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Europeans buy some time

After dithering, they reach a deal. But they and the U.S. still have tough decisions ahead.

By Mark Zandi

Paul Lachine / newsart.com

The U.S. economy dodged a bullet last week when European policymakers finally came up with a credible plan to address their debt problems. Europe hasn't solved its problems, but it has bought time to work on them and avoid a severe recession. The United States can weather a modest European recession, but a more serious downturn would be too much for our economy to bear.

Europeans' dithering over how to handle Greece's debts became a serious problem for them, and for us, more than a year ago. The U.S. and European economies are joined at the hip, most obviously because of the global stock market. Large U.S. companies do lots of business in Europe, and if Europe has a problem, this is immediately reflected in falling stock prices. The stock market also plays a central

role in our collective psyche; a stretch of negative trading days is quickly reflected in how much we spend and whether businesses hire.

Trade with Europe also supports many U.S. jobs. While China may have captured our attention in recent years, Europe is still a bigger market for U.S. exports, accounting for more than a fifth of what we ship overseas. A weak Europe means weaker demand for U.S. goods and services and fewer jobs.

Large U.S. financial institutions suffer when their European counterparts struggle. International banks lend to one another and team up to make loans to corporations. Along with loan guarantees, credit commitments, debt holdings, and other connections, such arrangements add up to a nearly $3.5 trillion exposure by U.S. banks to Europe, equal to almost a fourth of our yearly GDP. If these European relationships produce losses for U.S. banks, they will have less to lend to households and businesses at home.

The Europeans' most encouraging step involves shoring up their banks. Europe's financial institutions will now be required to value their portfolios of debt issued by Greece and other governments more realistically. As they do, many banks will find they no longer have enough capital - the financial cushion they need to withstand losses - and will be forced to raise more, either from private investors or from their national governments or the European bailout fund.

That bailout fund was also given more financial muscle, which it surely will need. Not only will the fund provide capital to troubled banks, but it will also buy bonds issued by struggling European governments, and may even have to lend directly to those governments. The bailout fund has already lent money to Greece, Ireland, and Portugal, and it is possible that Italy and Spain may eventually need help as well.

The Europeans have also put Greece on more solid financial ground. They are asking banks, pension funds, and other private-sector financial institutions to cut their IOUs from the Greek government in half. While Greece will still have an enormous debt load, it now has a fighting chance at managing it successfully.

Global investors have been assuaged by Europe's actions but won't be satisfied for long unless Europe follows through with the fundamental changes necessary to cut government deficits and debt loads.

This will require big public spending cuts and tax increases. Harder still, it will mean an overhaul of labor and trade laws, business regulations, and tax systems to jump-start economic growth. Many European economies can't compete globally; without major changes they may struggle for years. And maybe hardest of all, Europe's many national governments must coordinate their spending and tax policies or risk undermining their common currency, the euro.

It is thus likely that Europe will create more heartburn for the United States in the not-too-distant future. Indeed, it will probably take more financial turmoil for European policymakers to generate the political will to make those tough decisions. Riots in many European capitals in recent months show that European voters are likely to resist, making it hard for politicians to act without intense pressure from financial markets.

The U.S. situation isn't as precarious as Europe's, but there is much for us to learn in its experience. Most obviously, Congress and the Obama administration must address the nation's fiscal problems. Lawmakers face a critical test in the next few weeks, as the so-called supercommittee, composed of 12 senators and representatives, negotiates major reductions in future federal budget deficits. This process was part of the deal reached over the summer to raise the Treasury debt ceiling. If it falls flat and policymakers don't agree by Thanksgiving, global investors will turn their wrath on us.

It is also vital that policymakers extend the current payroll tax holiday for workers. Without action, everyone's taxes will rise next year. This makes little sense in a struggling economy, and runs the risk of reigniting a recession that would make our fiscal problems even worse.

Still, what the Europeans did last week is very encouraging, and while they need to do more, their actions suggest that they will. We too have made significant progress righting the wrongs that got us into this mess, and while we also have much more to do, I'm increasingly confident that we will find a way to do it.

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