BRITAIN IS BURNING. STRANGE that it should be so. After all, the catastrophic economic news of recent days, including the highly controversial downgrading of U.S. debt by Standard & Poor's, the burgeoning euro crisis in continental Europe and the market turmoil that followed both, has been made in New York City, Brussels and Berlin, not in the streets of North London. But if you look closer, it all makes sense. Britain, like the U.S., has been a center of both great wealth creation and a widening wealth divide over the past 20 years, thanks to the rise and, more recently, fall of the markets and global economic growth.

Now the U.K. is sharing the suffering of the rest of Europe—namely, deep budget cuts that are hurting vulnerable populations the most. As youth programs, education subsidies and housing allowances are axed by a state desperate to get out from under crushing sovereign debt, it's clear why the poorest populations in the most economically unequal large European nation are taking to the streets.

The only surprising thing is that it didn't happen sooner. We've known since the beginning of the financial crisis and subsequent economic downturn that the world order was changing in profound ways. But we've tried to wish it all away with talk of temporary blips and cyclical recessions. We've come up with every possible excuse, from tsunamis to a lack of market certainty, to explain why rich-country economies aren't rebounding.

But the past two weeks of dismal economic news have made the new reality impossible to ignore: the West—and most immediately Europe—is in serious trouble. This is no blip but a crisis of the old order, a phrase once used by historian Arthur Schlesinger Jr. to describe the failures of capitalism in the 1920s. It is a crisis that is shaking not only markets, jobs and national growth prospects but an entire way of thinking about how the world works—in this case, the assumption that life gets better and opportunities richer for each successive generation in the West.

As bad as things might seem in the U.S., the smoldering center of the crisis is Europe. Volatile continental markets and angry demonstrations from Athens to Madrid are manifestations of the desperate scramble by European politicians to contain the euro-zone debt crisis that threatens to unravel the single currency and destabilize the region. The European Union and the euro zone were supposed to bring about economic stability and remove traditional barriers to growth, such as tariffs and regulations. Instead it's become a selfish union in which flailing economies feed rising nationalism, angst over immigration and simmering distrust between rich and less affluent countries. "Europe is at the center of the global financial problems," wrote Michael Hartnett, chief global equity strategist for Bank of America Merrill Lynch, in a recent note to investors. "Those problems have been exacerbated by the inability, or the unwillingness, of policymakers ... to address the debt issues."

'Europe is about to blow. There is no longer any question of standing still or hoping the U.S. will kick-start the global economy. They are going to have to fix things at home.'

