

European Financial Stabilization Mechanism (EFSM) has not seen much success. These rescue funds are not big enough and lack the credibility needed to assure the investors. While doubts can be raised on the commitment of Greece, Ireland and other affected countries in imposing fiscal austerity measures, investors also fear that in case these measures are implemented, the economies would slowdown further and enough revenue would not be raised by the state to pay the debt.

More recently, the ECB has committed to provide three year liquidity to banks to deal with the situation. Despite this liquidity injection, banks seem reluctant to buy many government bonds. As per The Economist, Italy and Spain alone need to roll over €150 billion (\$195 billion) of debt in the first three months of this year. This means intensification of the crisis as the entire continent is trapped in the vicious cycle of slow growth, austerity and bigger budget deficits.

The Future of the Euro

The Euro could collapse if one of the weak links were to step out to devalue their currency or if Germany were to step out of the mess it finds itself in. This would mean high political and economic costs and a huge setback for the entire Euro Zone. For the countries that step out, it would mean tedious work in printing and circulation of old currency which would incur huge costs. Moreover, as pointed out by Barry Eichengreen of Berkeley any euro-zone country that even hinted at leaving the currency would trigger a devastating run on its banks, as depositors rushed to move their funds to safer places.

What will happen in the future depends a lot on the stronger economies. Whether they let the dreams of a unified and strong European Union shatter or act as shields for their neighbors remains to be seen. The rest of the world will have to wait and watch. And more importantly, learn.

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The U.S. Debt Crisis: Lessons learned

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The debt crisis in the U.S. during mid-2011 had President Barack Obama and the Americans on their toes since in the absence of an increase in the debt ceiling, the US government would have defaulted on its payments, leading to a tremendous blow to business and investor confidence –raising interest rates for everyone who borrows, undermining the value of the dollar and roiling stock and bond market. To deal with this, a framework for a budget deal was struck that would cut trillions of dollars in

federal spending over the next decade and clear the way for an increase in the government's borrowing limit.

Many in the US are happy that a solution has been found to such a crisis through mutual agreement, no matter what the terms of the agreement between Obama and the Republicans might be. But this is a naïve position which ignores the great damage that this compromise has done to the US society (in the form of a sharp regression in income distribution), to the US polity (in the form of a remarkable shift to the Right) and to the US and world economy (in the form of an accentuation of the world recession).

First, let's recall that archaic piece of legislation, passed in 1917, which puts a ceiling on the magnitude of the debt of its federal government in absolute dollar terms. (Since the various State governments in the U.S. are not allowed to run fiscal deficits and hence incur debt, the federal debt is synonymous with government debt). Fixing a debt ceiling in absolute dollar terms is extraordinarily silly for two obvious reasons: first, as the federal government incurs fresh fiscal deficits every year, which add to its debt, this ceiling fixed in absolute terms is naturally bound to be exceeded. Secondly, as prices and output rise, the Federal government's revenue, and expenditure also rise, and so does its fiscal deficit in absolute terms. Any absolute debt ceiling therefore must be exceeded for this reason as well. The debt ceiling in short needs to be revised upwards every so often. Not surprisingly, there have been umpteen such revisions, though, strangely, nobody has pushed for either repealing this legislation or even amending it to convert the ceiling to a

percentage of the GDP because the size of the fiscal deficit is a flow as distinct from debt, which is a stock.

Coming back to the present, Obama had to make a compromise with the deal to save U.S. from crisis. However, this is not new. In an effort to appease the Republicans, Obama in December 2010 had agreed to continue with the massive tax cuts for the rich introduced by Bush, apparently in the mistaken belief that, since one favor begets another, the Republicans would in turn do him the favor of raising the debt ceiling, a normally routine affair as we have seen, without much ado. The Republicans however insisted upon eating their cake and having it too. Having got Obama to continue with the Bush-era tax cuts, they made it a condition that they would agree to an increase in the debt ceiling only if severe cuts were affected in a range of items of federal expenditure, which were of benefit to the poor. And Obama has had to bow before them. Under the shadow of a silly piece of legislation passed in 1917, a further grotesquely regressive shift in income distribution has been affected by the Republican Party. In the process, their strength in American politics has increased greatly as they are now confident that they can push a pusillanimous Obama in the direction it wants.

Moving away from the political impact, let's analyze the economic impact. The U.S. has a deeply depressed economy. It will certainly continue to have a depressed economy all through next year. The worst thing to do in these circumstances is slash government spending, since that will depress the economy even further.

