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Crisis in Europe: Time for a Tough U.S. Response

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Three years on, through half measures and a fantastical faith in their own abilities, Europe's leaders have led the continent into an extended economic crisis. Indeed, by delaying decisive action for so long, Europe has managed to make matters substantially worse for the continent first, and for the rest of the global economy.

While the U.S. economy could never entirely avoid the distresses emanating from Europe, the magnitude of the domestic injury early on appeared modest. The U.S. response was correspondingly muted, with expressions of concern, sympathy, and a desire to help except by contributing to further bailouts. As the European crisis deepens, the U.S. should acknowledge the growing threat and respond accordingly.

First, America's national leaders, beginning with President Obama, need to set aside their political agendas and act to strengthen America's economy for whatever shocks come from Europe. Second, it is time the U.S. demanded that Europe cease temporizing and take decisive, conclusive action to restore Europe's economy and finances. This will likely require that Europe take painful and unpleasant steps.

Europe Goes from Bad to Worse. With roots going back to the adoption of the euro in 1999, the European crisis first broke into the open some 10 years later. In April 2009, the European Union told France, Spain, Ireland, and Greece to reduce their budget deficits in the wake of the credit crisis. What has since followed has been a steady stream of summits, conferences, grand announcements, protests, denials, finance mechanisms, and bailouts.

In short, what has followed has been damage control. The latest example is the drama surrounding the Spanish banking system. The cycle was a familiar one. First, the Spanish government insisted that its banks were fine and that it would never ask for nor accept a bailout. Then, the government acknowledged that some banks might need just a little help for a little while and tried to arrange to provide capital to Spanish banks through Spanish government borrowing.

That flopped. Then the government acknowledged that it would need a real bailout, and Europe responded with about 100 billion euros ($125 billion) cash. But some reports suggest that this is less than half of what will be needed to stabilize the Spanish banking system.[1]

Nor was the drama over with the announcement of the bailout. No doubt worried about Spanish sensibilities, Spanish Prime Minister Mariano Rajoy insisted that the bailout had "nothing to do" with the procedures imposed on Greece, Ireland, and Portugal when they were bailed out.

"Nicht wahr," insisted Germany and the European Union (EU), who confirmed that the "troika" of the International Monetary Fund, the European Commission, and the European Central Bank would oversee the funds. "Of course there will be conditions" was the EU response. German Finance Minister Wolfgang Schaeuble pointed out, "The Spanish state is taking the loans, Spain will be responsible for them. ... There will likewise be a troika."[2]

The Spanish example of too-late half measures is, unfortunately, not

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unique. Consequently, since the crisis began Europe has clearly and substantially weakened its banking system, which is propped up only by the ephemeral elixirs of central bank cash and shaky bailouts. The periphery has sent their economies into a deflationary spiral. Many have paved a fiscal path of ever-higher debt to the point where default on sovereigns is a distinct possibility. And having long dismissed the need for fast growth in favor of public-sector intervention and distribution, governments have now discovered the need for fast growth, but they conveniently again see public-sector spending as the means.

The Threat to the U.S. from Europe. The obvious threat to the U.S. from Europe's many crises is from a reduction in U.S. exports. According to the Department of Commerce, U.S. exports to Europe may have begun to slide as early as October 2011, as the widespread slowdown in Europe was only beginning to take hold.[3] In 2011, U.S. exports to Europe totaled $329 billion, representing about 22 percent of all U.S. exports.[4] While substantial, in a $15 trillion economy even a collapse in U.S. exports to Europe would have limited direct consequences.

The greater issue involves the effect of a deep recession and financial crisis in Europe on U.S. financial firms and markets. The 2008–2009 global financial crisis taught many important lessons about the state of modern finance. One lesson is that the global and interconnected nature of financial markets and firms means that financial shocks of a critical mass will spread far and wide.

This interconnectedness is made even more relevant because of a second lesson: No one—not the regulators, not the policymakers, and not those who run the firms themselves—fully knows the extent of the exposures and especially the structural weaknesses until the shockwave hits. In short, no one knows what no one knows—or how expensive that lack of knowledge will prove to be. Given the magnitude of the crisis in Europe, the potential threat to the U.S. is cause for real concern.

The U.S. Domestic Response: Politics Must Give Way to Growth. The U.S. domestic policy response to the building threat from Europe should be to make every possible effort to strengthen the U.S. economy and financial system in anticipation of whatever shockwaves may come from across the Atlantic.

To strengthen the economy, Congress and the President should immediately stop their posturing and politicking and disarm Taxmageddon. The threat of massively higher taxes in 2013 is already depressing economic activity and job growth. Facing the greater uncertainty about their own tax liability and about the state of the economy in 2013 if Taxmageddon strikes, firms are prudently holding back on the investments and other actions needed to propel the economy forward.[5]

The U.S. budget deficit is projected to exceed $1 trillion for the fourth straight year, adding to economic uncertainty. Congress and President Obama should defy conventional wisdom, set aside their political differences, and rein in federal spending immediately by choice rather than being eventually forced to do so, as countries across Europe have been.

