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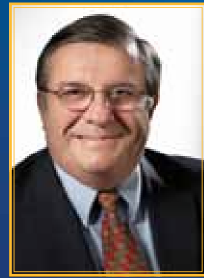

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Strange things are happening. When I was a youngster, TV comedian Red Buttons used to sing a song with this title about current trends. Today he would probably add verses about getting 20 inches of snow in October and how tiny Greece's debt problems could snowball and topple the world financial system.

On a brighter note, the U.S. economy has been looking better, with the odds of recession falling but still relatively high. Real GDP grew at a modest 2 percent annual rate in the third quarter – considerably better than in the first half. Much of the pickup reflects rebounds from parts shortages associated with the Japan earthquake as well as widespread flooding at home during the summer months. Initial claims for unemployment insurance have been coming down and car sales have firmed a bit. The biggest immediate threats to the fragile U.S. economy are the European debt situation and the U.S. Congress.

Debtors' Prison? As a youth reading Dickens' *David Copperfield*, I wondered how Macawber was supposed to pay his debts if he was thrown into debtors' prison. Well, austerity measures imposed on weak economies in order to reduce budget deficits raise the same question. How did the Europeans get themselves into such a bind? More important, how do they get themselves out?

Even before it was adopted more than a decade ago, I thought that the Euro was a bad idea. Along with many others, there were doubts over how "a one size fits all" monetary policy would work with such dissimilar members ranging from the thrifty Germans to the fun-loving Greeks. How would the Euro zone cope with recession if there was no transnational fiscal policy? How would they cope with financial crises without a "lender of last resort?"

Borrowing costs for Italy, Greece and others fell as they joined the monetary union in anticipation of their adopting conservative fiscal policies. But with the pressure off, they borrowed heavily instead. Meanwhile, European banks were encouraged to load up on this so-called "sovereign debt" because they were not required to hold any capital against bonds considered to be risk-free.

Almost two years ago, the Greeks began having difficulty servicing their debts in the wake of the global recession and feeble recovery. Ireland and Portugal had similar problems and, like Greece, required financial assistance from the more prosperous nations such as Germany, the Netherlands, and France. The *quid pro quo* for these bailouts was the enactment of austerity measures to reduce budget deficits by cutting government spending and raising taxes. Not surprisingly, these actions not only prompted protests, some quite violent, but they further weakened these economies. Unemployment has hit 14 percent in Ireland and 16 percent in Greece.

There's no doubt that Greece has been fiscally irresponsible, feeding a bloated public sector with massive borrowing. Italy, too, has had problems tightening its belt under the leadership of Silvio Berlusconi. Ireland, on the other hand, quickly and earnestly adopted the austerity measures but the effect, nonetheless, was deeper recession and a struggle to pay off the indebtedness. As I asked above, how do you pay off your debts from prison?

If Greece alone were to default on its debt, the global financial consequences would be modest – if there were no ripple effects. Greece is small. However, financial markets have begun to worry about the ability of Italy, the third largest economy in Europe, to meet its debt obligations of 2 trillion Euros vs. 350 million for Greece. Because it is so much larger than Greece, a default by Italy could trigger a global financial crisis.

Interest rates on Italian debt have risen to crisis levels – more than double the levels of a couple of years ago. Not only does this put additional strains on Italy's ability to roll over old debt and issue new obligations, it undermines the European financial system. Since higher market interest rates automatically mean lower market values on existing debt, the banks that hold these securities are faced with eroding equity and possible insolvency. Many of these banks are in Germany and France, so that all of the Euro zone is getting caught up in this mess.

Musings & Amusings:

Charles Dickens on solvency and credit default swaps

"Annual income twenty pounds, annual expenditure nineteen pounds nineteen and six, result happiness. Annual income twenty pounds, annual expenditure twenty pounds ought and six, result misery." Macawber

"Credit is a system whereby someone who can't pay gets another person who can't pay to guarantee that he can pay"

Interestingly, Germany is to its troubled debtor neighbors what China is to the United States. Problems elsewhere in the Euro zone have caused that currency to be undervalued (like the Chinese yuan). This has stimulated German exports, giving rise to balance of payments surpluses which the Germans have lent to their debtor neighbors! While it's more complex than this, there's a good deal of truth in the comparison.

