Is Europe's Sputtering Economy a Danger to American Recovery?

Michael Mussa sees the contraction in Greece and other countries as rattling US markets but not yet posing a major threat to the US recovery.

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Steve Weisman: Europe and Greece continue to be in some economic turmoil. What effect will that have on the global economic recovery and on the United States? This is Steve Weisman at the Peterson Institute for International Economics with Senior Fellow Michael Mussa to answer that question and others. Michael, welcome.

Michael Mussa: Good to be here with you again.

Steve Weisman: What is the state of play in Europe in terms of Greece dragging Europe back into a recession?

Michael Mussa: Greece, of course, is going to have a significantly negative growth this year, [as will] some of the other countries that are cutting back on their government spending and benefits.

Steve Weisman: Those include Spain.

Michael Mussa: Including Spain, Portugal, Ireland, that moved before in that direction, Italy, more moderately probably, the United Kingdom. Initial measures have been announced. And they're going to slow down recovery more broadly across a number of European countries and adversely affect some of the others.

But the overall direct effect of those government policies on European growth is going to be, I would say, moderate. I was expecting about 2 percent growth and I would cut that to say 1.5 percent this year. The direct effects on the rest of the world including the United States would be quite modest indeed, a tenth or two-tenths off of the projected growth rate.

But the broader concern is what's been happening in financial markets, which in Europe have been very tense, and credit markets, [which] have been disrupted. So, the channels of credit flow, even to quite creditworthy corporations where there's no doubt about their ability to service their debts, have been disrupted. And if that continues for an extended period of time, the impact on growth within Europe could be more substantial and the spillover effects to the rest of the world would then be more substantial.

In addition, we've seen asset markets in the United States and elsewhere react very negatively over the last six weeks or so. That's not just the European crisis, but that's been the most important element of it, that's reduced the value of people's stock market portfolios here and around the world. And if that process were to continue and deepen, then we could have more substantial effects not just in Europe, but also worldwide.

Steve Weisman: Are the markets overreacting?

Michael Mussa: It's the job of the financial markets to overreact, so that's sort of a normal situation. It can however, turn into a self-fulfilling prophecy. So the worry about it is legitimately a worry. I think it's a worry. It's not sort of the baseline expectation.

Steve Weisman: Is Europe carrying out the right policies as it faces this new disruption? You're hearing criticism that Europe should be pulling back on stimulus but others suggest that Europe should still be engaging in fiscal and monetary stimulus, especially Germany.

Michael Mussa: Well, the situation in different European countries is different and there are some that certainly have the fiscal room to continue with the stimulus measures. I've never been a great fan of fiscal stimulus as a way to propel an economy forward. There are exceptions when you're in a deep recession, as we have been. Then fiscal stimulus can be quite useful.

The Germans are more skeptical but they've been doing something over the last year. More generally, I think the European policy response was a little bit delayed in terms of dealing with the Greek situation and its broader spillover effects. But you want to remember in the United States, that initially, the House of Representatives defeated the Troubled Asset Relief Program (TARP) measures and it was only after we saw the crisis deepen following that congressional action that they turned it around and loaded the money.

Steve Weisman: In 2008.

Michael Mussa: In 2008. And now of course, everybody hates the TARP despite the fact that it probably was instrumental in preventing a much deeper crisis. So the Europeans have been a little slow in getting their act together but they've now, I think, acted quite forcefully, not only for Greece but also for the others and the ECB (European Central Bank) as it moved forward to provide support to financial markets. There's, I think, some more to do from the official sector. But some of the complaints that come from the private sector are that they're being affected and their cry is sort of, "Save me, save me, save me! Save me yesterday!" And that's a little bit unrealistic.

Steve Weisman: What about the new center-right British government, which is pulling back, at least in the fiscal area?

Michael Mussa: The government has announced that they intend to pursue a policy now of fiscal consolidation to bring down the government deficit. The measures they've so far announced have been comparatively modest, so their direct effect in terms of any immediate impact on the economy is not likely to be large.

There is obviously more that they are going to announce in the next few weeks. I was projecting that British growth would be on the order of 2 percent this year and I think they need to cut that back to 1.5 or a little more. Some of the fiscal tightening, though, involves cutting future pension benefits, particularly for government workers, which improves the longer run fiscal situation but have little immediate effect on current spending.

Steve Weisman: There's a lot of talk in Washington that American deficits and debts are going to have to be dealt with, but not maybe right now. What should the United States be doing right now, given the kind of recovery underway?

Michael Mussa: What we're seeing in 2010 is that the substantial stimulus package that was passed last year is continuing to spend out and there's still some of that to come in 2011. The current congressional debate is how much they should add now to spending late this year and next year, over and above what they've already put in.

Steve Weisman: What do you think?

Michael Mussa: I think that the proposals to add another $200 billion—now that's the 10-year figure—is, to my taste, a little large. But something on the order of two-thirds to three-quarters of that figure, that is to say $125 billion to $150 billion, which would mainly continue a number of programs, continue the extended unemployment benefits, continue the COBRA health insurance for unemployed workers, and continue significant financial assistance to state and local governments—

Steve Weisman: To the states, for teachers and the like.

Michael Mussa: Yes. That has been I think considerably exaggerated. Teachers are about a little more than a third of total public school employees. So let's say 300,000 teachers could lose their jobs, that'd be 10 percent of the total full-time equivalent teachers. That's nonsense. And $23 billion, and when you spread that over 300,000 teachers, that's $75,000 a piece, which is a lot of money. So I think there's a bit of exaggeration there and I think on that component of it, I'd cut it to no more than half of the $23 billion.

Steve Weisman: The US recovery? Your latest assessment?

Michael Mussa: We got a slight revision of GDP [that] doesn't really make any difference. Second quarter looks pretty good but the recent stock market sell-off and other developments cause a little bit more concern about how strong growth will be in the second half of the year. I still continue to expect it to be in the 4 percent range or a little bit better but I have to revise that forecast if the problems in Europe and elsewhere continue to deepen.

Steve Weisman: And unemployment?

Michael Mussa: Unemployment ticked up in the April report even though employment growth was strong. I continue to expect that we will now see positive employment growth going forward. We've got a lot of sense that these workers will be coming on in the May report or April. But beyond that, I expect the private sector will be adding a couple of hundred thousand jobs a month. And that will, over time, bring the unemployment rate down.

Steve Weisman: To nine or so?

Michael Mussa: I'm expecting it to get down to 9 percent by the end of the year. I have a relatively buoyant economic forecast compared to the consensus, so sort of the average forecast is for an unemployment rate probably 9.5 or somewhat above.

Steve Weisman: Mike Mussa, thank you as always.