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Fear Athens Less and Washington More

There comes a tide in the affairs of men …. And the one sweeping from Greece, across Europe and into the United States is washing away support for austerity, in some cases reinforcing opposition to it, largely from the Left. President Obama is delighted at this support for his refusal to cut spending in the face of mounting deficits, and the Republicans are feeling beleaguered at what they see as the disinterment of the body of works of John Maynard Keynes. No longer must the President sit at G8 meetings (in this weekend's case, G7 since Vladimir Putin finds it necessary to stay at home to deal with an unpleasant spate of dissent) and hear only the voice of Germany's iron Chancellor, Angela Merkel, extolling the virtues of thrift, austerity and balanced budgets. Now he has France's new socialist President, François Hollande, to preach the virtues of spending, "the indispensable stimulation of the economy", and, even better, high taxes-- up to 75% on incomes in excess of $1.35 million per year, which makes the team of Buffett and Obama mere pikers at the soak-the-rich game. Secretary of State Hillary Clinton expressed the administration's delight at Hollande's "different political approach….Different voices may be louder on growth than they have been….It's been our view that there needed to be adjustments to …austerity, so that there could be growth, both for economic reasons and for political reasons…. President Obama and our economic team have been saying for some time that growth had to factor into a European recovery." Take that, Mrs. Merkel and all you Republicans who want to cut entitlement spending and retain the Bush tax cuts that benefit "millionaires and billionaires", Obama shorthand for families earning more than $250,000 per year.

The hard-line austerity crowd remains impervious to experience. It seems clear that austerity, German style, is producing such rapid contractions in Greece, Italy, Spain and elsewhere that the debt burden rises rather than falls as the economy shrinks faster than the outstanding debt. But all the fault does not lie with Germany. Rather than emphasize spending cuts and structural reforms as their tools for meeting austerity goals, many politicians have chosen tax increases, regardless of the negative effect on economic growth. Mr. Hollande, the gout du jour at the White House, is not alone: even Britain's Tory Chancellor of the Exchequer is relying heavily on tax increases to bring down his country's deficit. So while it is reasonable to criticize Germany for its single-minded emphasis on budget balancing via austerity, it is equally reasonable to criticize some politicians for relying too heavily on growth-stifling tax increases to stanch the flood of red ink.

Americans are more than a little nervous about the situation in Europe. Reasonable or not, that nervousness was heightened when it was revealed that some risk managers and traders in the London office of JP Morgan Chase had lost some $2 billion-and-rising in trades that their boss, Jamie Dimon now characterizes as a hedge that morphed into a bet, and confesses he doesn't understand. So in the best 2+2=5 manner of nervous investors, some Wall Street folks decided that Greece's problems will lead to default (correct), which would lead to a run on Greek banks (already under way), and to serious losses for banks in Germany, France and elsewhere (certainly), and to unpredictable Lehmanesque consequences for America's financial institutions (unlikely). After all, if even Dimon, the nation's most talented banker -- so talented that even Barack Obama, no admirer of bankers, sings his praises -- can get it spectacularly wrong, how can we be certain that our financial institutions are immune from Europe's problems? Besides, all those Republicans who troop to the television studios to remind us that unless we change our profligate ways America will be the next Greece just might be making a valid connection between Europe’s problems and our own.

Not the clearest logic, since the mechanism by which Europe’s problems would be transmitted across the ocean remains elusive. Our banks are in far better shape in terms of capital and liquidity than their EU counterparts -- indeed, they are winning new customers as European banks pull out of the US market as part of their retrenchment strategies. American money market funds have reduced their exposure to European banks. The American economy is growing, not rapidly but growing, while the EU economy is headed into recession. The headline unemployment rate in America is about two percentage points less than that in the EU, and even woefully over-extended California is in better shape than, say, Spain, if you want to look beneath aggregate data. Exports account for a relatively small part of America’s GDP, 15%, and exports to the EU are far less important than exports to Canada and Mexico. So a recession-induced drop in European demand for US goods would not be a terribly significant drag on US output.

Still, many Americans believe in the contagion theory: today Europe, tomorrow the United States. The best explanation I could get from Wall Streeters for the persistence of this fear goes something like this. Investors in equities are poised at the exit. No one wants to be the last man not standing. They will hold onto their shares until the first sign of trouble, and then bolt for the door. A European event might provide that sign. The selling wave will drive down share prices and paralyze business investment and household spending here in the U.S.

So the story goes. My own view is that we Americans would do better to heed Voltaire than Hollande, and tend to our own garden. The rather tenuous connections that get us from Greece’s problems to an American recession should be less of a worry than home-grown political developments. At the end of the year America once again hits its statutory debt ceiling of $16.4 trillion, and will be unable to borrow to meet expenses unless that ceiling is raised. Earlier this week Republican House Speaker John Boehner made clear that his party will not support an increase in the ceiling unless the Democrats agree to equal or greater spending cuts. Which they won’t. Unless voters break the stalemate by turning over the White House to Mitt Romney and give the Republicans a majority in the senate, or alternatively re-elect Obama and turf enough Republicans out to give the Democrats control of the House, we will enter 2013 with divided government. With several moderates in both parties having lost primary fights or retiring, the center cannot hold -- or even exist. Left-leaning Democrats intent on maintaining or expanding the welfare state will face off against right-leaning Republicans opposed to any and all tax increases. The result would be a lot more troubling for America than a Greek default.