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One false move in Europe could set off global chain reaction

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If the trouble starts -- and it remains an "if" -- the trigger may well be obscure to the concerns of most Americans: a missed budget projection by the Spanish government, the failure of Greece to hit a deficit-reduction target, a drop in Ireland's economic output.

But the knife-edge psychology currently governing global markets has put the future of the U.S. economic recovery in the hands of politicians in an assortment of European capitals. If one or more fail to make the expected progress on cutting budgets, restructuring economies or boosting growth, it could drain confidence in a broad and unsettling way. Credit markets worldwide could lock up and throw the global economy back into recession.

For the average American, that seemingly distant sequence of events could translate into another hit on the 401(k) plan, a lost factory shift if exports to Europe decline and another shock to the banking system that might make it harder to borrow.

"If what happened in Greece were to happen in a large country, it could fundamentally mark our times," Angelos Pangratis, head of the European Union delegation to the United States, said Friday after a panel discussion on the crisis in Greece sponsored by the Greater Washington Board of Trade.

That local economic development boards are sponsoring panels on government debt in Greece is perhaps proof enough that Europe's problems are the world's. That the dominoes can tumble fast was shown Thursday when a new and narrowly drawn stock-trading policy in Germany helped trigger a sell-off on Wall Street.

It marks a change, Barclays Capital chief European economist Julian Callow wrote in a Friday analysis, from a situation in which the bonds of European countries were considered to carry virtually zero risk to a "brave new world" where sovereign default in one of the world's core economic areas is a tangible threat. Bank holdings of European debt are now being studied with the same focus given to holdings of U.S. mortgage-backed securities as the global financial crisis unfolded in 2008 -- and with the same suspicion that problems in one part of the world could wreck others.

The most vulnerable European countries -- Greece, Spain, Portugal and Ireland -- may represent only about 4 percent of world economic activity, but "the debt crisis and its ripple effects are bad news for all corners of the world," said Cornell University economist Eswar Prasad.

The risk of a worst-case scenario is still considered remote. European countries have pledged hundreds of billions of dollars to aid indebted neighbors that run into trouble, and they say they are committed to fixing the continent's larger economic problems. The euro and U.S. markets were both higher Friday after the German Parliament approved a key piece of that support program. A renewed effort by the U.S. Federal Reserve to ensure that European banks have adequate access to dollars has generated little demand -- a sign that a feared shortage of cash is not in the offing.

U.S. banks are not heavily exposed to the weaker European countries, Fed governor Daniel K. Tarullo said in testimony on Capitol Hill last week. Banks are in better shape overall, after fresh infusions of capital. Meanwhile, the U.S. economic recovery has been strengthening through the year, with jobs added in five of the last six months, and recent consumer spending and industrial output stronger than most forecasts.

But the fallout from Europe could still be widely felt. U.S. trade officials, hoping the country can dramatically boost its exports, are dismayed at the steep drop in the value of the euro -- which is around $1.25, down from more than $1.50 in November. The decline makes American goods more expensive compared with those produced in Europe. The slide in the common European currency could also change the way China and a host of Asian countries approach their currency policies, possibly making them less likely to agree with U.S. demands to raise the value of their money. If they raised it, Asian goods would become more expensive in world markets, making it easier for U.S. products to compete.

The connections are being closely watched. Analysts are studying how the involvement of Greek financial institutions in Eastern Europe, or Spanish banks in Latin America, could affect those economies. The International Monetary Fund and E.U. officials are doing biweekly checks on Greece's progress to ensure its economic reform program stays on track, according to Vassilis Kaskarelis, Greece's ambassador to the United States.

Inside the euro zone, banks are intimately linked, with a web of investments and cross-country bond holdings that could be a main vector for financial "contagion," with a default in one country weakening banks elsewhere.

There are some positive impacts in all this for the United States.

For one, uncertainty about European government debt has driven global investors toward U.S. government bonds, which in turn is pushing down long-term interest rates. The 10-year Treasury bond had a rate of 3.2 percent Friday compared with nearly 4 percent last month. Those lower rates should flow through to private borrowing, helping Americans getting mortgages or businesses looking to grow.

The European panic is also lowering the price of oil and other commodities on global markets, potentially making it cheaper for Americans to fuel their cars and heat their homes. A barrel of oil went for about $70 on Friday, down from almost $87 on April 6.

A final positive for the U.S. economy is that the stronger dollar will help keep inflation in check by reducing the cost of imports. That, combined with renewed worry about the strength of the recovery, is likely to give the Fed some leeway to delay raising interest rates above their current extremely low levels longer than it would have otherwise.

The most precise comparison is to the East Asian financial crisis that enveloped Thailand, Indonesia, South Korea and other nations in 1997 and 1998. There were widespread fears that the crisis would damage the U.S. economy, including through a financial contagion effect. The Fed even cut interest rates in the fall of 1998 to try to forestall a weakening in U.S. growth.

But there was little obvious impact on the U.S. economy, which grew 4.5 percent in 1997, 4.4 percent in 1998, and 4.8 percent in 1999.

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