Two Directions

No doubt you've read about the European Union summit meeting in Brussels this past week, which was billed, in advance, as the negotiation that would finally deliver a final solution to Europe's debt crisis. You will probably not be surprised to hear that the outcome fell short of expectations.

In all, 23 of the 27 European nations agreed to follow the lead of France and Germany. They drafted a resolution to impose more central control over national budgets, and enforce future spending and budget discipline across the 17 countries that use the euro as their currency. The summit, in other words, focused on preventing the next debt crisis rather than finding ways to meet the current one head-on.

Even future discipline may be too much to expect. One of the holdouts to the resolution was a major player: Great Britain, whose stiff opposition to mandatory budget guidelines (and giving up control to an outside agency) means that the other governments will have to enforce their agreement as an "understanding" between governments rather than through the full authority of a treaty. (The other non-signatories--Sweden, the Czech Republic and Hungary--want to consult their legislative bodies before signing on for more austerity.)

In separate analyses, the Economist magazine and economist Cliff Wachtel tell us that there was no progress on addressing the immediate threat of default of Greek, Italian and Spanish bonds, which has become more pressing as their rates soar on the open market. On Thursday, Germany rejected proposals to strengthen the European Central Bank's bailout fund, and the ECB's central banker later announced that he had no plans to lower bond rates or buy government bonds outright.

The Wall Street Journal reported that currency traders were not impressed by this outcome. They boosted the euro's value a bit on Friday to essentially where it was last week. Credit analysts at Moody's and Standard & Poors were apparently even less impressed. Moody's issued downgrades on the solvency of three major French banks. S&P put several European nations on a downgrade watch; look for France to be the next major nation to suffer the indignity of a ratings drop.

Bond defaults are one worry in Europe; the other is recession. Economists at investment bank UBS announced, during the summit meeting, that they expect the 17-nation Eurozone's aggregate economic growth to fall into negative territory (-0.7%) next year. Without stimulus, with declining economic activity, European nations will have to make do with lower tax revenues, further calling into question their ability to pay the debt they already owe. The threat of default causes investors to demand ever-higher bond rates, raising borrowing costs and making default more likely.

Interestingly, you find the opposite dynamic in the U.S., where economic growth was a modest but positive 2% for the third quarter, fueled by gains in retail sales, manufacturing and housing. This is good news, an improvement over the 1.3% growth in the second quarter. The U.S. unemployment rate, which topped 10% in 2009, has quietly fallen back to 8.6%. But the U.S.

Federal Reserve Board wants better news; on Tuesday, the Fed is expected to announce a strong commitment to keeping the federal funds rate near zero, and may soon undertake a third round of buying U.S. bonds as a way to encourage the housing and labor markets. Europe and the U.S. may be moving in opposite directions, in part because of opposite measures from their respective central banks.

Sources:

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