U.S. needs Europe to work out a deal

As Europe's heads of state try yet again to bail out Greece and contain the continent's financial crisis, Americans have more than a rooting interest in seeing them succeed.

With officials set to meet in Brussels today, many critical decisions still have to be made. Greece's creditors may be forced to write off as much as 60% of its 329 billion-euro ($458 billion) debt.

A Goldman Sachs report predicted the European Union would order banks to raise as much as 110 billion euros ($153 billion) of new capital, protecting them from Greek bond losses and give banks enough money to keep credit flowing to other borrowers. And officials are looking for ways to add money to a 440 million euro ($612 billion) bailout fund agreed to this spring, amid concern that it won't be big enough if Spain and Italy can't meet their debts.

The outcome of today's meeting will test the credibility of German Chancellor Angela Merkel and French President Nicolas Sarkozy, who pledged to produce a comprehensive plan before the Nov. 3-4 meeting of the G-20 nations' leaders in France.

If there is no deal on an orderly way to reduce Greece's debt load, the consequences will be felt on Main Street in both Europe and the U.S., said Eswar Prasad, a Cornell University economist and former head of the financial studies division at the International Monetary Fund.

Failure would make a European recession more likely, sending the value of the dollar rising and making American goods more expensive worldwide, even as European manufacturers try to boost exports to make up for weaker home markets, he said.

"It could lead to a further tightening of credit in the U.S," Prasad said. "Along with the stronger dollar and the effect on confidence, all of it would have a negative effect on the U. S. The time for half measures is long since past."

Amid the gloom, there are reasons to think the crisis can be defused. Prices on credit default swaps related to bonds of Spain and Italy, a form of insurance where a third party pays off creditors if a borrower defaults, remain at levels that indicate only a minimal chance the bonds will fail.

The best reason to think a crisis will be averted is that officials know the consequences of an uncontrolled failure that spreads beyond Greece would be unacceptable, said Joseph Lupton, an economist at J.P. Morgan in New York, comparing the fallout with what followed the failure of Lehman Bros. in 2008.

"If Spain went bankrupt, that would be massive," Lupton said. "If Italy went, that would be a Lehman-like event."

A successful deal requires agreement on how much money holders of Greek bonds will lose, how much capital private European banks will have to raise, and how to expand a rescue fund that was set up by the eurozone governments in May. Here is a primer on what is being discussed.

Greek debt

Investors understand that Greece owes far more than it can repay, Prasad said. The question is how much other governments and banks around the world will have to swallow. An earlier deal, reached in July, called for creditors to write off 21% of Greece's debt. But a persistently wide budget deficit and bad results from early sales of Greek government assets have made clear that Greece can't repay as much as it agreed to this summer.

Whether banks will accept larger losses is the question. Goldman had earlier predicted a haircut of as much as 50%.

Raising banks' capital

Banks maintain a cushion of capital to protect themselves against loan losses, and also to give themselves money to make new loans. With the prospect of defaults by Greece, and the more remote potential of losses on debt from Italy, Spain, Portugal and Ireland, the banks will deplete the capital they have and will need to raise more, Prasad said. Italy's debt is the largest, at about 1.8 trillion euros ($2.6 trillion).

The problem is that the most obvious way to do that is by selling more stock, at a time the stock market is likely to offer low prices. Some banks might be tempted to rebuild capital, which is measured as a percentage of the amount of their loans outstanding and other risky assets, by refusing to make new loans rather than by raising new capital, Lupton said. That could cause a European recession, or worsen a downturn J.P. Morgan thinks has already begun, he said.

The other thing to watch is how quickly the summit orders the continent's few dozen b iggest banks to raise capital, Lupton added. If banks are given a year or more to bolster capital, they're more likely to try to do it by slashing credit. A better solution would be to require fast capital infusions that would make banks sell stock, he said. Ideally, banks would be forced to raise as much as 200 billion euros ($278 billion), he said.

Bailout fund

The last issue is how much money should be added to the existing European Financial Stability Facility, which would provide backup borrowing authority to support eurozone c ountries. There is broad agreement that the existing 440 billion euro fund is too small, Prasad said.

The idea is that if central bankers assemble a big enough fund to protect investors from potential losses on Spanish and Italian defaults, creditors are less likely to sell off the bonds so rapidly, that they cause a de facto bank run, Lupton says.

With Germany balking at committing more money to the EFSF, negotiators are working on alternatives that will let the fund protect more Spanish and Italian bonds without new commitments from taxpayers.