THE EUROZONE CRISIS: DESTABILIZING THE GLOBAL ECONOMY

HEARING

BEFORE THE

SUBCOMMITTEE ON EUROPE AND EURASIA

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THE EUROZONE CRISIS: DESTABILIZING THE GLOBAL ECONOMY

THURSDAY, OCTOBER 27, 2011

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON EUROPE AND EURASIA,
COMMITTEE ON FOREIGN AFFAIRS,
Washington, DC.

The subcommittee met, pursuant to notice, at 2 o'clock p.m., in room 2172, Rayburn House Office Building, Hon. Dan Burton (chairman of the subcommittee) presiding.

Mr. BURTON. The committee will come to order. This hearing is on the eurozone crisis and the potential destabilizing of the global economy. And the subcommittee will come to order.

Since the fall of 2009, starting with the revelation of Greek fiscal problems, we watched a series of unfortunate events take place that have fostered bailouts of Greece, Ireland and Portugal and possible intervention in Spain and Italy. Europe and the entire global economy are in a dire predicament that has far-reaching consequences. Trillions upon trillions of dollars are at stake as we look to stem a possible worldwide economic depression.

Members of the European Union created the Eurozone in 1992 with a vision to create a single monetary policy for all of Europe. The euro would become the common currency adopted among nations who all adhered to a strict monetary policy that provided greater stability. However, the Eurozone also brought additional bureaucracy where individual nations still acted in their own best interest, oftentimes hiding or misstating realities of their economy, which only exacerbated the situation. In addition, the European Union failed to adopt mechanisms that could move swiftly to deal with quickly changing market conditions and important oversight institutions to provide transparency and accountability among the Eurozone partners.

The current economic situation in Europe has uncovered many of these shortfalls and has exposed them as the main causes of the ongoing crisis. Accordingly, the Europeans have left the world wondering if the steps they are taking to right the crisis are effective and enough.

Due to the crisis, we have witnessed a creation of three European lending mechanisms, the largest, the trillion dollar European Financial Stability Facility, along with the assistance from the European Central Bank and the International Monetary Fund, has so far lent Portugal, Greece and Ireland over $1 trillion. This is only the beginning as some analysts estimate that Europeans will need another $2 trillion to recapitalize European banks and the coffers of crisis countries.

Meanwhile, European leaders continue to meet repeatedly and results depend on a clear consensus on how to resolve a problem that has been fluctuating for nearly 2 years.

The United States is not immune from these troubles, and this is not just a European problem that Europeans must solve.

The U.S. economy intertwines with the European economy, and the nations of Europe combine to be the largest trading partner of the United States and the partnership is approximately five times greater than our partnership with China. Due to the crisis, U.S. exporters face tougher market conditions, as the euro devalues and European partners cannot afford to import as many manufactured or agricultural goods.

The United States stock markets, which are going up like a rocket today, are in a constant flux as traders react to the changing stabilities of the investment climates. U.S. banks, despite ample warnings of the ongoing market volatility, still hold European bonds and securities, a value estimated to be as high as $2 trillion, and we will talk about that in a few minutes.

As chairman, I visited with leaders and discussed with experts the complexities of the crisis. Many public leaders I have met with have not provided clarity and have not been forthcoming regarding the true extent of the crisis. Political leaders over the months, including U.S. officials, have routinely relayed to us that the crisis is close to stabilizing, that recovery is working, that governments are taking reform measures and that growth is just around the corner.

In contrast, the EFSF has grown from 440 billion euros to 780 billion euros to now over 1 trillion euros. Additionally, I asked Treasury officials to testify in September, to which they asked for postponement until after the IMF and the World Bank meetings and the meetings they had yesterday. This past Tuesday, they again asked us to delay this hearing to November until after the G–20 meetings. Their excuse, contrary to what we hear from public statements, is that the markets are too volatile and that any statement can further harm the situation.

These are not signs that recovery is working or that growth is just around the corner. The U.S. Government should not ask or expect the American people to play kick the can while political leaders sort out the global economy behind closed doors. The people and the markets have a right to know. If we are not open and transparent, we are only preserving an artificial sense of stability. And this is not sustainable, and the longer we wait, the worse it will be when reality comes crashing down.

The current situation does not call for us to point fingers and lay blame. I recognize that the crisis is not easy to solve. The complexities of the crisis are diverse and unique, with each country having its own cocktail that has led to its current predicament. However, we must be honest about the situation and no longer gloss over dilemmas that may drag the entire globe into a deep recession, and we are very concerned about the financial involvement that the United States may face down the road.

And with that, I will yield to my goodlooking friend here, my ranking member Mr. Meeks.

[The prepared statement of Mr. Burton follows:]

Remarks of the Honorable Dan Burton, Chairman
Subcommittee on Europe and Eurasia
Committee on Foreign Affairs
U.S. House of Representatives

Hearing on: "The Eurozone Crisis: Destabilizing the Global Economy"

*****As prepared for delivery*****

October 27, 2011

Since the fall of 2009, starting with the revelation of Greek fiscal problems, we have watched a series of unfortunate events take place that has fostered bailouts of Greece, Ireland, and Portugal and possible intervention in Spain and Italy. Europe and the entire global economy are in a dire predicament that has far-reaching consequences. Trillions upon trillions of dollars are at stake as we look to stem a worldwide economic depression.

Members of the European Union created the Eurozone in 1992 with the vision to create a single monetary policy for all of Europe. The Euro would become the common currency adopted among nations who all adhered to a strict monetary policy that provided greater stability. However, the Eurozone also brought additional bureaucracy where individual nations still acted in their own best interest, oftentimes hiding or misstating realities of their economy. In addition, the European Union failed to adopt mechanisms that could move swiftly to deal with quickly changing market conditions and important oversight institutions to provide transparency and accountability among the Eurozone partners. The current economic situation in Europe has uncovered many of these shortfalls and has exposed them as the main causes of the ongoing crisis. Accordingly, the Europeans have left the world wondering if the steps they are taking to right the crisis are effective and enough.

Due to the crisis, we have witnessed the creation of three European lending mechanisms, the European Financial Stabilization Mechanism (EFSM), the trillion-dollar European Financial Stability Facility (EFSF), and the soon to enter force European Stability Mechanism (ESM). The EFSF, along with assistance from the European Central Bank and International Monetary Fund, have so far lent Portugal, Greece, and Ireland over 1 trillion dollars. This is only the beginning as some analysts estimate that Europeans will need another 2 trillion dollars to recapitalize European banks and the coffers of crisis countries. Meanwhile, European leaders continue to meet repeatedly without any results or clear consensus on how to resolve a problem that has been fluctuating for nearly two years.

The United States is not immune from these troubles and this is not just a European problem that Europeans must solve. The U.S. economy intertwines with the European economy. The nations of Europe combine to be the largest trading partner of the United States and the partnership is approximately five times larger than our partnership with China. Due to the crisis, U.S. exporters face tougher market conditions as the Euro devalues and European partners cannot afford to import as many manufactured or agricultural goods. The United States' stock markets are in constant flux as traders react to the changing stability of the investment climates. U.S. banks, despite ample warning of the ongoing market volatility, still hold European bonds and securities – a value estimated to be as high as 2 trillion dollars.

As Chairman, I have visited leaders and discussed with the experts the complexities of the crisis. Many public leaders I have met with have not provided clarity and have not been forthcoming regarding the true extent of the crisis. Political leaders over the months, including U.S. officials, have routinely relayed to us that the crisis is close to stabilizing, that recovery is working, that governments are taking reform measures, and that growth is around the corner. In contrast, the EFSF has grown from 440 billion Euros to 780 billion Euros to now over 1 trillion Euros. Additionally, I asked Treasury officials to testify in September to which they asked for postponement until after IMF and World Bank meetings. This past Tuesday they again asked us to delay this hearing to November, until after the G20 meetings. Their excuse, contrary to what we hear from public statements, is that the markets are too volatile and that any statement can further harm the situation. These are not signs that recovery is working or that growth is around the corner. The U.S. government should not ask or expect the American people to play kick the can while political leaders sort out the global economy behind closed doors. The people and the markets have a right to know. If we are not open and transparent, we are only preserving an artificial sense of stability. This is not sustainable and the longer we wait the worse it will be when the reality comes crashing down.

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Mr. MEEKS. Thank you, Chairman.

And I want to thank Chairman Burton for scheduling this hearing on the Eurozone crisis and its effects on the global economy. The Transatlantic trade relationship is the largest in the world, and it is in our interest to make sure that this works to the benefit of the estimated 15 million jobs that have been generated from this relationship on both sides of the Atlantic.