Even more important, policymakers should adopt some commonsense steps that are necessary to rein in entitlement spending for the medium to long term.[6] The basic policies needed to stabilize the finances in the Medicare and Social Security programs in particular are well-understood, in many cases

1. See Nouriel Roubini and Megan Greene, "Get Ready for the Spanish Bailout," EconomistMeg.com, May 14, 2012, http://economistmeg.com/2012/05/14/get-ready-for-the-spanish-bailout/#more-1841 (accessed June 15, 2012).
2. See Sonya Dowsett and Gareth Jones, "Market Euphoria over Spanish Bank Bailout Fizzles," Reuters, May 11, 2012, http://www.reuters.com/article/2012/06/11/us-eurozone-spain-idUSBRE85908Z20120611 (accessed June 15, 2012).
3. See U.S. Department of Commerce, Economic Statistics Agency, "Economic Indicator: The European Economy and U.S. Exports—A Seasonally Adjusted View," December 9, 2011, http://www.esa.doc.gov/Blog/2011/12/09/economic-indicator-foreign-trade-european-economy-and-us-exports-seasonally-adjusted (accessed June 15, 2012).
4. News release, "U.S. International Trade in Goods and Services Annual Revision for 2011," Exhibit 13, U.S. Department of Commerce, U.S. Census Bureau, June 8, 2012, http://www.esa.doc.gov/sites/default/files/ei/documents/2012/June/usinternationaltradeingoodsandservices28annualrevisionfor201129.pdf (accessed June 15, 2012).
5. See Curtis S. Dubay, "Taxmageddon: Massive Tax Increase Coming in 2013," Heritage Foundation *Issue Brief* No. 3558, April 4, 2012, http://www.heritage.org/research/reports/2012/04/taxmageddon-massive-tax-increase-coming-in-2013.
6. See David S. Addington, "Federal Budget: What Congress Must Do to Control Spending and Create Jobs," Heritage Foundation *Issue Brief* No. 3538, March 14, 2012, http://www.heritage.org/research/reports/2012/03/federal-budget-control-spending-and-create-jobs.

already tested in law, and entirely evolutionary.[7]

Finally, the uncertainty plaguing the U.S. economy is also due in part to the flood of regulations pouring or about to pour out of Washington from, among other causes, Obamacare and the Dodd–Frank financial market reforms. Even the threat of new regulations causes businesses to hesitate to make new investments, because those investments may be made obsolete or unprofitable by an unfavorable regulation.[8] Congress and President Obama should declare a regulatory cease-fire, at least until the European crisis passes and the U.S. unemployment rate approaches full employment.

The U.S. External Response: Europe Needs Credible Reform Now. Externally, the U.S. needs to change the tone and content of its message to Europe. President Obama has been urging European governments to spend more now, even as their borrowing costs and debt far exceed sustainable levels. That might save one of the continent's tottering governments in the short run, but it would only exacerbate the economic crisis.

Europe needs structural reforms—most acutely in its labor markets—and credible plans to restore fiscal discipline. Past U.S. expressions of sympathy and goodwill should, in light of the continued, unaddressed economic threat, grow into strong urgings and demands that Europe undertake the fundamental reforms needed to restore confidence that growth can again be sustained.

Europe faces choices that are economically complex and politically difficult. It has for a decade operated under an unstable hybrid system whereby some economic and political elements have been unified across the continent, such as the euro, while others have not, such as fiscal and banking policy in addition to a patchwork political structure. This cannot continue, as European officials have come to recognize. As Europe considers its options, it is important for the U.S. to support national sovereignty and economic freedom in Europe, as these principles are ultimately in the best interests of Europe and the U.S.[9]

It is not for the U.S. to tell Europe what path to take. The people of Europe themselves, and not unelected technocrats, must decide their future. However, it is incumbent on America's leaders to take the steps at home that are necessary to ensure that America is in as strong a position as possible to withstand any coming storm and to demand that Europe act decisively to put itself back on a path of sustainable economic growth.

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7. See J. D. Foster, "Premium Support Is Incremental, Not Radical Medicare Reform," Heritage Foundation *Backgrounder* No. 2649, February 7, 2012, http://www.heritage.org/research/reports/2012/02/premium-support-is-incremental-not-radical-medicare-reform; and David C. John, "Fix Social Security to Give Better Future for Our Kids," Heritage Foundation *Commentary*, July 12, 2011, http://www.heritage.org/research/commentary/2011/07/fix-social-security-to-give-better-future-to-our-kids.
8. See James L. Gattuso and Diane Katz, "Red Tape Rising: Obama-Era Regulation at the Three-Year Mark," Heritage Foundation *Backgrounder* No. 2663, March 13, 2012, http://www.heritage.org/research/reports/2012/03/red-tape-rising-obama-era-regulation-at-the-three-year-mark.
9. See Nile Gardner and Ted R. Bromund, "Five Conservative Principles That Should Guide U.S. Policy on Europe," Heritage Foundation *Issue Brief* No. 3524, March 1, 2012, http://www.heritage.org/research/reports/2012/03/5-conservative-principles-that-should-guide-us-policy-on-europe.