



Distant thunder: Greek police battle protesters as the euro crisis intensifies.

Above the Fray No More

For the United States, there is much to fear from Europe's debt crisis but not much it can do. **By Bruce Stokes**



PHOTO: ASSOCIATED PRESS/PETROS GIANNAKOURIS

BRUSSELS—Europe’s sovereign-debt crisis is back with a vengeance, and if the United States seems to be in splendid isolation, think again.

Greece, which kicked off euro crisis 1.0 in April 2010, is again spiraling out of control. Bond investors, convinced that some kind of default is likely, are demanding yields as high as 25 percent. Workers and retirees, furious about drastic cuts in spending, are rioting in the streets. Ireland and Portugal, euro crisis 2.0, may not be far behind.

Anxiety about a broader contagion is

hammering the euro and rattling European bond markets, and the United States is more vulnerable than it looks. When the first wave of Europe’s debt crisis hit a year ago, the U.S.’s fledgling recovery immediately began to stall. Stock-market volatility spiked to levels not seen since the depths of the financial crisis, and stock prices weakened.

Last year, the Federal Reserve Board jumped in with a second round of “quantitative easing”—creating money out of thin air to buy Treasury bonds, push down long-term interest rates, and rev up economic activity.

If the European crisis gets worse again, the United States will have fewer tools to fight off a contagion.

Even dovish members of the Fed’s board have little stomach for a third round of emergency measures. The Fed could offer liquidity to the European Central Bank, exchanging dollars for euros. But critics in Congress, already unhappy about previous currency swaps, are likely to make the Fed pay heavily for doing it again.

Back in the 1990s, the Treasury Department helped Mexico through its financial crisis by lending \$20 billion from a dormant program called the Exchange Stabilization Fund. But that probably isn’t possible now, either. After the Mexico crisis, Congress changed the law to require congressional approval for such rescues. In today’s anti-spending environment, approval would be virtually impossible.

That leaves the White House with jaw-boning. It could plead with Wall Street to remain calm, and it could try to persuade other nations to help Europe. But without money to back up its words, the chances of success are low. All the while, Washington has to be wary that deep-pocketed Beijing will step in to help Europe, with costly geopolitical consequences for the United States.

Washington has a huge financial stake in the taming of the euro crisis. American banks have \$1.3 trillion in outstanding loans in Europe, according to the Bank for International Settlements. Europe is America’s largest trading partner, accounting for 22 percent of U.S. merchandise trade exports (China buys only 7 percent). Europe is the largest destination for U.S. foreign investment, and it supplies 57 percent of U.S. corporations’ foreign earnings.

But the biggest danger posed by European financial turbulence could be psychological. Even though Greece’s problems posed no direct threat to the U.S. economy, American financial institutions became risk-averse because they didn’t know how the crisis would ripple through the rest of the financial system.

“The transmission [of Europe’s problems] was through the financial system,” said Vin-

cent Reinhart, a former top Fed official who is now a senior fellow at the American Enterprise Institute. “The big lesson from the financial crisis was that we didn’t understand all the interconnections. That made people risk-averse.”

Risk avoidance may be quite rational, given how fast problems can travel. “A year ago when some raised the possibility of contagion from Greece, we were told Europe is different,” said William Rhodes, former vice chairman of Citigroup and the author of *Banker to the World: Leadership Lessons From the Front Lines of Global Finance*. “Unfortunately, they were wrong. Markets now move in nanoseconds, not like in the 1980s with Latin America or the 1990s in Asia.”

STATE OF THE CRISIS

The euro crisis has been a slow-motion train wreck since it erupted last year. It began when the Greek government asked for a €110 billion (\$156 billion) bailout from other euro-zone countries and the IMF. Since then, Ireland has received €85 billion (\$121 billion) in help; Portugal has gotten €78 billion (\$111 billion); and the European Union has created a permanent European Stabilization Mechanism, to come into being in 2013, with €440 billion (\$625 billion) available for emergencies.

