. Leaving aside the question whether the German banks might also have misbehaved in Spain, a beggar thy neighbor approach could hurt the Germans themselves as much as their Eurozone partners. If the Zone disintegrates, Germany will find itself with the only strong currency, surrounded by countries that have devalued their own. The effect on German exports to Europe, the driving engine of its economy, would be swift and calamitous. In effect, the Germans and their Zone compatriots are in a similar kind of relationship as China and the U.S. – one party economically strong, but dependent on weaker partners continuing to buy its exports.

There are some lessons that the U.S. can, we think, derive from the Eurozone situation. First, austerity alone will not solve the problems of a country with very high unemployment. Economic growth must not be stifled by drastically cleaving programs. Secondly, we should be thankful that we are able to borrow money from the rest of the world for almost nothing. Not only are we lucky, but we must work to stay that way – our policies must convince the rest of the world that we continue to be a safe place to put its money. That reassurance can only come from evidence that our economy is recovering and will continue to grow. Finally, we can see in the Eurozone travails another example of how interconnected the world has become. We ignore that fact at our peril.

Here are the cost data for this month:

- **Scrap and Pig Iron.** The prices for #1 dealer bundles and #1 busheling (Chicago) continued to decline a bit, to $440 and $448 per mt., respectively. This is the fourth straight month that these prices have gone down, but they still are well within the range of historic highs. The spot price for Brazilian pig iron (cif New Orleans) also declined some, to $478 per mt.
• **Natural Gas.** What has happened to natural gas prices is truly remarkable. In the last year, those prices have decreased by almost 60% to levels not seen in the last decade. These prices are undoubtedly due to increased supplies made possible by the new “fracking” technology, and there seems to be no let up in developing hitherto unexploitable supplies.

• **Ocean Freight.** The Baltic Capesize Index remains steady, as it has for the last four months, around 1500. Compared with the extreme volatility we saw 2008, bulk ocean carriage costs are very placid.

• **Foreign Exchange.** Despite the almost daily alarm bells from the Eurozone, we have finally seen some stability in foreign exchange markets. The euro is now worth $1.31, down a penny from last month. The pound is down two cents to $1.61, and the Canadian dollar is off one cent at par.

As ever, we are interested in having your views and suggestions. Please be in touch. We will be posting this letter on our website, [www.coreysteel.com](http://www.coreysteel.com) and on the international site, [www.steelonthenet.com](http://www.steelonthenet.com).