I agree with the chairman that it is important for us to get an accurate perception of U.S. exposure to the Eurozone crisis. But I think it is just as important to look forward and examine how we can transition from this situation, where the Eurozone is under immense pressure, to a situation where growth is generated and jobs are created from our mutual trade and investments.

The financial crisis has exposed serious structural shortcomings in the mechanisms governing the euro project and tested European unity. I find it relevant to note that while it has not been beautiful to look at, European leaders do appear to have the resources, the capacity and the political will to deal with the challenges they face.

Just yesterday European leaders reached an agreement with the banks to take a 50-percent loss on the value of their Greek debt and expanding their capital reserves. There is also an agreement to expand the European Financial Stability Facility to approximately $1.4 trillion. And I hope that these measures will allow Europe to move forward.

I think it is important for us to acknowledge that there are different reasons for the Eurozone problems. I suspect that we are committing an analytical error by discussing one Eurozone crisis as opposed to a Greek fiscal crisis, an Irish banking crisis and a Portuguese competitiveness crisis. Are they even really related? Are we throwing ourselves off track by cobbling these issues together and looking in vain for single causes, symptoms and solutions? I hope that our panel can give us a detailed perspective on that.

Some of the commentary that I have read recently seems more like Schadenfreude, the German expression, which I did not pronounce correctly, but taking delight in others' bad fortune, than actual analysis. We can probably agree that the euro came into existence prematurely and without the requisite institutional oversight.

But it seems to me that we may have lost sight of the advantages of the euro entirely during the last couple of years. I would point to price transparency and stability; elimination of exchange-rate fluctuations; fees and transition costs; increased cross-border trade; market expansion; and lower interest rates. And I ask our panelists to evaluate whether these benefits no longer outweigh the disadvantages that are more obvious today than they were in the past.

Estonia just joined earlier this year, and as far as I am aware, others are still lining up to qualify. What should we make of this fact? Is there a scenario under which the euro emerges from the current situation in a stronger, leaner and meaner form? I believe that it is important to know the details about how problems arose in the Eurozone in order for us to avoid them in the future.

But ultimately, I think the biggest question is how do we find opportunities to ensure growth and job creation together with the Europeans, for it is important for both sides of the Atlantic to create jobs and to lift ourselves out of this economic situation that we are in?

And I thank you, Mr. Chairman. I yield back.

And I apologize because, Mr. Chairman, I know this hearing is important, but there is an airplane waiting for me, and there is a meeting waiting for me in New York.

Mr. BURTON. And your wife is waiting for you.

Mr. MEEKS. And my wife is waiting for me. I got 670,000 who vote for me, and they need me there.

Mr. BURTON. That is more information than I need, but I am glad you are here. We will give you all the questions and answers, and the other members.

Mr. MEEKS. Great. Thank you, sir. And thank you for being here.

Mr. BURTON. I want you to know that, since you are only looking at me——

Mr. MEEKS. I am just nervous leaving you here by yourself, though. You know, generally, I have to hold your hand and kick you under the table.

Mr. BURTON. Get out of here.

Let me just say to you that this is a very important hearing, even though you just have me to look at.

Many of my colleagues had to get back to their districts; that is why they left. But I can assure you that all of the information you are going to give us today will be utilized and that everybody on the committee will have it, as well as others, because this is a very, very important issue right now. I know the stock market and everybody is Kumbaya today, everything is great, but I hope you will give us the real picture so the American people know where we stand.

Jacob Kirkegaard, you have been with the Peterson Institute for International Economics since 2002. Your diverse current research focuses on long-term fiscal challenges, European regional economic integration, structural economic reform issues, among other issues, and it is good to see you again.

I appreciate you being here.

Desmond Lachman joined American Enterprise Institute after serving as managing director and chief emerging market and economic strategist at Salomon Smith Barney. He previously served as deputy director on the International Monetary Fund's Policy, Development and Review Department and was active in staff formation of IMF policies. At AEI, Mr. Lachman is focused on the global macro-economy, global currency issues and the multilateral lending agencies.

I really appreciate you being here as well.

And Bruce Stokes joined the German Marshall Fund as a senior Transatlantic fellow for economics in September 2010. He is a former international economics columnist for the National Journal, a Washington-based public policy magazine, where he is now a contributing editor. He is also a former senior fellow at the Council on Foreign Relations.

So since I am going to be using your testimony in a lot of ways, I need to swear you in, so that we have it, because I am going to have the Treasury testify, and if there are any differences, we want to make sure that we have got it on the record.

So could you stand and raise your right hand, please?

[Witnesses sworn.]

Mr. BURTON. Thank you very much. Okay.

Mr. Kirkegaard, would you like to start off?

Mr. KIRKEGAARD. Most certainly.

Mr. BURTON. If we could try to keep the remarks to 5 or 6 minutes, we would really appreciate it, so we can get into the dialogue and questions.

STATEMENT OF MR. JACOB FUNK KIRKEGAARD, RESEARCH FELLOW, THE PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. KIRKEGAARD. Chairman Burton, Ranking Member Meeks——

Mr. BURTON. I don't think your microphone is on.

Mr. KIRKEGAARD. Chairman Burton, other members of the committee, it is a pleasure for me to appear before you to testify on the origin, current status of and responses to the euro area crisis.

In my oral remarks today, I intend to summarize my available written testimony as well as briefly touch on the events of last night in Brussels. It is clear that the euro area has gradually, since May 2010, taken the central place in an increasing volatile global economy. The correct diagnosis for the euro area crisis is, however, not one but at least four deep overlapping and mutually reinforcing crises: A crisis of institutional design, a fiscal crisis, a crisis of competitiveness; and a banking crisis. None of the four crises can be solved in isolation. The current euro area situation is therefore characterized by an extreme degree of complexity.

Essentially no single comprehensive answer to the crisis is currently available to European policymakers, and as a result, the drawn-out inconclusive crisis containment efforts witnessed in Europe since early 2010, in which I will include yesterday's deal in Brussels, will continue. Economic catastrophes may be avoided, but certainly all volatility will remain with us for the foreseeable future.

The euro area suffers, first and foremost, from a fundamental institutional credibility problem. It needs a new rule book. Binding rules for individual member states' fiscal performance must be crafted enabling the euro area as a whole to compel even large countries, such as Italy, to comply with them. The currency union must moreover be equipped with a sizable independent fiscal capacity capable in a crisis of both providing emergency financial assistance to member states in need and act broadly and forcefully to restore market confidence. European leaders have so far merely begun these tasks, and ultimately any credible solution will require a revision of the European treaty, a process which in itself will take several more years.

Secondly, the euro area suffers from a fiscal crisis centered in Greece, a country which will need to restructure its government debt. However, as concerns over fiscal sustainability in the euro area stretches also to Italy, a country which is too big to bail out, the principal challenge in the euro area is how to avoid the issue of contagion and how to ring-fence an inevitable Greek debt restructuring so as to avoid a generalized undermining of the risk-free status of euro area government debt. To achieve this goal, substantial further financial support will in the years ahead have to be made available to Greece, Ireland and Portugal, and it is clear that such resources should overwhelmingly come from the euro area itself with a component provided by the IMF. However, ultimately euro area fiscal stability will only be achieved through the longer-term domestic consolidation and reform effort, notably in Italy.

Thirdly, large parts of the euro area's southern periphery suffers from an acute crisis of competitiveness, which these countries, without the ability to devalue national currencies, have no short-term way to overcome. Instead, the euro area periphery is compelled to gradually restore their competitiveness through deep supply-side structural reforms of labor and product markets. Previous experiences from other countries suggest that this type of reform will only have a positive economic effect in the long run, while indeed adversely affecting growth in the short term.

Lastly, the euro area suffers from an oversized and undercapitalized banking system which owns a large amount of national government debt from the euro area. There is, consequently, across the euro area a large degree of interdependence between the financial solidity of large domestic banking systems and the national government—and national government solvency. Euro area leaders have recently raised capital requirements for euro area banks last night again to 9 percent core tier equity, but recalling the precarious fiscal situation of several governments themselves, they will be unable to bring the longer-term recapitalization process of the euro area banking system to an expeditious conclusion. Instability will consequently continue to haunt the euro area banking system in the times ahead.

Now, turning now to the Transatlantic relationship and the effects on the U.S. from this farfetched crisis, there is no doubt that Europe, as the largest destination of U.S. exports and foreign direct investments, as well as extensive cross ownership of loss financial institution, the United States will suffer a significant negative adverse shock from a further unexpected rapid deterioration in the euro area crisis.

It is consequently in the vital national interest of the United States that Europe fixes its problem. However, the possible direct action by policymakers in the United States had been limited by the fact that this is, despite increasing global spill-over potential, still at heart a domestic economic crisis inside another sovereign jurisdiction. The ability of U.S. Government—of the U.S. Government to bilaterally affect the outcome of the euro area crisis is consequently and indeed appropriately limited.

