British banks, whose fortunes in turn are enmeshed with those of U.S banks (Figure 5). Eventually, these countries' debts will likely be written down by at least 30 cents on the dollar, which will hit the European banking system about as hard as did the 2008 Lehman meltdown.

Lessons for the United States

10. The United States budget deficit has swollen to over US$1.5 trillion, or around 10 percent of GDP, while its public debt to GDP ratio has already risen to around 70 percent. This has placed the United States' public finances on a clearly unsustainable path, even before considering the serious public finance problems at the state level. It is of note that US public debt levels as a percent of GDP are on a path to reach within a year or two those levels at which a funding crisis in Europe's periphery was triggered.

    Europe's recent difficult experience with its public finances would seem to offer the United States the following cautionary lessons:

    a. US policymakers should not take comfort from the fact that, despite its very poor public finances, the US government can still finance itself at very low interest rates. Up until mid-2010, the Greek, Irish, and Portuguese governments all were able to fund themselves at relatively low interest rates only to find themselves subsequently virtually shut out of the capital market.

    b. When markets finally do lose confidence in the sustainability of a government's public finances they tend to do so in an abrupt manner. This tends to be highly disruptive to financial markets and it tends to be associated with prolonged and deep economic recessions. One also finds that once a government loses the market's confidence it proves difficult for it to regain the market's trust.

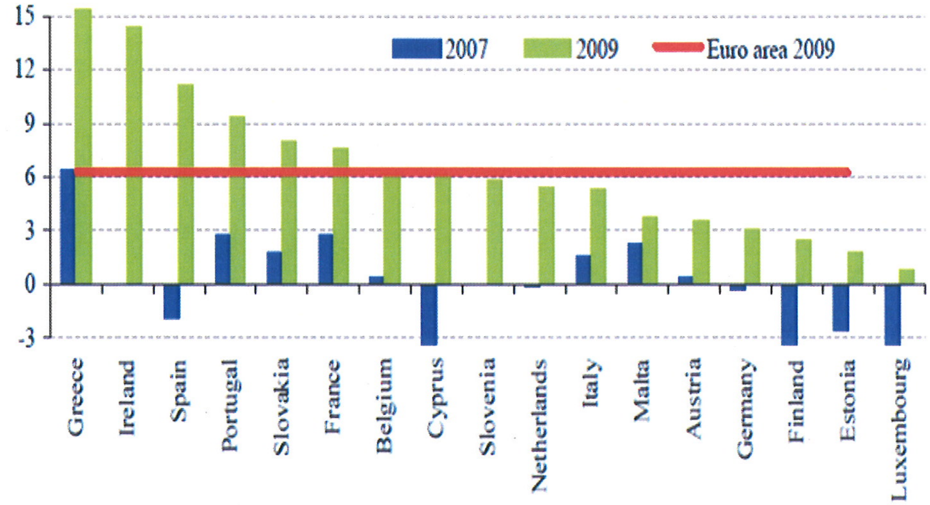
    c. Dependence on foreign sources of financing exposes a government to the vicissitudes of foreign credit markets. It also places a government in a position where foreigners can dictate the terms of future lending that can be harmful to a country's economic growth prospects.

d. Disruption in a government's bond market can have important implications for the financial system, which tends to be a primary holder of government bonds. Experience shows that a weakened financial system is generally associated with lower long-term economic growth.

Figure 1.

Europe: General government deficits

(as a percentage of GDP)

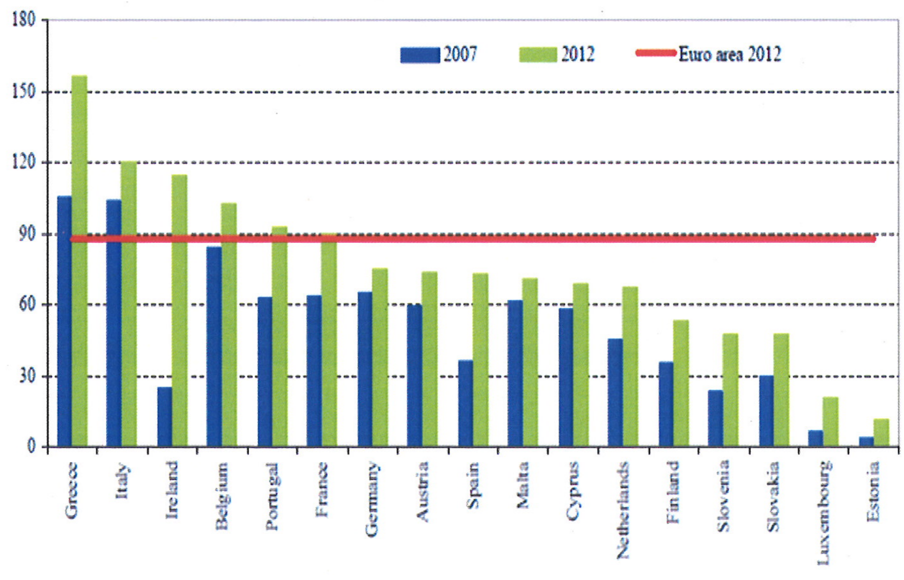


Source: European Commission's economic forecast autumn 2010 6

Figure 2.