—KENNETH ROGOFF, HARVARD UNIVERSITY

Why the Euro Is Everyone's Problem

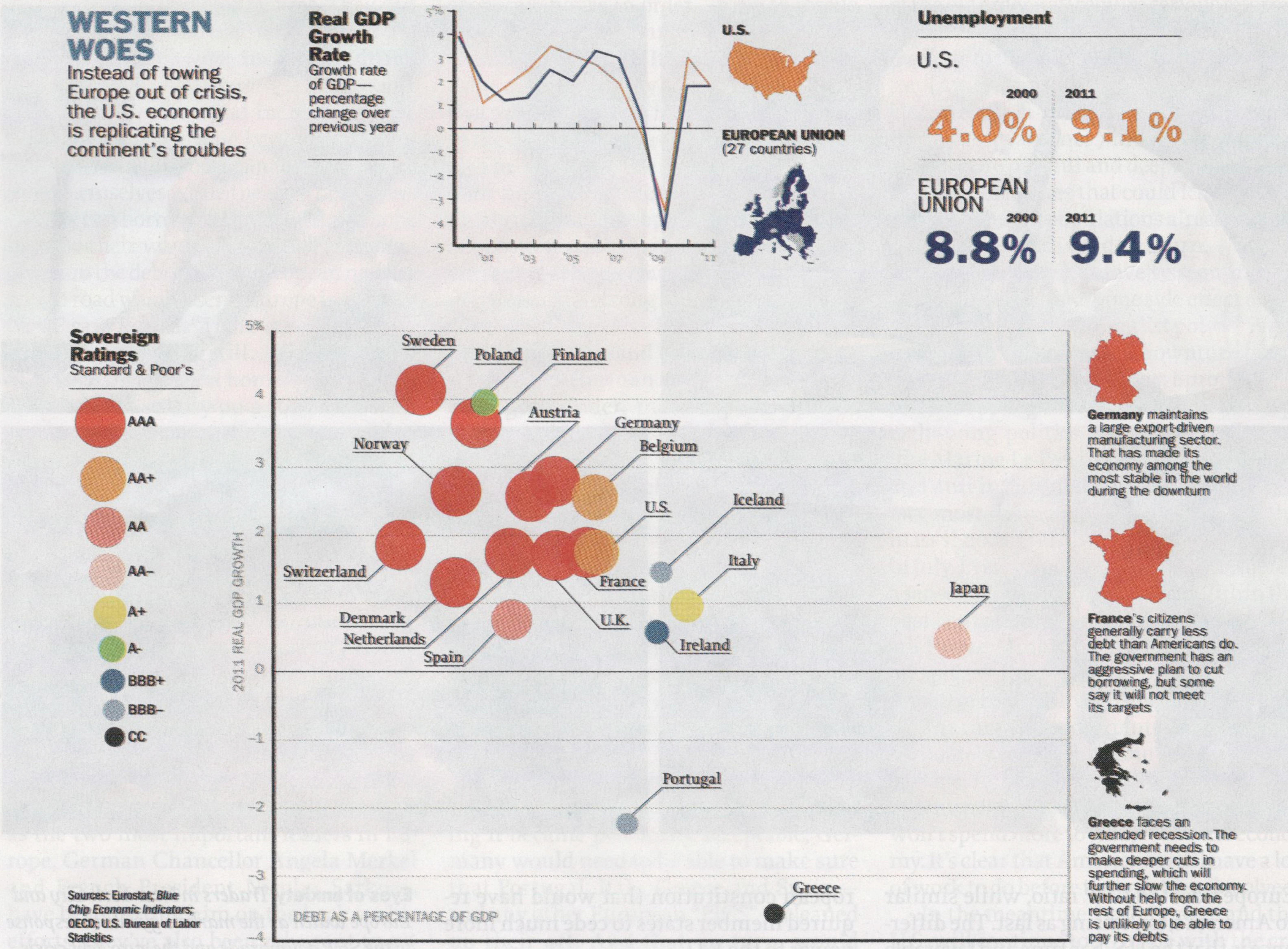
WHILE THE CRISIS MAY SEEM TO BE Europe's problem, if it results in a breakup of the euro zone or even a growth-dampening series of costly bailouts, it will reverberate from Beijing to Boston and back. Europe is the largest trading partner of both the U.S. and China. It's home to one of the world's largest pools of wealthy consumers. If they stop buying our stuff, everyone suffers. Meanwhile, a dramatic depreciation of the euro or a dissolution of the union would make nations from Asia to Latin America that hold the euro as a reserve currency much weaker. Even the mere effort to contain the crisis with looser monetary policy on either side of the Atlantic creates a risk of inflation and hot money that could punish emerging markets, economists like Goldman Sachs' Jim O'Neill have warned.

The worries have now come to a head. Borrowing costs for Europe's weaker economies, like Greece, Ireland, Portugal, Spain and Italy, have skyrocketed as halfhearted measures to stabilize markets have made investors suddenly wary that the European center is not going to hold and that richer countries like Germany simply aren't committed to the monetary union. That's why bond spreads are widening, European stocks are tanking and the European Central Bank is desperately trying to calm markets by buying up weaker countries' debt.

All this could have happened six months ago or three months ago or three months from now. But the crisis exploded in the past week because of the slow-growth news coming out of the U.S. As improbable as it sounds, "Europe's Plan A, B and C was to outgrow its debt problem via the normalization of the economic situation in the U.S.," says Harvard economist Kenneth Rogoff. "When they saw the U.S. growth numbers coming in so much weaker than they expected, it became clear that the world wasn't going to normalize. And they panicked."

While economists were betting on 4% growth in the U.S. earlier this year, numbers released in recent days show that the American economy grew a paltry 1.3% in the second quarter of this year, after a truly anemic first-quarter figure of 0.4%. With growth like that, Americans can't even save themselves from 9%-plus unemployment at home, let alone save the world. The much feared 2% economy, now the consensus prediction for U.S. growth this year, has become a reality. The U.S. is no longer the economic counterweight to Europe. It is Europe.

According to Rogoff, the pre-eminent seer of the crisis, who wrote the sovereign-debt history *This Time Is Different: Eight Centuries of Financial Follies* with economist Carmen Reinhart in 2009, Europe and the U.S. are not experiencing a typical recession or even a double-dip Great Recession. That problem can ultimately be corrected with the right mix of conventional policy tools like quantitative easing and massive bailouts. Rather, the West is going through something much more profound: a second Great Contraction of growth, the first being the period after the Great Depression. It is a slow- or no-growth waltz that plays out not over months but over many years. That's what happens after deep financial crises that require bailouts by beleaguered states, which are then left with few resources and tools to cope with a stagnant, high-unemployment environment rife with populist politics,



social instability and violence of the kind we've most likely only begun to see in the streets of Athens and London.