At the same time, in my opinion, the U.S. Government representatives have since the beginning of the euro crisis exercised important indirect pressure through multilateral channels and especially the IMF to expedite the European crisis resolution process and push it in generally beneficial directions.

However, it is not for the United States to bilaterally provide any financial support to the euro area. This is a task predominantly for Europe itself as well as the appropriate multilateral organization, notably the IMF. Indeed, the euro area crisis has underlined how it is in America's evident national interest to help maintain the prominence of the IMF as the key global financial crisis manager. As a declining relative share of the global economy, it is evidently in the United States' direct interest to sustain the global dominant role of the IMF, thereby shielding it from potential threats from new institutional initiatives originating outside the traditional G–7 countries.

Upholding the dominant position of the IMF, in whose establishment, design leadership, and current modus operandi the United States has historically played a far larger role than its current and especially future global economic weight will dictate, is a critically important issue. It is consequently in the direct interest of the United States to continue to fully support the IMF and participate fully in all internationally agreed capital commitments to the IMF and provide the organizations with the biggest possible toolkit with which to combat future global economic crisis in general, including currently in the euro area.

However, the euro area crisis is first and foremost a European crisis and should and will ultimately be solved predominantly through European efforts and resources.

I thank you for this opportunity to address the committee today and look forward to answering any questions you might have.

[The prepared statement of Kirkegaard follows:]

Congressional Testimony

The Euro Area Crisis: Origin, Current Status and European and U.S. Responses

Jacob Funk Kirkegaard, Peterson Institute for International Economics

Testimony before the U.S. House Committee on Foreign Affairs Subcommittee on Europe and Eurasia
Thursday October 27th, 2011

Subcommittee Chairman Burton, ranking member Meeks, members of the Subcommittee on Europe and Eurasia, it is a pleasure to testify before you today on the origin, current status of and European and U.S. responses to the euro area crisis. In my written testimony, I will address three issues; the origins of the four principal aspects of the euro area crisis, the recent crises responses by European and U.S. leaders, and the impact of the euro area crisis on U.S. political and economic interests.

The Origin of the Euro Area's Four Different Crises, their Overlaps and Mutual Reinforcement

The euro area crisis has gradually since May 2010 taken center-place in an increasingly volatile global economy. It has become evident that the crisis consists of four distinct, though frequently overlapping and mutually reinforcing crises; 1) A design crisis, as the euro area from its creation in the 1990s has lacked crucial institutions to ensure financial stability during a crisis; 2) A fiscal crisis centered in Greece, but present across the southern euro area and Ireland; 3) A competitiveness crisis manifest in large and persistent pre-crisis current account deficits in the euro area periphery and even larger intra-euro area current account imbalances; and 4) A banking crisis first visible in Ireland, but spreading throughout euro area via accelerating concerns over sovereign solvencies.

Before proceeding to discuss each crisis in more detail, it is immediately important to note how each of the four simultaneous crises currently raging in the euro area would pose a significant challenge for policymakers in any individual country, and that none of the four can credibly be solved in isolation. The current euro area economic and political situation is characterized by an unusual degree of complexity, frustrating attempts at a single expeditious comprehensive solution. No silver bullet answer to the euro area's current travails is available to EU policymakers, and the drawn-out inconclusive crisis containment efforts witnessed in Europe since early 2010 is set to continue for a while yet.

<u>The Euro Area Design Challenge</u>
The concrete thinking about an economic and monetary union (EMU) in Europe goes back to 1970, when the *Werner Report*[1] laid out a detailed three stage plan for the establishment of EMU in Europe by 1980. Members of the European Community would gradually increase coordination of economic and fiscal policies, while reducing exchange rate fluctuations and finally fixing these irrevocably. The collapse

[1] Available at http://aei.pitt.edu/1002/1/monetary_werner_final.pdf.

of the Bretton Woods system and the first oil crisis in the early 1970s caused the Werner Report proposals to be abandoned.

By the mid-1980s, following the 1979 creation of the European Monetary System and the initiation of Europe's internal market, European policymakers again took up the idea of EMU. The *Delors Report*[2] from 1989 envisioned the achievement of EMU by 1999, moving gradually (again in three stages) towards closer economic coordination among the EU members, with binding constraints on member states' national budgets, and a single currency with an independent European Central Bank (ECB).

While Europe's currency union therefore has lengthy historical roots, it was an unforeseen shock – German reunification in October 1990 – that provided the political impetus for the creation of the Maastricht Treaty[3], which in 1992 provided the legal foundation and detailed design for today's euro area. With the historical parity in Europe between (West) Germany and France no longer a political and economic reality, French president Francois Mitterrand and German Chancellor Helmut Kohl launched the EMU process as a principally political project to irrevocably join the French, German and other European economies together in an economic and monetary union and cement European unity.

This political imperative for launching the euro by 1999, however, frequently facilitated that politically necessary compromises, rather than theoretically sound and rigorous rules and regulations made up the institutional framework for the euro.

While the earlier Werner and Delors reports discussing the design of EMU had been explicit about the requirement to compliment a European monetary union (e.g. the common currency) with a European economic union complete with binding constraints on member states' behavior, political realities in Europe made this goal unattainable within the timeframe dictated by political leaders following German reunification.

The continued principal self-identification among Europeans as first and foremost residents of their home country[4], i.e. Belgians, Germans, Poles, Italians etc., made the collection of direct taxes to fund a large centralized European budget implausible. The frequently discussed relatively high willingness of Europeans to pay taxes does not "extend to Brussels". The designers of the euro area was consequently compelled to create the common currency area without a sizable central fiscal authority with the ability to counter regional specific (asymmetric) economic shocks or re-instill confidence in private market participants in the midst of a crisis – like the one the euro area is currently experiencing.

Similarly, the divergence in the economic starting points among the politically prerequisite "founding members" of the euro area moreover made the imposition of firm, objective fiscal criteria for membership in the euro area politically impossible. The Maastricht Treaty in principle included at least two hard "convergence criteria" for euro area membership – the so-called "reference values" of 3 percent general government annual deficit limit and 60 percent general government gross debt limit[5].

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[2] Available at http://aei.pitt.edu/1007/1/monetary_delors.pdf.

[3] Available at http://www.eurotreaties.com/maastrichtec.pdf.

[4] See Kirkegaard (2010) at http://www.piie.com/publications/pb/pb10-25.pdf.

[5] The actual numerical reference values to article 104c of the Maastricht Treaty are in a Protocol on the Excessive Deficit Procedure to the Treaty. Available at http://www.eurotreaties.com/maastrichtprotocols.pdf. The Maastricht Convergence Criteria for euro area membership eligibility include three additional metrics; inflation (within 1.5 percent of the three EU countries with the lowest inflation rate); long-term interest rates (within 2

However, in reality these threshold values were anything but fixed, as the Maastricht Treaty Article 104c stated that countries could exceed the 3 percent deficit target, if "*the ratio has declined substantially and continuously and reached a level that comes close to the reference value*", or "*excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value*". Euro area countries could similarly exceed the 60 percent gross debt target, provided that "*the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace*".

In other words, it was a wholly political decision whether a country could become a member of the euro area or not, and had relatively less to do with the fundamental economic strengths and weaknesses of the country in question. As it was politically inconceivable to launch the euro without Italy, the third largest economy in continental Europe, or Belgium, home of the European capital Brussels, both countries became members despite in 1997-98 having gross debt levels of almost twice the reference value of 60 percent (Figure 1).

As a result, Europe's monetary union was launched in 1999 comprising of a set of countries that were far more diverse in their economic fundamentals and far less economically integrated than had been envisioned in the earlier Werner and Delors reports. Yet, not only did European political leaders proceed with the launch of the euro with far more dissimilar countries than what economic theory would have predicted feasible, shortly after the launch of the euro, they went further and undermined the remaining credibility of the rules-based framework for the coordination of national fiscal policies in the euro area.

Building on the euro area convergence criteria, the Stability and Growth Pact (SGP) was intended to safeguard sound public finances, prevent individual euro area members from running unsustainable fiscal policies and thus guard against moral hazard by enforcing budget discipline. However, faced themselves with breaching the 3 percent deficit limit in 2002-2004, France and Germany pushed through a watering down of the SGP rules in March 2005[6] that, as in the Maastricht Treaty itself, introduced sufficient flexibility into the interpretation of SGP that its enforcement became wholly political and with only limited reference to objective economic facts. Individual euro members subsequently failed to restore the long-term sustainability of their finances during the growth years before the global financial crisis began.