Europe: General government gross debt

(as a percentage of GDP)



Source: European Commission - Autumn 2010 Forecast 7

Figure 3.

European Periphery 10 year Credit Default Spreads

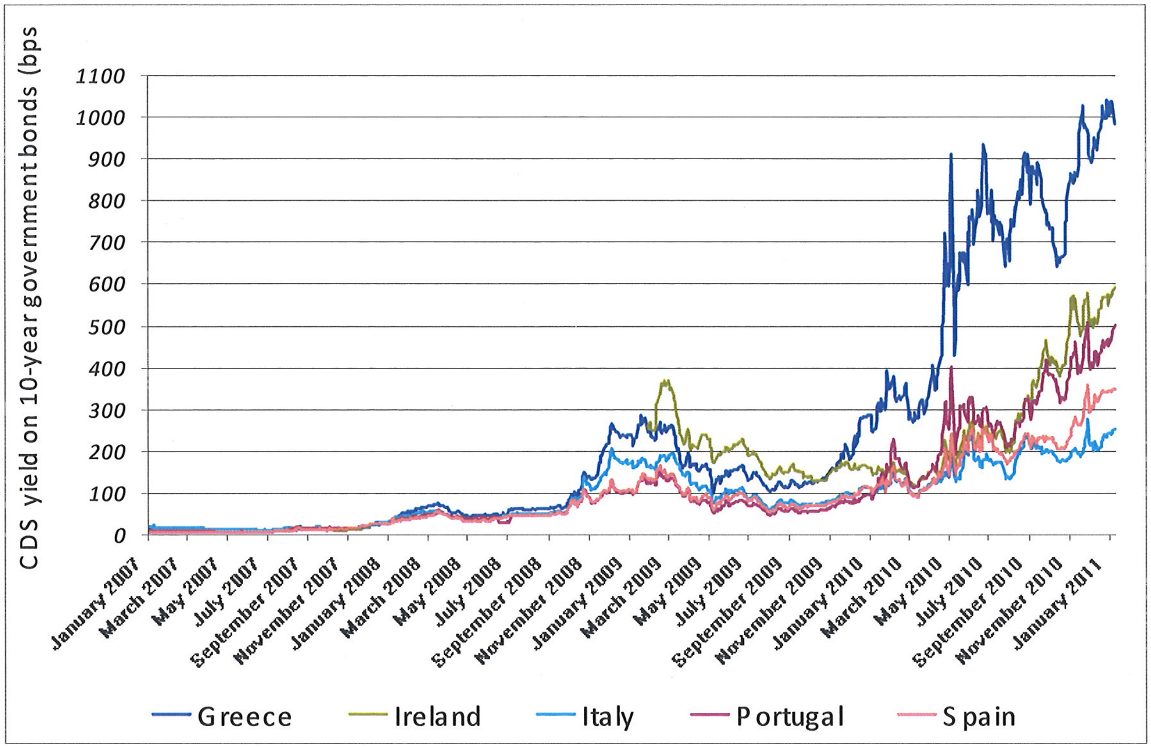


Figure 4.

The Greek Economy is Collapsing

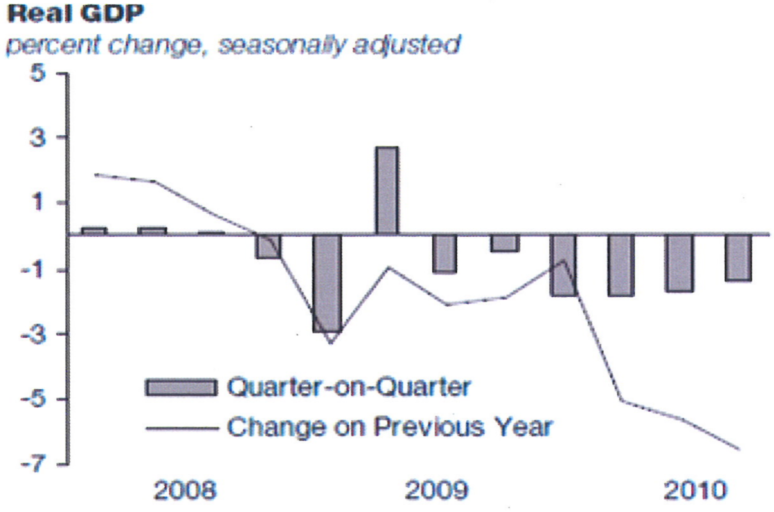


Figure 5.

European Bank Exposure to the Periphery