Those measures have diminished—but not eliminated—fears of a wider crisis. “A lot of what is being put in place is untested,” cautioned Fabian Zuleeg, chief economist at the European Policy Center in Brussels. If financial markets don’t think that the measures are credible, the contagion could spread.

“We are living dangerously,” concurred Jean Pisani-Ferry, director of Bruegel, a Brussels-based economic think tank.

Big challenges lie ahead. The purpose of a bailout fund is to avoid, or at least postpone, a restructuring of sovereign debt. A write-down would scare off investment in public bonds for years to come, and a bailout fund is meant to reassure markets that such write-downs won’t be necessary.

But bailouts work only if investors think they will, and investors aren’t convinced about Europe yet. For Greece, where skepticism has pushed yields on two-year government bonds to 25 percent, failure threatens to become a self-fulfilling prophecy. As a result, a restructuring of government debt looks increasingly likely, possibly through a “voluntary” extension of maturities or a reduction in interest rates.

SPAIN: TOO BIG TO SAVE

European officials contend that the bailout of Portugal and creation of the permanent stabilization mechanism have built a firewall on the Iberian Peninsula. But financial mar-

kets are already testing Spain, and Madrid's cost of borrowing is rising.

The markets could be right. Spain's central bank classifies 46 percent of local savings banks' financial exposure as "problematic" after the country's housing bubble burst. Spanish home prices have fallen about 15 percent from their peak in 2008, but that is much less than the one-quarter drop in the United Kingdom or the even bigger declines in Ireland and the United States. Morgan Stanley expects "a more pronounced decline in house prices" in Spain over the next two years, implying even more mortgage problems. Estimates of the eventual cost of restructuring the savings banks range from €20 billion (\$28.5 billion) to €100 billion (\$142 billion).

"The probability of a full-blown crisis in Spain has decreased, but it cannot be ruled out," said Eric Chaney, chief economist at AXA, one of France's biggest insurance conglomerates. Roubini Global Economics, a New York City consulting firm, estimates that Spain has a one in three chance of losing its access to financial markets sometime in the next two years.

For the European Union, the problem is that because of Spain's size, a bailout could easily empty the stabilization fund.

"The good news is that Spain is too big to fail," one European official remarked. "The bad news is that it is also too big to save."

REASONS FOR PESSIMISM

The IMF forecasts that growth in the euro area in 2012 will be only 1.8 percent, which would further aggravate the problems of weak countries.

The European Central Bank's decision in early April to raise its main interest rate to forestall inflation won't help growth. And sustained high oil prices could weaken pros-



No easy answers: Fed Chairman Ben Bernanke (left) has helped the European Central Bank's Jean-Claude Trichet handle currency swaps.

pects even further. Chaney predicts that if the price of oil climbs above \$150 a barrel and stays there through 2012, the euro area could slip into recession in 2012.

"The main side effect of this second recession would be a full-blown euro debt crisis," he said. "The rise of risk aversion would trigger a liquidity squeeze for weaker economies, such as Spain and, possibly, Italy."

Another cause for worry is the health of Europe's banks. "Despite some reduction during the last year, cross-border exposures remain sizable and concentrated within euro-area creditor countries," the IMF's regional survey concluded. "The system would still be severely tested if euro-area stresses were to intensify."

This is a particular problem in Germany, where leverage, the ratio of banks' assets to their capital, is among the highest in Europe and more than twice that of U.S. banks. Ger-

man banks have \$189 billion in Greek, Irish, and Portuguese debt on their books. Since banks' ability to lend is based on the value of their assets, any restructuring of their debt would force them to book big losses and would constrain lending.

French banks, with \$113 billion in Greek, Irish, and Portuguese debt, are also exposed. The Organization for Economic Cooperation and Development recently warned that it was "difficult to assess" the banks' strength because the French government didn't publish details about the financial sector's health.