How would we be affected if the Italians go into default? U.S. banks have sizable loan exposure to European banks and some holdings of European sovereign debt. Although much of this is hedged, there are concerns that the counterparties to these hedges might not be able to pay off in the event of a crisis. Slower economic growth in Europe, with recession spreading to Germany, and France, would seriously retard exports from the U.S., which – until now – have been an economic bright spot.

What's next? The European responses thus far have been far from adequate. Instead of easing, the European Central Bank raised interest rates under Jean Claude Trichet. His newly appointed successor, Mario Draghi, recently reduced overnight interest rates a quarter point as one of his first official acts. Although the bank has purchased some sovereign debt to support it (keep prices up and interest rates down), the ECB has refused to engage in the massive quantitative easing undertaken by the U.S. Federal Reserve which has flooded the economy with liquidity and kept long-term interest rates down.

Bailout funds have been made available to help troubled countries pay their debts but at the price of austerity Moreover, it's unlikely that the Europeans on their own could put together enough funds if Italy and or Spain were to need assistance.

Why such inadequate responses when so much is at stake? It's a combination of institutional and cultural issues. At the institutional level, the ECB has a single statutory responsibility which is to fight inflation. In contrast, the Federal Reserve has a dual mandate to maintain stable prices and reasonably full employment. Concern over unemployment has enabled the Fed to continue to pursue quantitative easing even when the inflation rate has picked up in response not top oil prices. The ECB's inflation preoccupation goes back to Germany's hyperinflation in the 1920s which helped pave the way for Adolf Hitler.

Culturally, there is resentment from the Germans and other member nations such as Finland over having to come to the rescue of those irresponsible southern Europeans. The northerners view themselves as are thrifty, hard working people unlike those folks towards the south. We see some of this same sentiment in the United States with the opposition to extending unemployment benefits out of fear that it subsidizes idleness.

In Europe, there was a belief that pursuing austerity measures would somehow bolster confidence and energize the economy. Not surprisingly, that hasn't happened in the face of rising unemployment and political paralysis. This should be a lesson to those who have the same views in the United States.

What's next? Greece has named Lucas Papademos as interim prime minister. In Italy, Mario Monti has replaced Berlusconi. Both new leaders are card-carrying economists who studied at MIT and Yale, respectively. (There has to be an economist joke in here somewhere.) These changes may make it more likely that both countries will pass legislation with the requisite austerity measures. However, both countries – and others – will still have difficulties paying their debts as their economies contract.

One option is for Greece to drop the Euro and adopt its own currency, (the new and improved drachma?) Problem is there are no procedures for leaving the union so that exit could be chaotic. Abandoning the Euro would allow Greece to default on its debts and devalue its new currency. These actions would have some benefits for the Greek economy, but the process is extremely complex. The task of reprogramming ATMs, vending machines, etc. would be formidable. There would be massive capital flight out of Greece to avoid financial losses associated with devaluation. The much weaker replacement currency makes the Greeks poorer because they have to pay much more for imported items.

Then there's the possibility that focus would simply shift to the next country likely to default and devalue: Italy, Spain, Portugal, etc. My guess is that the result would be a scary global replay of September 2008 when U.S. financial institutions were teetering and the system had to be bailed out by massive intervention on the part of the Treasury and the Federal Reserve.

My next guess is that the crisis is moving not just beyond the willingness but the ability of Germany and France to deal with it by adding to bailout funds. One possibility is for the ECB to engage is large scale quantitative easing by purchasing huge amounts of troubled bonds. This could stabilize the situation and beat back the speculators. Of course, there's opposition from the Germans and others to this large scale expansion of the monetary system. But the threat of recession, deflation and chaos might make them set their inflation paranoia aside for a while.

At the end of November, financial markets rallied on a surprise announcement that the Fed, ECB, and other major central banks would make cheap loans available to banks around the world. What this means remains to be seen. The actions provide liquidity to the global financial system, but do not address the fundamental European problems such as the ability of troubled nations to pay their debts and prospects for very slow economic growth. In short, this was certainly not a "get out of jail free" card.

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