By 2005 the euro area was as a result of numerous shortcuts taken to achieve and sustain a political goal, a common currency area consisting of a very dissimilar set of countries, without a central fiscal agent, without any credible enforcement of budget discipline or real deepening economic convergence.

Initially, however, none of these danger signs mattered, as the financing costs in private financial markets of all euro area members quickly fell towards the traditionally low interest rates of Germany (Figure 2).

It is beyond this testimony to speculate about the causes of this lasting colossal mispricing of credit risk in the euro area sovereign debt markets by private investors in the first years after the introduction of the euro. The financial effects of this failure on the other hand were obvious, as euro area governments

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percent of the three lowest interest rates in the EU); and exchange rate fluctuations (participation for two years in the ERM II narrow band of exchange rate fluctuations).

[6] See EU Council Conclusions March 23rd 2005 at http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/84335.pdf.

and private investors were able to finance themselves at historically low (often significantly negative real) interest rates seemingly irrespective of their economic fundamentals. Large public and private debt overhangs were correspondingly built up in the euro area during the first years of the euro area and in the run up to the global financial crisis in 2008. Financial markets' failure to properly assess the riskiness of different euro area countries papered over these issues until the global financial crisis finally struck.

The euro area institutional design has in essence been that of a "fair weather currency", with no central institutions capable of compelling the member states to act in unison. As a new, untested and severely under-institutionalized entity, the euro area has had no capacity to act forcefully during the current crisis or restore confidence among private businesses and consumers. Unless that changes, the euro area will be unable to exit the current crisis.

European policymakers therefore today are faced with the acute challenge of correcting the design flaws in the euro area institutions that their predecessors in their quest to quickly realize a political vision for Europe helped create. The euro area needs a new rule book. Leaders must in the midst of this crisis craft a new set of euro area institutions that for the first time provide the common currency with binding fiscal rules for its member states, and a centralized fiscal entity capable of acting in a crisis on behalf of the euro area as a whole. This will require the transfer of sovereignty from individual member states to the supra-national euro area level considerably beyond what has previously occurred in the EU.

The Euro Area Fiscal Challenge

The euro area fiscal crisis is concentrated in Greece, which according to the latest IMF/EC/ECB estimates will have a general government debt surpassing 180 percent of GDP by 2012. Despite Greece's IMF program and associated financial support from the EU and IMF since May 2010, the country is at this point clearly not able to repay all its creditors in full and has to restructure its government debt. Greece will consequently be the first ever euro area country and first OECD member since shortly after World War 2 forced to restructure its sovereign debt.

Portugal and Ireland are currently subject to IMF programs, too, but in contrast to Greece have successfully implemented their program commitments to this date[7]. Through continued strong reform implementation and access to financial assistance from the EU and IMF in the years ahead, it looks still potentially feasible for Portugal and Ireland to in the medium-term restore their access to private financial markets at sustainable interest rates.

However, as illustrated in figure 3, the cost of financing for Spain and Italy has also risen substantially in recent month with secondary 10y bond market yields currently between 5.5 and 6 percent. Unlike, however, the three smaller euro area countries with IMF programs, Spain and Italy are economies of a size that makes them "too big to bailout" for the euro area, even with IMF help. The fact that financial markets have begun to doubt the fiscal sustainability of "too big to bailout" members of the euro area is at the heart of the euro area policy makers' fiscal challenge.

The key link between Greece and Spain and Italy is the issue of "contagion"[8], i.e. a situation in which instability in a specific asset markets or institutions is transmitted to one or more other specific such

[7] See IMF press release 11/374 at http://www.imf.org/external/np/sec/pr/2011/pr11374.htm and IMF press release 11/330 at http://www.imf.org/external/np/sec/pr/2011/pr11330.htm.

[8] See speech by ECB vice-president Vitor Constancio for a precise definition and discussion at http://www.ecb.int/press/key/date/2011/html/sp111010.en.html.

asset markets or institutions. Inside a currency union like the euro area, where the central bank is legally barred from guaranteeing all the sovereign debts of individual member states[9] and the for political reasons each sovereign members' debts remains distinct[10], yet the debt is denominated in the same currency and governed by at least some common institutions, the phenomenon of contagion has particular force. If private investors begin to fear that a precedent will be set inside the euro area with the imposition of haircuts on Greek sovereign debt, they will assess the riskiness of other euro area members' sovereign debt differently once the "risk free status" of euro area sovereign debt has been impaired. The large increases in the interest rates on Italian and Spanish government debt seen immediately following the July 21st, 2011 EU Council decision to first introduce haircuts on Greek government debt looks, in the absence of simultaneous new bad economic news released from the two countries, to be largely due to contagion.

Given the high public and private debt levels built up before the global financial crisis in Spain and Italy, the sudden emergence of contagion and associated reprising by private investors of the riskiness of these two countries has the potential initiate destabilizing self-fulfilling interest rate-solvency spirals. Contagion from Greece causes Italian interest rates to go up, which given Italy's high existing debt levels adds materially to the interest burden, necessitating further austerity measures, further reducing economic growth in the short-term, leading to lower government revenues and increased financial market concerns, again increasing both the Italian government deficit and interest burden. The presence of contagion inside a currency union, where many individual members have high debt levels consequently have to potential of turning what might previously have been stable and sustainable high debt burdens into unstable unsustainable debt burdens.

The unique degree of independence of the ECB adds a further complication to such contagion inside the euro area. Its independence derives from Article 282 of the EU Treaty[11], which states that the central bank "*shall be independent in the exercise of its powers and in the management of its finances. Union institutions, bodies, offices and agencies, and the governments of the Member States shall respect that independence.*" With Treaty-defined independence, the ECB is more akin to a Supreme Court than a central bank in the mold of the U.S. Federal Reserve, whose independence is derived from the Federal Reserve Act passed by Congress (which Congress expressly reserves the right to amend, alter, or repeal[12]). The ECB has no political masters and the EU Treaty moreover bars bar elected officials from criticizing its decisions.

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[9] Article 123 in the EU Treaty states "*Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States (hereinafter referred to as 'national central banks') in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments.*"

[10] As discussed above, with the vast majority of European citizens still self-identifying as citizens of their respective countries (rather than the euro area), a pooling of all the national sovereign debts of the euro area into a single debt instruments – similar to what Alexander Hamilton achieved for the U.S. states' war debts in 1790 – is not a realistic political option in Europe at this point. Another critical political difference is that unlike the war debts incurred by U.S. states during the Revolutionary War, the outstanding debts of individual euro area members have not been incurred in order to achieve a "common cause". The political narrative of seeing such debts "honored in common" by all euro area members consequently does not exist.

[11] http://www.ecb.int/ecb/legal/pdf/fxac08115enc_002.pdf.

[12] http://www.federalreserve.gov/aboutthefed/section31.htm

In a sovereign and financial crisis, such total central bank independence might actually hinder the restoration of market confidence, because it might further undermine investors' trust in the solvency of a government that does not ultimately control its own central bank, lacks its own currency, and thus has no ultimate lender of last resort. The European Treaty's Article 123 forbids the ECB to extend credit to member states, preventing it from issuing any blanket guarantees for their sovereign debt. Due to the complete independence of the ECB and the restrictions the EU Treaty places on it, the euro area thus lacks an important confidence boosting measure in the face of contagion.

On the other hand, the ECB's independence and status as the only pan-euro area institution capable of direct forceful action to calm global financial markets bestows upon the ECB's governing council a degree of leverage over elected officials in this crisis not seen elsewhere in the world. This gives the ECB leadership the ability to engage in horse-trading with democratically elected governments behind closed doors, where it can quietly demand that government leaders implement far-reaching reforms. A clear example of this came in August 2011 just ahead of the ECB's initiation of emergency support purchases of Italian government debt. The sitting and incoming presidents of the ECB wrote bluntly to Italian Prime Minister Silvio Berlusconi , stating that "the [ECB] Governing Council considers that pressing action by the Italian authorities is essential to restore the confidence of investors[13]" followed by a list of more than ten specific required reforms to be implemented by the Italian government.

The degree of independence and influence of the ECB matters for the attempts to find an expeditions solution to the euro area fiscal crisis, as it is actually not in the ECB's interest to act too decisively to immediately try to end any contagion or the crisis more broadly. It is not that the ECB cannot step in. There is no asset it cannot buy, if the governing council agrees. The strategy of allowing financial market mayhem to pressure European governments is therefore less risky than it seems. Ultimately, the ECB has the means to calm markets down but its intention is to do so only to avoid absolute disaster.