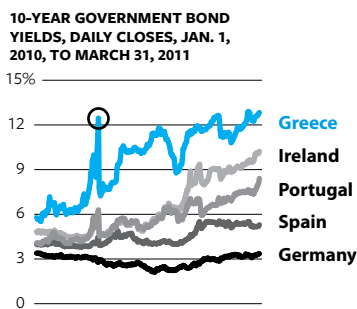
France's finance minister, Christine Lagarde, denies any vulnerability. "The French banks are safe, solid, and will withstand the stress tests," she said in a recent interview. Others aren't so confident.

"I am not saying there are skeletons in the cupboard," said Nicolas Veron, a senior fellow at Bruegel. "But if there were, there

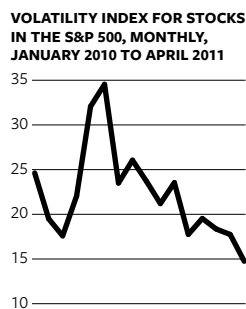
Not-So-Splendid Isolation

For years, the U.S. economy kept growing regardless of foreign calamities, such as the Asian crisis. Not anymore. In April 2010, bond-market panic over Greece and other small European economies jolted U.S. markets and may have helped stall the recovery last summer. Momentum resumed but only after the Federal Reserve signaled plans in July for another round of "quantitative easing."

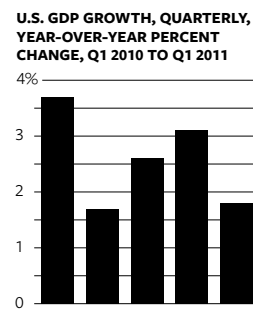
Sources: Institute of International Finance; Yahoo Finance; Bureau of Economic Analysis



Euro-panic: 10-year bond yields
Panic about Greek government debt erupted in April 2010 and spread to Ireland, Portugal, and Spain.



Volatility Index for S&P 500 stocks
As bond investors panicked in Europe, the Volatility Index for U.S. stocks spiked to its highest level since the financial crisis.



Euro-stall in the U.S.?
America's economic recovery, which had been strong in late 2009 and early 2010, slowed sharply.

would be very little way for the outside world to hear the bones rattling.”

What really keeps some IMF officials awake at night is the prospect of European zombie banks. These are financial institutions that survive through infusions of government cash but have so much bad debt on their books that they cannot lend sufficiently to help spur the local economy.

“It is very difficult to tell zombies from nonliving human beings,” Veron said. “That is why horror movies are so much fun, why the current moment is so dangerous, and why there is a risk that we will pay a high price for inaction.”

Daniel Gros, director of the Center for European Policy Studies in Brussels, says that European policymakers are asking for trouble.

“Europe is making a fundamental mistake by allowing the two key elements of any resolution of the crisis, namely, debt restructuring and real stress tests for banks, to remain taboo,” he said. “As long as this persists, the crisis will fester and spread, eventually threatening the stability of the euro zone’s entire financial system.”

MORE-IMMEDIATE PROBLEMS

With nationalist resentments rising and voters angry about spending cuts, domestic European politics may pose an even more immediate challenge to managing the euro crisis.

The third-largest party in the newly elected Finnish parliament is the True Finns, a populist group that opposes bailouts, jeopardizing Finland’s guarantee of funds in the E.U.’s stabilization mechanism.

At the same time, German Chancellor Angela Merkel’s government grows weaker by the day. For more than a year, Merkel has tried to allay domestic opposition to bailouts, to avoid a politically embarrassing bank recapitalization, and to respond to pressure from abroad for more leadership. Yet, the loss of a major state election in late March; growing opposition within her own party to a new bailout of Greece; and the collapse of public support for Merkel’s coalition partner, the Free Democratic Party, suggest that the chancellor may have little maneuvering room.