It's a very different era than the historically exceptional period of rapid global growth from 1991 to 2008, the period in which the European Union, the euro and the dream of greater European integration were born. The linchpin of this age of optimism was, of course, the U.S. It helped rebuild Europe after World War II and toppled its main ideological competitor, the Soviet Union. The dollar and U.S. government debt, backed by America's well-functioning democracy and strong growth prospects, remained the largest, most liquid and (seemingly) safest investments on the planet. It was in this environment, in which all boats were rising, that the euro began to gain strength.

Needless to say, the global picture has changed. It is a measure not only of the long tail of America's special position in the global economy but also of just how bad things are in Europe and elsewhere that there hasn't been a rush out of U.S. Treasuries. Following the S&P downgrade, ascribed to our slower growth and debt-ceiling shenanigans, investors piled into Treasuries as the market tanked. China, the largest foreign holder of T-bills, issued a stern warning to the U.S. to "cure its addiction to debt." But central bankers from Beijing aren't breaking down doors in Frankfurt to convert their dollar holdings to euros. The euro is the only viable alternative to the dollar as a global reserve currency. The British pound is history, and emerging-market currencies are still too small, volatile and controlled. And while plenty of investors are fleeing into gold, the world gold market isn't big enough to accommodate serious dollar diversification without massive inflation in gold itself. Prices are already at record levels.

It's unclear at this stage whether the euro will even survive the debt crisis that has engulfed Europe, one that is in many ways worse than the one they're experiencing in the U.S. On the surface, the picture doesn't seem so bleak. After all, the average euro-zone deficit is only 6% of GDP, compared with 10.6% in the U.S., and

Eyes of anxiety *Traders in New York City and Europe watch as the markets gyrate in response to the S&P downgrade and the euro debt crisis*

BENJAMIN NORMAN—THE NEW YORK TIMES/REDUX; FREDRIK VON ERICHSEN—NEWSCOM

Europe's debt-to-GDP ratio, while similar to America's, isn't rising as fast. The difference is that the U.S. has time and favorable borrowing rates on its side; Europe has neither. Also, the U.S. can tackle its fiscal problems if it finds the will to rise above partisan politics; the politics of the E.U.—and in particular its lack of true political integration—makes it impossible for it to actually get to the root of the euro crisis.

That's because the euro zone is essentially a selfish union. Europeans want to benefit economically from their proximity to one another and want at all costs to avoid expensive and destructive wars—either trade or shooting—with their neighbors. Beyond that, many of their political, cultural and social agendas diverge. At each stage in the development of modern Europe, from the creation of the European Union to the introduction of the euro, it has always been difficult to get nations to agree to deeper political integration, which is hardly surprising given what a heterogeneous place Europe is. That's why in 2005 voters rejected a European constitution that would have required member states to cede much more power to the E.U.

The Casino Continent

THE RESULT IS A MONETARY UNION THAT can sometimes resemble a casino. The existence of a European Central Bank (ECB) means that countries like Greece, Belgium and Ireland are free to borrow from the credit window and take on more debt than they can handle. But the fact that there's no centralized political control or accountability means that more-prudent member countries like Germany have no way to stop weaker states from undermining the viability of their shared currency.

Of course, there's also no one to tell Germany that it shouldn't let its state-owned banks leverage themselves 50 to 1 on junk assets. The hypocrisy of it all is evidenced by the fact that nearly all the euro-zone countries have flouted the core economic rule that in theory limits annual budget deficits to 3% and debt-to-GDP ratios to 60% for all members. "We created the stability pact as a set of rules for the euro. But it has become a pact of cheaters and liars," says Jean Arthuis, a centrist politician and head of the finance commission in the upper house of France's Parliament.

The euro zone's early doubters always believed that Greece or other weak nations would cheat on the deficit issue. The result now is a continent—and a common currency—that is shaky, requiring perhaps trillions in capital injections from France and Germany, first among others, into a rescue fund to prevent the euro's collapse.

Even in good times, it is never easy to balance the fiscal needs of a high-cost exporter like Germany with those of cheap and cheerful service economies like Greece, Spain and Portugal. In bad times, it's impossible. The poorer peripheral countries in Europe used to be able to devalue their individual currencies to maintain global competitiveness. Post-euro, with that quiver removed, they have two choices. They can make painful structural reforms that are unpopular with voters, including cutting welfare programs, reforming tax collection, trimming pensions and increasing competitiveness by working harder and longer (starting with the politicians currently sunning themselves while the euro crumbles). Or they can borrow from the ECB and hope to grow their way out of trouble. It's obvious from the debt loads of European nations which road was chosen. "Europe is about to blow," says Rogoff. "There is no longer any question of standing still... They are going to have to fix things at home."