A sweeping preemptive "helping hand to euro area governments" under speculative attack would from the perspective of the ECB be counterproductive, as it would relieve pressure on governments to reform. The ECB's game is thus not to end the crisis at all costs as soon as possible, but to act deliberatively to cajole governments into implementing the crisis solutions it wants. The market volatility seen accelerating in recent months becomes something not to be avoided, but to use as a club against recalcitrant and reform-resistant euro area leaders.

European policymakers therefore today are faced with the acute challenge of enabling Greece to restructure its unsustainable sovereign debt, while at the same time ensuring that such an event has no precedent-setting effects inside the euro area and that contagion among sovereign debt markets consequently is contained. Ring-fencing Greece geographically and in the time dimension (i.e. assuring that Greece will only ever go through a single one-off sovereign debt restructuring) will require further financial assistance in the coming years be provided to Greece itself, as well as Portugal and Ireland. The sizable majority of this support must sensible come from the rest of the euro area, with some continued financial participation also of the IMF.

In addition to further restrict contagion, euro area leaders must device a method which can provide a degree of preemptive financial support to "too big to bailout" euro area members and potentially lower

[13] Full text of ECB letter to Silvio Berlusconi at http://www.corriere.it/economia/11_settembre_29/trichet_draghi_inglese_304a5f1e-ea59-11e0-ae06-4da866778017.shtml?fr=correlati.

their primary bond market cost of finance. This is the key aspect of the current debate surrounding how to utilize the €440bn European Financial Stability Facility (EFSF) most effectively. However, given the constraints on and reluctance of the ECB to participate directly in any such financial support (though for instance providing leverage to the EFSF) to large non-IMF program countries, the resources available to euro area leaders will be constrained. Any financial benefits to large beneficiary countries like Spain and Italy from new euro area measures will moreover be relatively limited, due to the large weight inside the euro area itself of the beneficiary countries themselves. Irrespective of the ultimate format chosen by euro area leaders, the "correlation between benefactors and beneficiaries" will be so large that the financial advantage will be relatively modest. There will be no euro area "bazooka" created from the EFSF.

Ultimately, the euro area will have to rely on its large members to "bail themselves out" through a lengthy period of fiscal consolidation. Financial markets are unlikely to be satisfied with this outcome, and while the ECB will continue to act as a conditional final defender of financial stability in the euro area, heightened levels of uncertainty and volatility will remain a feature of the euro area sovereign debt and other asset markets several years ahead.

The Euro Area Competitiveness Challenge

The euro area was wrought by merging together in a single currency a number of highly divergent European economies, and for reasons of political expediency any binding political euro area rules and intrusive regulations that could during the euro's first decade have forced a real economic convergence to occur among divergent euro area members were abandoned. Cushioned by the seemingly secure access to cheap financing once inside the euro area, most member states moreover scaled back the implementation of structural reforms of their national economies[14].

The principal exception was Germany, which in the years immediately after the euro introduction implemented a series of far reaching reforms of especially its labor markets and pension system. Consequently, Europe's traditionally strongest and most competitive economy during the first decade of the euro area gradually pulled itself even further ahead of most of the other members of the common currency. A persistent pattern inside the euro area consequently became the widening current account imbalances with Germany and other Northern members running surpluses and especially the Southern peripheral members running deficits (figure 4).

Financing their large external deficits posed few obstacles for peripheral countries prior to the global financial crisis, even as it became clearer that the inflows of foreign capital were increasingly channeled towards financing speculative real estate investments, rather than adding to new productive asset investments. With the disappearance of foreign private capital following the onslaught of the global financial crisis, peripheral euro area deficit countries and their banks suddenly found themselves instead overwhelmingly dependent on financial support from the ECB. However, while such central support will be continuous inside any functioning currency union, a longer-term requirement for peripheral euro area nations to regain competitiveness and restore external balance (or surplus) remains[15]. Without improving external competitiveness and increasing exports/reducing imports, the euro area periphery

[14] See Duval and Elmeskov (2005) for an in-depth analysis at http://www.ecb.int/pub/pdf/scpwps/ecbwp596.pdf.

[15] It can be seen in figure 4 how peripheral deficits have declined substantially since 2008. This, however, can be mostly related to the severe economic contractions experienced in the euro area periphery, which has temporarily caused import levels to collapse.

will not during their current prolonged period of fiscal consolidation be able to restore domestic economic growth.

Inside a currency union without the ability to devalue their currency against major trading partners, peripheral euro area members, however, do not have access to the traditionally fastest and most effective way through which a country can regain external competitiveness[16]. Consequently, the euro area peripheral countries only have means at their disposal to increase the competitiveness that might be effective in a longer-term framework. Such measures include numerous traditional "supply-side structural reforms" of especially peripheral euro area labor markets, where the often legally sanctioned coercive power of labor unions, the rigidity of collective bargaining agreements and automatic wage indexation to the public sector must be curtailed. Nominal wage levels at the firm level must be brought into line with productivity, an effort which in numerous instances will lead to nominal wage cuts.

European policymakers face a competitiveness challenge today in which the precise requirements of the euro area periphery to regain their external competitiveness and for the euro area as a whole to limit intra-euro area imbalances will vary depending on individual country circumstances and require additional measures in surplus countries (such as Germany), too. It is furthermore evident that available policy options inside a currency union are of a structural reform character. Such reforms can only hope to be effective in raising competitiveness and potential economic growth rates in the medium term, and will indeed in the short term, though for instance required nominal wage declines, hurt economic growth.

The Euro Area Banking Crisis

The first manifestations of a banking crisis in the euro area in Ireland in 2008 had relatively few pan-euro area elements about it. The Irish real estate boom was clearly supported by the record low negative real interest rates in the country following the introduction of the euro (figure 5), but the 2008 collapse of the Irish banking sector and subsequent required rescue of the Irish government by the EU and IMF was overwhelmingly due to domestic Irish domestic factors and failures[17]. That on the other hand is not true of the most recent volatility to affect the euro area banking system.

Several systematic ailments that plaque the euro area banking system are illustrated in table 1; First of all, the euro area's banking system is very large relative to the size of the overall home economies with average euro area financial institutions' gross debt equal to 143 percent of GDP (U.S. equal 94 percent). Secondly, euro area bank leverage is very high at tangible assets at 26 times common equity (U.S. level is at 12 times); and thirdly, euro area banks tend to own a lot of the debt issued by their own governments (something U.S. banks do to a much smaller degree).

The sheer size of the euro area banking system makes it – as illustrated in Ireland in 2008-10 – problematic for individual already indebted euro area governments to credibly issue guarantees to stand behind their domestic banks in a crisis. This issue is aggravated by the low level of common equity (core

[16] I shall in this testimony not discuss the option of member leaving the euro area. I will refrain from this for three main reasons; first of all, I consider the costs of any country leaving the euro area as catastrophically high for the country in question, irrespective of whether it is Greece or Germany. Secondly, it is clear from the political announcements of all EU leaders that the departure of any country from the euro area will not be tolerated (such a departure could prove to have a very serious contagion effect). And thirdly, as under the current EU Treaty, the departure from the euro area is legally undefined and thus presumed impossible.

[17] See the Nyberg Report at http://www.bankinginquiry.gov.ie/Documents/Misjuding%20Risk%20-%20Causes%20of%20the%20Systemic%20Banking%20Crisis%20in%20Ireland.pdf.

tier 1) capital in the euro area banks. With low private shareholder risk capital levels in euro area banks, euro area governments risks being frequently called upon to rescue domestic banks as only a thin layer of private equity capital is available as first-loss risk capital. Disproportionally large capital injection requirements are another risk to euro area tax payers in rescues of thinly capitalized banks. There is consequently across the euro area a large degree of interdependence between the financial solidity of large domestic banking systems and national government solvency.

The bank large ownership of government debt in the euro area presents a particularly intractable concern. Euro area (and other) banks are under the Basle Agreements not required to set aside any risk capital to offset any future losses on government bond holdings. Sovereign bonds have by definition been deemed "risk free". Consequently, when Greek government debt must be restructured, it will impose upon the euro area banks credit losses for which they have previously not set aside capital, and given the scale of ownership of such debt among domestic Greek banks will require that these be recapitalized with money from international donors. The same dynamic is inevitable across essentially all euro area members, as the domestic banking system will face ruinous capital losses if national sovereign debt is restructured, due to the high domestic government debt ownership.

Fearful that banks would require very large amounts of new equity capital, which would in many instances have to come from governments themselves and might therefore pose a challenge to some governments' own solvency, European banking regulators have been reluctant to include any potential impairment of banks' sovereign debt holdings in EU bank stress tests in 2010 and 2011. Given, however, the justified market concerns about the solvency of at least one euro area sovereign (Greece) and the potential for contagion to other euro area sovereign bond markets, stress tests that do not include the potential for losses on sovereign bonds cannot provide a credible measure of the riskiness of any euro area banking system. As long as solvency concerns exists about euro area governments, a high degree of volatility will surround the euro area banking system, which again provide a powerful feedback loop to increased investor fears about the financial stability of governments in the first place.