French politics were in their own state of upheaval—even before New York City police arrested Dominique Strauss-Kahn, the IMF director and presumed Socialist Party candidate for president, on charges of attempting to rape a hotel chambermaid. France will hold its presidential elections next spring; financial markets are looking closely to see if President Nicolas Sarkozy or his Socialist Party opponent grows wobbly on spending discipline. Sarkozy’s popularity had already sunk to low levels, making tough budget policies even harder to support. But now Strauss-

Kahn’s career-ending sex scandal has turned the race upside down. He is expected to plead not guilty but was denied bail and remains behind bars. Meanwhile, France’s far-right challenger, Marine Le Pen, is gaining traction with her ultranationalist message.

“The resilience of France in the election period will be a big test,” a senior French official acknowledged.

Needless to say, Strauss-Kahn’s arrest causes big problems for the IMF as well. He had played a central role in the European negotiations over the past year and had elevated the organization’s influence in part because of his credibility as a highly regarded former finance minister. Strauss-Kahn was supposed to meet this week with European finance ministers in Brussels to discuss Portugal and Greece. John Lipsky, the IMF’s second-in-command, will take over as acting director.

Lipsky, a former top economist at JPMorgan Chase, doesn’t enjoy nearly as much status with European leaders. “At these high levels and issues of national and global importance, personal stature and personal chemistry does matter,” wrote Jan Randolph, head of sovereign-risk analysis at IHS Global Insight. “It’s like losing an experienced ship’s captain, while navigating particularly difficult, uncharted waters.”

LIMITED TOOL CHEST

Absent German or French leadership, financial markets may look to the United States if the European crisis gets much worse. But the Obama administration has few tools for the task.

Fed action. The most likely immediate response could come from the Federal Re-

serve Board, which still has the authority to provide unlimited U.S. dollars to foreign central banks in return for an equivalent amount of their currency. In 2007 and 2010, the Fed and the European Central Bank swapped dollars for euros to provide short-term liquidity when European capital markets were under strain.

Both Fed and Obama administration officials say they could ramp up such exchanges again. The Fed can also make short-term emergency loans to commercial banks in distress. It did so in 2008 when the U.S. subsidiaries of the Franco-Belgian Dexia bank and the Dublin-based Depfa bank borrowed tens of billions of dollars. The banks had gotten into trouble when they could not roll over their debts after capital markets froze up during the crisis. Because Dexia was the world’s largest lender to municipalities and Depfa was deeply involved in infrastructure lending in the United States, the Fed justified the loans as necessary to protect the American financial system.

But the Fed has to be wary of Congress’s reaction to any perceived “bailout” of Europe. “What in the world are we doing thinking we can pass out tens of billions of dollars to banks that are overseas?” asked Rep. Ron Paul, R-Texas, a longtime Fed critic, who has already promised to hold a congressional hearing on the issue.

Jawboning. Barring direct intervention by the Treasury Department and the Fed, the Obama administration may be constrained to jawboning Wall Street to keep calm.

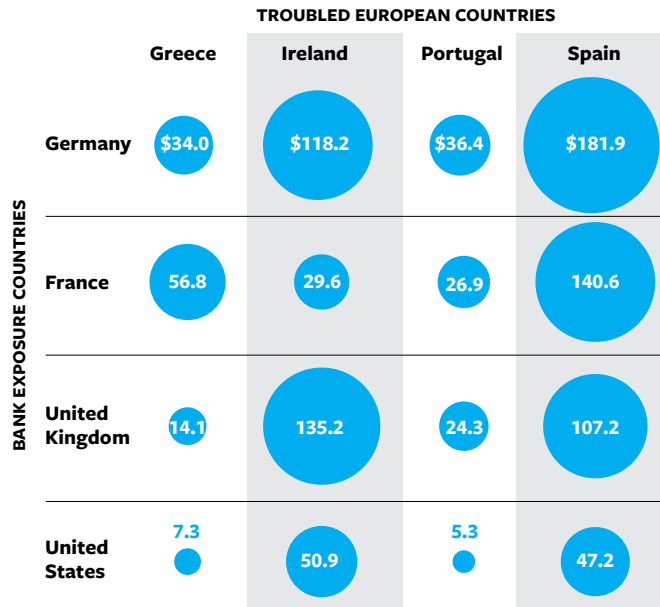
In 2009, at a time of widespread concern that Western banks would retrench from Eastern and Central Europe, various central banks and large financial institutions agreed to what became known as the Vienna Initia-



Unhappy partners: German Chancellor Angela Merkel (right) reluctantly supported Greek Prime Minister George Papandreou in his plea for help.