Also, a fiscal deficit can be curtailed either through garnering larger tax revenue or through effecting expenditure cuts. How it is curtailed, and upon whom the impact of tax increases and expenditure cuts falls, are important issues affecting the class distribution of income. Ironically, a good deal of the increase in government debt in the US has been caused by the government's effort to bail out banks from the financial crisis they had collectively brought upon themselves, and also by the Bush tax-cuts for the rich, which themselves not particularly anti-recessionary, could not be reversed even as the government had to work out a stimulus package against recession. But this very increase in government debt imposed by the rich and the financial interests has been used by the same interests to bring about cuts in welfare expenditures for the poor!

This deal will hurt the poorest of Americans as cutting spending means taking money from the poor. The consequence of such regressive policies is a level of inequality unknown in other developed nations. As the Nobel laureate Joseph Stiglitz points out, in the past 10 years the income of the top one per cent has risen by 18 per cent, while that of blue-collar male workers has fallen by 12 per cent.

Moreover, even though markets reacted favorably to the deal with Asian markets jumping on the news and dollar rising against the Japanese yen, I have my doubts regarding the amount of investment will increase in long term. This is because an investor would be reassured, not dismayed, by a demonstration that the President is willing and able to stand up to the blackmail on the part of right-wing extremists. Instead, Mr. President has chosen

to demonstrate the opposite.

Some would argue that Obama had no choice in the matter, but this is erroneous. He did have an obvious way out which was suggested by many, but he did not follow it. While government bonds are counted as government debt, money issued by the government is not. The Federal Reserve holds \$1.7 trillion of government bonds at the moment, which it has been buying in its effort to lower long term interest rates (for stimulating a recovery). This sum is counted as government debt and hence figures in all calculations about whether government debt is within the statutory ceiling. If the government merely substitutes money printed by it for government bonds in the Federal Reserve Board's portfolio, then its debt falls well within the ceiling (since the estimated excess over the ceiling is \$1.5 trillion which is less than the \$1.7 trillion of government bonds with the Fed). True, substituting government notes for government bonds (it does not matter to the Fed because interest rates on government bonds are near-zero, and much of the Fed's interest earnings come to the government treasury anyway), appears to be a phoney solution; but since the debt-ceiling problem is a phoney problem anyway, a phoney solution is all that it requires, and this solution is quite enough to counter the arm-twisting by the Republicans.

The fact that this would worsen the recession in the US and in the world capitalist economy as a whole has been rightly emphasized by many writers. Countering a recession requires increased spending. Since the US cannot suddenly expand its net exports (and if it did, then some other countries' recession would be accentuated since it would have to be based on

a "beggar-thy-neighbor" policy), its domestic expenditure has to increase. Since neither private consumption expenditure nor private investment are showing any signs of a recovery (they would recover once the economy begins to recover), the increased spending will have to come from the government, and, in the absence of taxes upon the rich, will have to be financed by a fiscal deficit (taxes on the poor nullify the expansionary effects of government spending). Curtailing the fiscal deficit, and that too via cuts in expenditures for the poor, will therefore aggravate the recession in the US, and hence the world economy.

Duties of Care in Finance

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Financial crises in the 19th and early 20th centuries were followed by plugging of loopholes in the system or checking the practices which apparently caused the crises. One can conclude that the crises were followed by reforms in the financial system. A prominent example would be, for 50 years after the Great Depression of the 1930s, the 'Money Power' was held to account by the countervailing power of the government. At the heart of the political check was America's Glass-Steagall Act of 1933. Glass-Steagall Act aimed to prevent commercial banks from gambling with their depositor's money, by mandating the institutional separation of retail and investment banking. This cautious approach to banking was later called the 'repressed financial system', by

economists. The act ensured that retail banks fulfilled the necessary function of the financial intermediation without taking major risks, while the government kept aggregate demand high to maintain full-employment level of investment. There was a fundamental shift in the response of the system to financial crises after 1980s. Plugging of loopholes or reforms did not follow financial crises that happened after 1980s. 'Money Power' struck back. There was a demand for more free hand and loosening of controls on financial systems, this demand was aided and abetted by a group of economists. The policy makers opted in favor of this demand. The Big Bang of 1986 in London ended the separation of banking functions in Britain. This major policy shift in Britain fuelled the demand for similar policy shift in other countries, as this allowed the banks to increase their profits substantially. After prolonged lobbying by the financial services industry, US president Bill Clinton repealed the Glass-Steagall in 1999. From that point on, commercial and investment banks could merge and the composite entities were authorized to provide a full range of services, including underwriting and other trading activities.

The merging of the retail, investment and commercial banks has brought forth new set of problems. The retail banking function of banks is fairly stable and involves very low risks compared to the investment banking function. The customers of the two functions also have very different profiles and expectations from the bank. Hence the combining of these functions is definitely not benefiting the retail banking customer, however it exposes them to a far bigger risk emanating from the speculative activity of the investment bankers. Retail