Lastly, in addition to low capital levels and associated concerns, many euro area banks also suffer from substantial liquidity risks with high degrees of dependence on short-term wholesale funding from markets where access may prove ephemeral and subject to rapid changes.

Euro area governments face the challenge of rapidly having to stabilize their oversized and in the aggregate undercapitalized banking systems without having to dispend large amounts of capital themselves, as this could further jeopardize their own solvency. Further postponement today of forceful measures to stabilize the euro area banking system with new outside capital risks throwing the euro area into an accelerating credit crunch as banks de-lever and conserve their scarce capital. This would rapidly have a strongly detrimental effect on the broader growth prospects of the euro area.

Not all euro area governments are in the same situation though, as for instance the German government would quite easily be able to manage an even very large government-led recapitalization of its national banking system. However, due to the close linkages among sovereigns (and consequently their banking systems) inside the euro area and the observable presence of contagion between them, a key challenge for European policymakers will be to move expeditiously to a new system of tougher pan-European banking support, regulation and supervision. The establishment of a new set of common regulatory institutions for the European banking system will, however, due to the obvious implications potential government financial crisis support for banks have for governments' own solvency require a new level of fiscal integration in the euro area and the commensurate loss of national fiscal sovereignty.

The fact that the City of London, the EU and euro area financial center, is located in the UK, which can safely be assumed to remain outside the euro area itself for the foreseeable future, further complicates this type of banking sector integration initiatives.

U.S. and European Responses to the Euro Area Crisis

U.S policymakers have faced substantial obstacles in their dealing with the euro area crisis. First of all, the U.S. domestic economic crisis itself has demanded the keen attention of many relevant authorities. Most importantly, though, the possible direct actions by U.S. policymakers have been limited by the fact that the euro area crisis is, despite its increasing global spillover potential, still at heart a domestic economic crisis inside another sovereign jurisdiction. For straightforward reasons of accountability, the euro area crisis should be dealt with overwhelmingly by European policymakers, using European financial resources and being guided by European political norms, traditions and institutions. The ability of the U.S. government to directly bilaterally affect the outcome of the euro area crisis is consequently and appropriately limited.

At the same time, the U.S. government representatives have in my opinion since the beginning of the euro area crisis in early 2010 exercised important indirect pressure through multilateral channels and especially the IMF to expedite the European crisis resolution process and push it in generally beneficial directions. This is especially the case with respect to impressing upon European policymakers the importance of the stability of the banking system and the importance of restoring growth to the crisis stricken euro area periphery.

In recent months, U.S government authorities have in addition provided European policymakers with direct and constructive first-hand advice concerning emergency crisis measures which were successfully utilized earlier during the crisis here in the United States. This concerns particularly U.S. experiences using central bank leverage to maximize the financial impact of a finite pool of taxpayer money to fight different aspects of a widespread financial crisis[18].

Lastly, the constant, seamless and expeditious collaboration with respect to for instance foreign exchange swaps between the Federal Reserve and ECB (and other central banks) should be mentioned as an essential example of direct U.S. government engagement to address the economic fallout from the euro area crisis.

In general, the efforts of the U.S. government to address the euro area crisis have been constructive and beneficial within the relatively limited scope they can credibly attain.

Turning to European responses to the euro area crisis, there is no doubt that had EU leaders acted much more forceful earlier in the crisis, much volatility and lost economic output could have been avoided. However, paraphrasing former defense secretary Donald Rumsfeld, you fight an economic crisis with the institutions you have, not the institutions you might want. Certainly, the euro area went into its current financial and sovereign debt crisis woefully under-institutionalized, making what has been financially required to contain the crisis politically illegitimate in real time. Just as it took a huge tumble in the U.S.

[18] See http://www.piie.com/realtime/?p=2372 for a discussion of what European policymakers should learn from U.S. experiences with collaborative crisis resolution in the TALF program jointly implemented by the Federal Reserve and U.S. Treasury.

stock-market after the first failed vote to get the TARP program passed by Congress in October 2008, European leaders have not been politically able to act proactively before the circumstances left no other choice. The result has been a crisis resolution strategy characterized by an incremental reactionism to developments in financial markets, but unable to get ahead of them.

However, recall as this testimony has made clear the extraordinary degree of complexity that characterizes the task in front of EU leaders today. Not one, but multiple simultaneous crises currently torment the euro area economies, none of which can be solved quickly or independently. Moreover, the sheer political boldness of the unique euro area experiment should be kept in mind, too. The degree of pooling of sovereignty and fiscal integration among sovereign entities already implemented during this crisis by EU leaders has historically only been accomplished by territories, countries and governments in the immediate aftermath of wars of independence, decolonization or political revolutions. That it can take place today in Europe in the midst of what is after all "only" a very deep economic crisis is testament to the extraordinary political will among Europe's democratically elected leaders to sustain their currency union. This will, combined with the revealed aversion of Europe's populations to turn to populist electoral alternatives, even during times of acute economic crisis, suggests that as long as Europe can avert imminent economic disaster – which its powerful central bank and squabbling leaders will manage – a steady and sustainable progress out of the crisis can be maintained.

Contrary to many descriptions of the euro area crisis response, it has not been a wasted crisis. Important decisions about strengthening Europe's fiscal rules have been taken[19], which implies an unprecedented transfer of fiscal sovereignty from national parliaments to the euro area level. Ultimately, strengthened fiscal and economic convergence rules in the euro area – which may in the longer term require a change in the EU Treaty to accomplish – is the tool with which the euro area will ensure that its "too-big-to-bailout" countries of Italy and Spain will implement the required economic reforms to ensure solvency.

The euro area with the €440bn EFSF now for the first time has a centralized fiscal vehicle that can provide resources to individual countries hit by asymmetric shocks. As the ESFS gives way to the permanent European Stability Mechanism (ESM) in 2012 or 2013, this new central fiscal agent will become a permanent new institutional feature of the euro area. In recent weeks, European leaders have similarly finally begun to more forcefully address the chronic under-capitalization problem in the euro area banking system. The euro area banking system cannot however become genuinely stable until the governments that back it are.

A more credibly-sized restructuring of the outstanding privately held Greek debt is now being negotiated. While this alone will far from restore Greek debt sustainability, an around 50 percent NPV reduction will provide the political credibility in euro area donor countries of this being the "one and only Greek debt restructuring" ever. Following such a restructuring, providing concessional financing for Greece going forward to ensure its fiscal sustainability will wholly be a matter for the official sector and the euro area in particular. This should help limit the potential for additional contagion spreading to other countries from a Greek restructuring. The euro area provision of subsidized financing to Ireland and Portugal until these have regained market access, combined with the two countries strong IMF program implementation, will further in the longer term restrict contagion and help restore the credibility of euro area sovereign debt as "risk free".

[19] See http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/11/647 for the latest developments of the EU so-called six-pack of reforms to fiscal monitoring rules.

None of the euro area's responses have so far and will in the future serve as a silver bullet solution to the euro area crisis. The euro area crisis is simply too widespread and too complex for such answers to be crafted. The euro area crisis will therefore continue to add to global economic uncertainty and financial market volatility in the months if not years ahead.

The Impact of the Euro Area Crisis on U.S. National Interests

It is in America's vital national interest that Europe and the euro area, comprising the United States' strongest historical strategic allies and with whom Americans, especially in an era of growing multi-polarity in the world, share the relatively broadest norm and value community, fix their economic crisis. With Europe the largest destination of U.S. exports and foreign direct investment and extensive cross-ownership of large financial institutions, it is first of all inescapable that the U.S. domestic economic will experience a further negative external shock from an unexpected further rapid deterioration of the euro area economic crisis. Should such deterioration occur, it is certain that the EU as a whole will be forced to look even more exclusively inward and correspondingly lose even more of its willingness and declining capacity to assist the United States in the defense of its global political and economic interests.

However, despite these euro area crisis aspects of "our currency, but your problem too", it is not commensurate with an appropriate and responsible defense of America's national interest, keeping in mind the U.S. federal fiscal outlook, to bilaterally provide any financial assistance to the euro area. This is a task predominantly for Europe itself, as well as the appropriate multilateral organizations, noticeably the IMF.