Bank Exposure in Troubled European Economies

European banks are heavily exposed to the debt problems of troubled countries. Banks hold large volumes of both government bonds and corporate loans that are at risk, especially in Greece and Ireland. U.S. banks lent money less aggressively in Europe, but they face problems there too.



In billions of U.S. dollars, December 2010

Source: Bank for International Settlements

tive. Through provision of new credit lines, risk-sharing, and loan guarantees, Western banks were persuaded to keep their money in the region. Similarly, in 2010, Berlin and Paris prevailed upon their banks to keep their money in Greece and Ireland.

In the wake of a euro crisis, Treasury could similarly lean on American financial institutions to not pull their money out of Europe. But Washington's powers of persuasion may be limited: Many of the biggest financial players in Europe are American hedge funds; as largely unregulated entities, these funds may feel little need to stay in government's good graces.

The administration could also orchestrate a euro rescue effort by the non-European

members of the G-20 group of major economies. In 2009, the G-20 successfully coordinated economic stimulus moves to keep the Great Recession from worsening. In the future, G-20 countries could buy European debt. Before Japan was devastated by an earthquake and tsunami, Tokyo had offered to buy as much as 20 percent of any bonds issued by the European bailout mechanism. Other G-20 members, such as Saudi Arabia, could make similar commitments to help calm financial markets.

Avoiding a worst case. The limited options available to the Obama administration mean that U.S. officials have influence only at the margins.

The Treasury Department could lean on the IMF to pressure Berlin and Paris to get on with restructuring European debt. If a debt write-down is inevitable, it may be better to take the bitter medicine now rather than drag it out at enormous economic and political expense. Support is growing for such a move among some conservative German officials and a number of European economists. As a provider of roughly a third of the euro bailout packages, the IMF has leverage on such timing and the resources to help Europe through the process.

The White House could also consider lowering trans-Atlantic trade barriers to help reignite European growth. A 2010 study by the European Center for International Political Economy in Brussels concluded that simply eliminating all tariffs on merchandise trade between Europe and the United States would boost the European economy by \$86 billion and provide a similar benefit to the American economy.

THE CHINA OPTION

The limited array of tools could change global political dynamics by elevating the role of China. Beijing sits on \$3 trillion in foreign-exchange reserves and has offered to buy Greek, Portuguese, and Spanish debt.

But as one IMF official quipped, "Borrowing money from the Chinese is like borrowing money from Tony Soprano. You have to worry about the vig."

The vig, or interest rate, would not necessarily be financial. E.U. officials already complain that bringing trade cases against China is increasingly difficult because smaller European nations do not want to offend a potential creditor.

Once indebted to China, however, Europe may find itself over a barrel. When Washington borrows from Beijing, China needs dollar assets as much as the United States needs Chinese money. Europeans will not be so lucky. "While it might be difficult for China to move out of the dollar," observed Francois Godemont, a senior policy fellow at the European Council on Foreign Relations, "abandoning the public debt of a euro-zone country will be much easier. China thus holds an implicit threat over those indebted countries."

In the end, if Europe and the United States are fortunate, none of these scenarios need play out. Europe may continue to muddle through its euro woes.

"I expect a certain level of crisis that is manageable," the European Policy Center's Zuleeg said. "But it is very much a question of luck."

Although luck is a thin reed upon which to risk the future of the U.S. economy, it may be the White House's best hope. ■



Out of action: The arrest of IMF Director Dominique Strauss-Kahn (right) on sex charges probably eliminates a key player.