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What's Next For Europe?

Many scenarios exist for dealing with the continent's debt crisis, but few are palatable.

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Every day brings new fear from Europe. First, it's the threat of a default by Greece. Then it's the Italian government on the verge of collapse. Next, it could be Portugal and Spain. Markets worldwide respond with massive selloffs. Already, it has cost Greek Prime Minister George Papandreou his job and a similar outcome appears set for Italian Prime Minister Silvio Berlusconi.

What now? None of the next steps for Europe look terribly palatable and the ramifications could be dire for American investors, too. Here are a few of the ways the crisis could play out in the coming months, along with economic experts' assessments of the likelihood and potential consequences of each step.

Greece Leaves the Euro Zone

Likelihood: Relatively low

Outcome: Relatively bad

In this dangerous scenario, the costs seem to outweigh the benefits. The idea is that Greece would return to its former currency, the drachma, which would then depreciate against the euro. This would allow Greek exports to rise and tourism—one of the country's key industries—to flourish.

It sounds great, but the potential repercussions are sizable. Switching currencies and extricating itself from the European Union could create a world of problems, says Gennaro Zezza, research scholar at the Levy Economics Institute of Bard College and associate professor of economics at the University of Cassino in Italy. Leaving its debt denominated in euros while the drachma devalues would make paying its debt increasingly difficult and potentially force a default, which would create problems for the entire continent. "If Greece defaults, then there would be losses for German and French banks, and this is not a nice outcome or an outcome that anyone would look forward to," says Zezza. Denominating the debt in the new currency, meanwhile, would amount to a haircut for holders of Greek debt. While this may be a solution, says Zezza, it could prompt other troubled countries (like Italy) to attempt the same. Haircuts on the huge Italian debt would cost banks in France, Germany, and America much more, making for global repercussions.

Still, while unpalatable, a Greek exit is not necessarily a recipe for disaster...at least, not total disaster, says Benn Steil, senior fellow and director of international economics at the council on Foreign Relations. "I think the euro zone could survive the pullout of small peripheral countries like Greece. It would be touch-and-go. The financial repercussions would be enormous, but I think that's possible," he said at a Council on Foreign Relations meeting in New York on Thursday.

Italy Gets a Bailout

Likelihood: Low

Outcome: Potentially livable

Neither the European Financial Stability Facility nor the International Monetary Fund has enough resources at its disposal to bail out Italy from its enormous debts. "I think that the Italian debt is so large that we cannot really think of a bailout," says Zezza.

Still, some are holding out hope for help from the IMF. The Wall Street Journal's Simon Nixon this week called the fund "the only really viable source of liquidity, at least in the short-term."

Italy Defaults

Likelihood: Medium

Outcome: Varying levels of pain

Whether an Italian default happens at this point depends on who is doing the handicapping. There is a "better than even chance" of some sort of default in Italy, according to **Bernard Baumohl, chief global economist at the Economic Outlook Group,** who believes that the fallout depends on the type of default. If investors simply bail on Italian bonds, there could be a "complete unraveling of the sovereign debt market in Europe," potentially triggering a depression. If, however, Italy restructures its debt, the consequences could be bad but manageable, Baumohl says. "If it does happen and it happens successfully, then the worst that would follow would be that private investors, particularly the banks, would have to suffer quite a hit," he says. This could mean that banks would reduce their lending, sending Europe into a recession—a recession that is likely to happen anyway, he adds.

Not everyone is so optimistic about the potential for restructuring. "With regard to Italy, restructuring in my view is out of the question without a breakup of the euro zone," says Steil.

European Central Bank Follows the Federal Reserve in Printing Money

Likelihood: Not terribly high, but growing

Outcome: Looks promising

Unfortunately, one of the most promising solutions is also not currently an option under the ECB's mandate. The ECB cannot currently print money—that is, buy assets from EU countries. It can only purchase those on the secondary market. But altering that mandate, says Zezza, may make for the most favorable solution. Changing the policy and announcing the purchase of unlimited quantities of bonds, he says, "should be an insurance for everyone holding these assets."

So could it happen? Germany will likely take convincing, not wanting to risk inflation, says **Baumohl**. But he thinks that the current crisis should make persuading hesitant states easier: "If cooler heads prevail and they understand that there is an emergency in Europe, they can move much more quickly, put in some clauses that would allow the ECB to do whatever is necessary to stabilize the sovereign debt issue."