On the issue of the IMF, the euro area crisis has on the other hand made it clear that it is in America's national interest to help boost the prominence of the IMF as the key global financial crisis manager. As a declining relative share of the global economy, the United States must realize that its overarching strategic national interest lies in sustaining the global legitimacy of particularly the IMF and other existing global economic governance institutions, thereby shielding them from potential threats from new institutional designs originating outside the traditional G-7 countries. Sustaining the legitimacy of such existing global institutions, in whose establishment, design, leadership, and current modus operandi the United States historically played a far larger role than its current and especially future global economic weight dictates, is far more important for the United States' continuing impact on global economic governance and the global economic system than any other global economic issue currently debated here in Washington.

It is consequently in the national interest of the United States to continue to push governance reforms at the IMF and participate fully in all internationally agreed capital commitments to the IMF to provide the organization with the biggest possible toolkit with which to combat global economic crises in general and the euro area crisis right now in particular. To the extent that additional IMF resources might in the future be committed to the euro area as part of standard IMF programs, the United States should support this.

In making this commitment, it should be recalled that the IMF as the super-preferred creditor has never lost money any money lent to crisis-stricken countries, even if these ultimately had to restructure parts of their government debt. Properly utilized in the euro area through the IMF, U.S. taxpayer funds are safe. It is in America's national interest that they – if required – can be deployed.

Figure 1: General Government Gross Debt 1998, 11 Original Euro Area Members, Percent of GDP

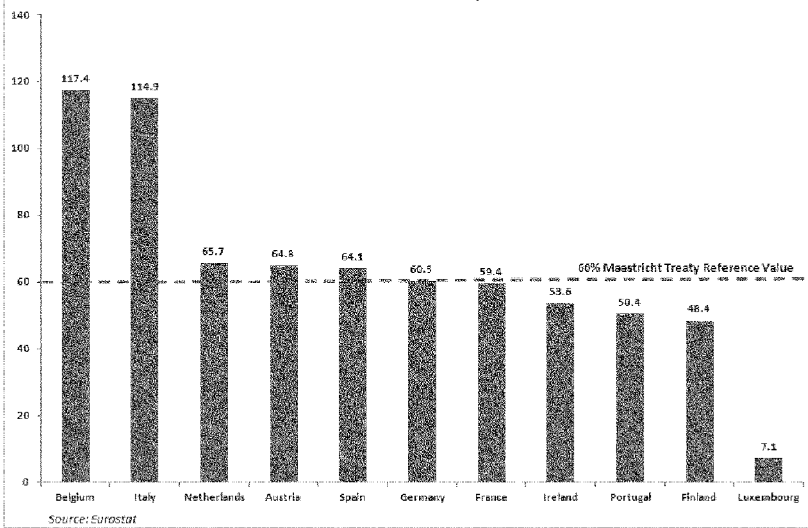
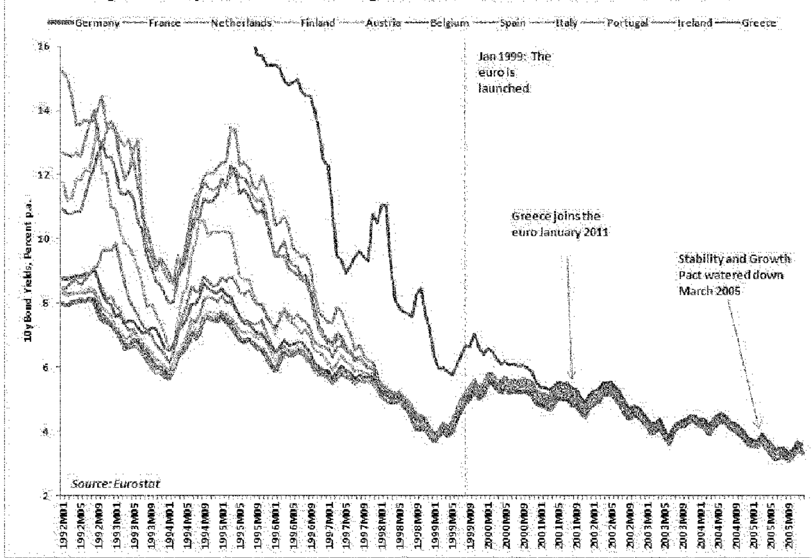


Figure 2: 10y Bond Rates Among Euro Area Members Jan 1992-Dec 2005



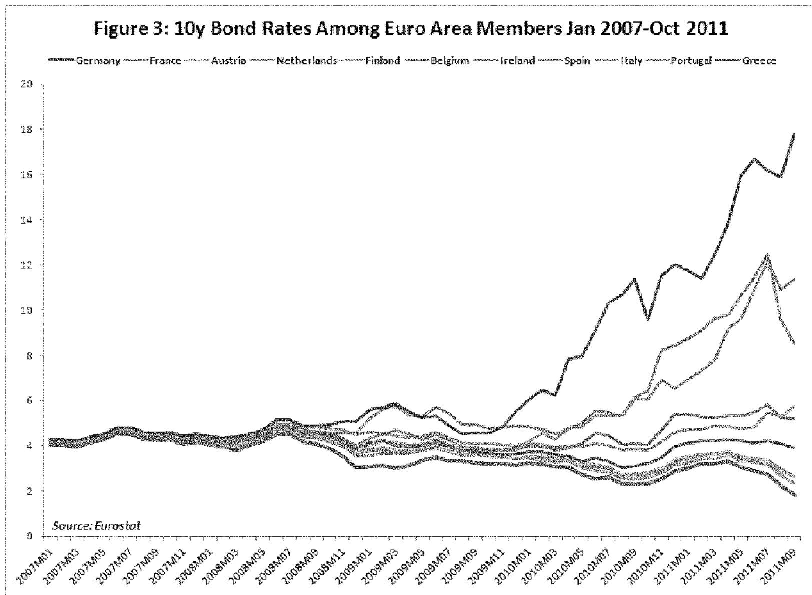


Figure 3: 10y Bond Rates Among Euro Area Members Jan 2007-Oct 2011

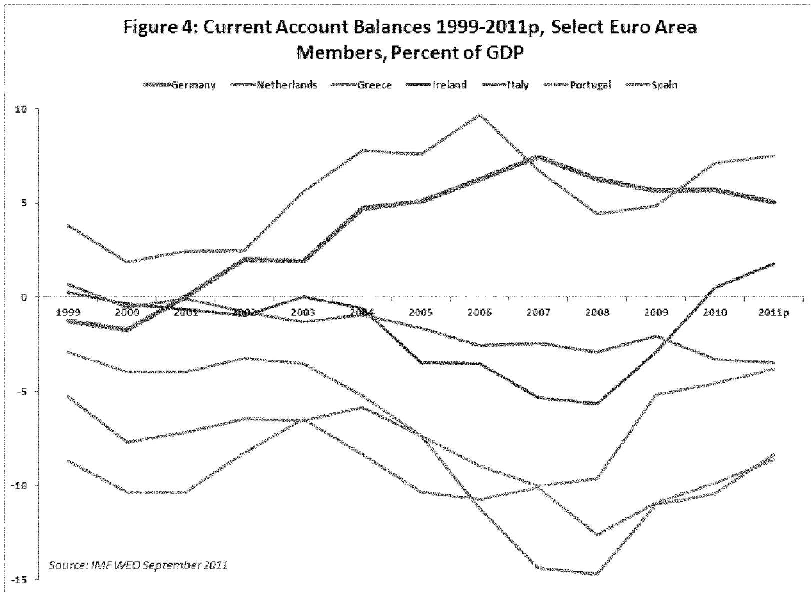
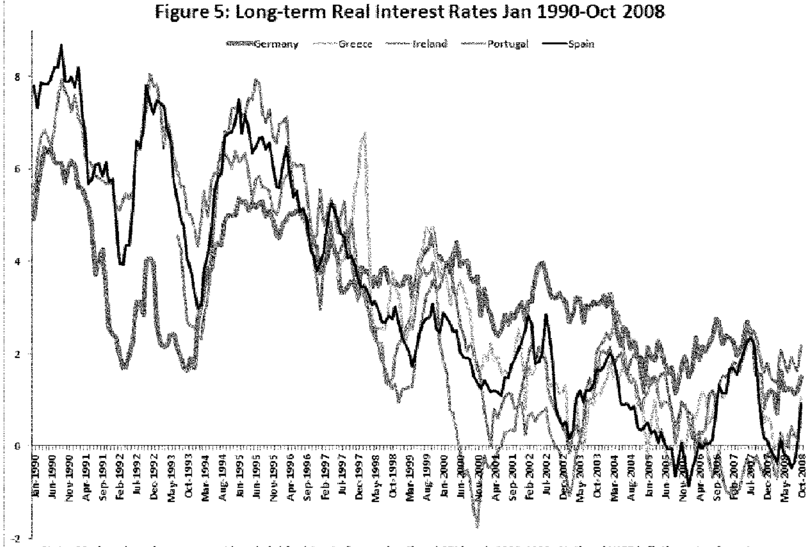


Figure 4: Current Account Balances 1999-2011p, Select Euro Area Members, Percent of GDP
Germany
Netherlands
Greece
Ireland
Italy
Portugal
Spain
10
5
0
-5
-10
-15
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011p
Source: IMF WEO September 2011

Figure 5: Long-term Real Interest Rates Jan 1990-Oct 2008



Note: 10y benchmark government bond yield subtracted annual national CPI levels 1990-1998. National HICP inflation rates from Jan 1999. *Source: Eurostat; OECD*

Table 1: Banking Systems in the Euro Area 2011

	Financial Institutions' Gross Debt (% of GDP)	Bank Leverage (Ratio of tangible assets/common equity in domestic banks)	Bank Claims on the Public Sector (Percent of GDP)
Euro Area	143	26	N/A
Belgium	112	30	23
France	151	26	17
Germany	98	32	23
Greece	22	17	28
Ireland	689	18	25
Italy	96	20	32
Portugal	61	17	24
Spain	111	19	24
United States	*94*	*12*	*6*

Source: IMF GFSR September 2011, table 1.1

Mr. BURTON. Thank you very much.
Mr. Lachman.