That's not so easy on a continent with a currency and a monetary system underpinned by multiple political systems, economies and fiscal priorities. Figuring out how to bail out the euro zone is a lot tougher than figuring out how to bail out the U.S. financial system, although throwing money at the problem is a certainty. For starters, there's no single institution or figure, like former Treasury Secretary Henry Paulson, that can marshal the troops and put together a TARP-style program for indebted nations. The head of the ECB, Jean-Claude Trichet, has been trying to play that role, buying up billions of euros' worth of shaky Italian and Spanish bonds. But even as the two most important leaders in Europe, German Chancellor Angela Merkel and French President Nicolas Sarkozy, have been patting him on the back for his efforts, they've also been reluctant to get serious about giving more money to the euro-zone rescue fund that was set up to deal with crises exactly like this one.

The message is clear: the two strongest nations in the euro zone don't yet have the stomach to commit to saving the common currency. The markets, which as ever loathe uncertainty, have reacted badly because investors know the ECB's efforts are just a Band-Aid. The central bank simply doesn't have the firepower to stem the crisis.

How to Bail Out Europe

THERE IS A WAY OUT. GERMANY, ONE OF THE strongest and most solvent economies not only in Europe but in the rich world, could swoop in and save the day by leading an effort to guarantee all Spanish and Italian debt as well as the debt of the major European banks. This would calm markets. But it would be hugely expensive, not to mention politically contentious. After all, why should prudent Germans—who have their economic house in order—have to rescue a bunch of spendthrift, books-cooking Greeks and Italians? It's a tough sell politically, as evidenced by a June poll showing that 71% of Germans have little confidence in the euro, up from 46% in 2008.

The reality is, the Germans are in for pain no matter what. Euroskeptics like to argue that Europe might be better off economically without the common currency—the Germans would enjoy the privileges of a strong deutsche mark, and Greece could devalue the drachma enough that its hotels would be full of even more sunburned German tourists. But if the euro goes under, most experts believe there would be, as HSBC chief economist Stephen King put it, "unmitigated financial chaos." Skyrocketing borrowing costs for many of Europe's slow-growth, highly indebted countries would result in a recession or even a depression that wouldn't leave Germany unscathed. After all, about 40% of German exports stay in Europe. Meanwhile, competitors like Italy (which has a strong manufacturing sector) could nibble at Germany's economic edge by offering lower prices thanks to their highly devalued currency.

Bailing out Europe would represent a huge economic and political cost. Assuming it became politically acceptable, Germany would need to be able to make sure that Portugal, Italy, Greece and Spain—and any other European "PIGS"—cleaned up their act. And that, in turn, would require a real political union in Europe, one in which Brussels, the euro capital, and perhaps to a disproportionate extent Berlin had control of the purse strings and fiscal policies of the euro zone.

As difficult and politically improbable as it sounds, experts like Rogoff, as well as many politicians and economists in Europe, believe it will happen, and possibly quite soon. But that would be only the beginning of the hard work. Fixing the crisis of the old order will require serious reforms of everything from Europe's sclerotic labor markets to its still vulnerable financial sector. (American banks, despite their troubles, are much better run and capitalized than European ones.) Most important, it will require painful and deeply unpopular austerity measures that could lead to more violence among populations already struggling to cope with the downturn.

The two strongest nations in the euro zone—Germany and France—don't yet have the stomach to commit to saving the common currency

Rioting of the kind we've seen in London and Athens is just one side effect of the new age of austerity. Populist politics is another. Just as the economic downturn in the U.S. helped fuel the Tea Party, Europe's debt crisis is fueling a resurgence of polarizing, right-wing politics embodied by figures like Marine Le Pen in France. Xenophobia and anti-immigrant sentiment are rife, a fact most dramatically illustrated by the mass shootings at a Norwegian youth camp in July. Even in mainstream politics, there's a sense that unity is impossible. Within the past few months, Sarkozy, Merkel and British Prime Minister David Cameron have all spoken about the end of the European dream of multiculturalism.

The turmoil is a portent for the U.S. It is ultimately facing the same problem as old Europe: how to grow amid a continuing downturn when the public sector can't or won't spend more to jump-start the economy. It's clear that Americans still have a lot of work to do before that problem is solved.

In the meantime, both Europe and the U.S. will continue to struggle with the crisis of the old order. Populations will have to come to terms with no longer being able to afford the public services they want. Investors will have to cope with a world in which AAA assets aren't what they used to be. Businesses will deal with stagnating demand, and workers will face flat wages and high unemployment. All this will take place at a time that is in many ways the opposite of the optimistic two decades that preceded the financial crisis. Think the 1970s, without inflation (though there are those who think a whiff of inflation to wipe out debt might not be a bad idea). It's the end of an era in which the West and Western ideas of how to create prosperity succeeded. The crisis in Europe and the challenges yet to come on either side of the Atlantic take us into a whole new era. The rules and risks of it are only just becoming clear. —WITH REPORTING BY WILLIAM BOSTON/BERLIN, BRUCE CRUMLEY/PARIS AND MICHAEL SCHUMAN/HONG KONG ■