Gloom, Doom and the Hidden Rays of Hope – Part 2

"Europe is approving a bigger bailout fund." I feel as if that headline has been on the front page of so many newspapers so often that it has lost its value to impress. And yet here it is again. This time, the bailout fund is the European Financial Stability Facility, which is getting some new powers: it will soon be able to buy government bonds and lend directly to governments and banks. The problem is that it won't have enough money backing its new powers to actually solve the crisis. This is a bit like empowering firefighters to go into burning buildings, but not giving them sufficient water for their hoses.

Europe is caught in a long bout of something that we're very used to seeing after financial crises: extend and pretend. The underlying reality of their dilemma is that there are hundreds of billions -- or maybe more -- in losses for someone to take. If Greece and Ireland and Portugal take them, that means default and likely exit from the Euro. If they default, that means defaulting, in large part, on loans owed to German and French banks, which could cause a banking crisis in those countries. For them not to default, however, means that taxpayers in other European countries have to take those losses.

The solutions to this crisis which are economically plausible are not politically plausible, and vice-versa. As economist Carmen Reinhart commented "If the policymakers were to be proactive, they would restructure Greek debt alongside bank recapitalization and at the same time, restructure both Portugal and Ireland as well." That is to say, they would do it all at once. But the sticker shock to that strategy would be enormous.

What is proving politically plausible is to do just enough to survive the week, and do it in the nick of time. We've seen this over and over again in this crisis. But the irony of this strategy is that it's likely making a resolution harder. The longer Europe spends under this cloud, the harder it is for them to grow. The harder it is for them to grow, the worse these debts become. And the worse these debts become, the harder they are to pay off. The cost of denying the problem is to make the problem worse. But for Europe's leaders, that is, at least for now, an easier price to pay. Actually fixing the problem might ultimately be cheaper, but it requires a wealth of political capital and continental unity that they simply don't have.

Howard Schneider of the Washington Post reports that Europe is approving a bigger bailout fund but that it may not be enough: "One by one, European parliaments are blessing a $600 billion bailout fund considered an important step in solving the region's financial crisis. But there is an unspoken problem: The fund may not be big enough to do a job that involves backing such major countries as Italy and Spain and boosting capital levels in the region's financial system. Germany's Parliament delivered an important vote of approval Thursday for the European Financial Stability Facility. But even if other governments follow suit, officials will need to pivot quickly into a contentious debate about how to boost the size of the fund to perhaps several trillion dollars. That's what many analysts feel is needed for the 17-nation euro zone to prove its commitment to standing behind weakened euro-zone governments and the region's financial system."

Matt Phillips of the Wall Street Journal reports that The Fed's "Operation Twist" is working surprisingly well: "As the Federal Reserve Bank of New York prepares to release on Friday new details about the central bank's rate-lowering program, some bond-market strategists have done their own back-of-the-envelope assessment already. Their conclusion: Operation Twist could in some ways do as much--or more--for the bond market than its predecessor, known as QE2. The program also could prove to be a boost for stocks...Even though Operation Twist hasn't begun being implemented, it already is having an impact on long-term interest rates. It also is affecting what bond investors are buying and selling, pushing many to buy somewhat more risky bonds like mortgage securities and corporate bonds. That's the outcome the Fed has suggested it wants to achieve. 'Operation Twist has greater punch than the QE2 program, or should,' said Ray Stone, an economist at Stone & McCarthy Research."

George Soros writes in an Op-Ed that Europe needs to take immediate steps to prevent a deep recession: "Three bold steps are needed. First, the governments of the Eurozone must agree in principle on a new treaty creating a common Treasury for the Eurozone. In the meantime, the main banks must be put under European Central Bank direction in return for a temporary guarantee and permanent recapitalisation. The ECB would direct banks to maintain credit lines and outstanding loans, while closely monitoring risks taken for their own accounts. Third, the ECB would enable countries such as Italy and Spain to temporarily refinance themselves within limits at a very low cost. These steps would calm markets and give Europe time to develop a growth strategy, without which the debt problem cannot be solved."

Michael Gerson of the Washington Post writes also in an Op-Ed that Europe could learn something from American history: "The European Union’s long-term problem is a structural flaw. It shares a common currency but not a system to ensure that its individual members are fiscally responsible. The United States faced a similar challenge in 1790, when Treasury Secretary Alexander Hamilton engineered the federal assumption of state debts incurred during the Revolution -- a remarkable success, which caused the price of American bonds to soar. 'He touched the dead corpse of public credit,' said Daniel Webster of Hamilton 'and it sprung upon its feet.' Only Germany has the strength and standing to play a similar role in Europe. But Germans are reluctant Hamiltonians. They naturally resist paying the bills for their profligate European cousins. And other nations have plenty of historical reasons to fear German dominance in Europe. Still, Germany is being led, step by shuffling step, into this role."

Paul Krugman in the New York Times writes that blaming the slow recovery on Obama is silly: "Listen to just about any speech by a Republican presidential hopeful, and you’ll hear assertions that the Obama administration is responsible for weak job growth. How so? The answer, repeated again and again, is that businesses are afraid to expand and create jobs because they fear costly regulations and higher taxes...The first thing you need to know, then, is that there’s no evidence supporting this claim and a lot of evidence showing that it’s false. The starting point for many claims that anti-business policies are hurting the economy is the assertion that the sluggishness of the economy’s recovery from recession is unprecedented. But, as a new paper by Lawrence Mishel of the Economic Policy Institute documents at length, this is just not true. Extended periods of 'jobless recovery' after recessions have been the rule for the past two decades."

And finally, Brad DeLong opines on the Project Syndicate website that deficit-financed stimulus is a free lunch: "The US government can currently borrow for 30 years at a real (inflation-adjusted) interest rate of 1% per year. Suppose that the US government were to borrow an extra $500 billion over the next two years and spend it on infrastructure - even unproductively, on projects for which the social rate of return is a measly 25% per year. Suppose that - as seems to be the case - the simple Keynesian government-expenditure multiplier on this spending is only two. In that case, the $500 billion of extra federal infrastructure spending over the next two years would produce $1 trillion of extra output of goods and services, generate approximately seven million person-years of extra employment, and push down the unemployment rate by two percentage points in each of those years...So what is not to like? Nothing."

So there you have it: a roundup of many perspectives and my own comments about the ongoing economic crisis. If you have your own comments you would like to share with me about our economy or the global situation, please feel free to send them to me. We are all in this together and I believe that it is only going to be the concerted efforts of all of us making our opinions clear to our elected representatives that will see us through this difficult time.