STATEMENT OF DESMOND LACHMAN, PH.D., RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE

Mr. LACHMAN. Thank you, Mr. Chairman, for giving me the honor to testify before this subcommittee.

In my remarks, what I would like to do is to emphasize the seriousness of this Eurozone crisis and to provide reasons why I think we are going to see an intensification of the crisis in the months ahead, despite the summit last night.

What I would also like to do is I would also like to emphasize the importance of this crisis for the United States economy, both through our export side and through our bank exposure.

I agree that the crisis is a complex crisis, but I would say that the main origin of the crisis is that for many years, the countries did not play by the rules of a currency union. Whereas the Maastricht criteria required that these countries run budget deficits of 3 percent of GDP, countries, Greece, Portugal, Ireland and Spain, routinely ran deficits either well in excess of 10 percent of GDP or very close to 10 percent of GDP. As a result, they built up huge debt positions well over 100 percent of GDP; they lost competitiveness; and they had very large balance of payment deficits.

The essence of the peripheral countries' problem right now is, how do you correct those kind of imbalances when you don't have a currency to devalue? IMF EU-imposed fiscal austerity in these circumstances is driving these economies into very deep recessions. That in turn is making them lose their tax base, make them lose the political willingness to stay the course, and it is an exercise in futility to impose further fiscal austerity on them of the type that we are getting right now.

I think that what is also important to understand in the crisis is that while we are talking about relatively small countries at the European periphery, these countries are enormously indebted to the banks in the core countries. If we look at Portugal, Ireland, Greece and Spain, we are talking about $2 trillion worth of sovereign debt, and a lot of that is held by the banks.

What we have seen in recent months is not an easing of this crisis but an intensification of the crisis. Greece's economy is on the cusp of a major default. Its economy is in free fall. They are not meeting the IMF targets. There is really real political tension on the streets. The Papandreou government doesn't look like it has got a long life ahead of it.

This has spread to Ireland and Portugal, but what is really of concern is the difficulty of Spain and Italy to borrow in capital markets without the support of the ECB. If Spain and Italy were to fail, that would be the end of the European experiment.

The European banking system is already showing real signs of strain that are reminiscent of our banking crisis in 2008–2009. Banks are not lending. Banks are parking money with the ECB. They don't trust one another's balance sheet. We are already at the start of what could be a credit crunch in Europe.

The final point about the intensification of the crisis is we are seeing that the key economies of Germany and France are losing steam. They look like they are already on the close edge of a recession. And if we do get a banking credit crunch, that is almost certain to push them into recession. And without growth in Europe, there is no way that the countries on the periphery are going to resolve their problem.

A positive sign in Europe is that at last, after many months of denial, the Europeans are recognizing that they have got a major problem. What they tried to do last night is move the crisis in the right direction. They tried to get resolution on the Greek situation. They tried to begin recapitalizing the banks. And they tried to put up a firewall against Spain and Italy.

I am afraid that I have got doubts about the efficacy of this program, and I think that this might be another episode of too little too late that has characterized the Europeanefforts to date. It is not clear that a haircut of Greece of 50 percent puts Greece on a sustainable path when the Europeans themselves recognize that Greece's debt after all of this is still going to be at 120 percent of GDP.

It is also not clear that the Europeans can come up with $1.4 trillion of unconditional money to provide a credible firewall to Spain and Italy. That money is going to be subject to Italy and Spain agreeing to conditions either imposed by, effectively, the Germans through their Bundestag or through the IMF.

Funny, I would say, that on the issue of the bank recapitalization, the way in which it is being gone about is this is likely to provoke a deepening in the credit crunch in Europe because the banks, far from raising capital at depressed equity prices, what they are going to do is they are going to engage in restricting their lending and selling off assets, which is going to be not good for the European economy.

My final point is that we in the United States should not take any comfort out of what is going on in Europe from purely self-interest reasons. You have mentioned that the United States has got very strong trade relations with Europe. We have got very strong investments in Europe. I would say that that is certainly true. But what is of deep concern is the interconnection between the United States financial system and that in Europe.

I would just point out that money market funds in the United States were reported by Fitch rating agency to have as much as 45 percent of their $2.7 trillion of assets lent out to European banks. That is an amount that is way in excess of $1 trillion. The U.S. banks themselves have got loan exposure to France and Germany of $1 trillion. And we don't know the extent of credit default swaps and other derivatives that our banks have written both on the periphery and on the European banking system, so we really do have to hope that the European situation resolves itself.

The U.S. is helping the Europeans, both through the Federal Reserve, providing liquidity through their swap operations and through the IMF.

I would just close by saying that I am not sure that there is a whole lot more that the United States can do or that the United States should do. The problems in Europe, in my view, are ones not of liquidity but are ones of solvency that require debt write downs and don't require more money to be thrown at it. I don't see why

United States taxpayers should be putting up more money risk on that side.

And I would just note that in 2008–2009, when the United States had a banking and credit market crisis, the Europeans did not come and provide us with financing. I think I would see it exactly the same way; this is a European problem that the Europeans need to address. And we have got to hope that they address it correctly because if they don't, we are in the same boat as they are.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Lachman follows:]

American Enterprise Institute for Public Policy Research

Statement before the House Committee on Foreign Affairs
Subcommittee on Europe and Eurasia
On The Eurozone Crisis: Destabilizing the Global Economy

The Eurozone Debt Crisis and the United States

Desmond Lachman

Resident Fellow
American Enterprise Institute

October 27, 2011

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Testimony for Foreign Affairs Subcommittee on Europe and Eurasia

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Thank you Chairman Burton, Ranking Member Meeks, and members of the Subcommittee for affording me the great honor of testifying before you today. My name is Desmond Lachman and I am a Resident Fellow at the American Enterprise Institute. I am here in my personal capacity and I am not here to represent the AEI's view.

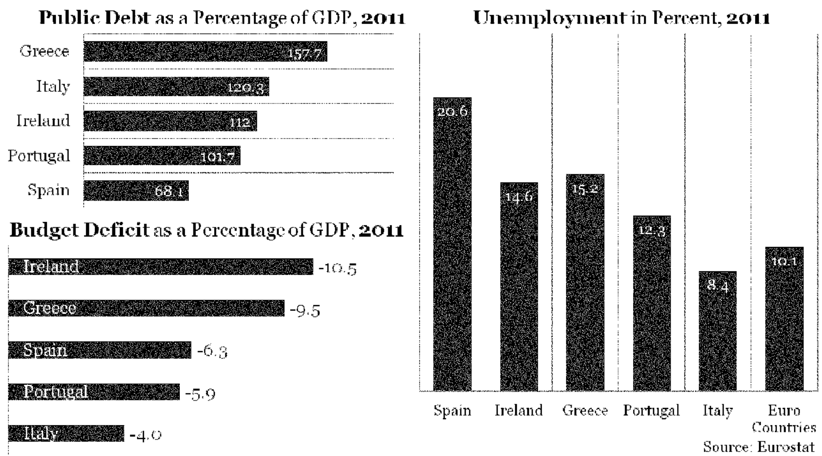
In the testimony that follows I set out the reasons why I think that there will be a further significant intensification of the Euro-zone debt crisis in the months immediately ahead. I also lay out the reasons why I think that the efforts currently underway by European policymakers to address this crisis will fall short of what might be needed to resolve this crisis in an orderly fashion. Finally, I attempt to draw out the serious risks that the Eurozone crisis poses to the US economic recovery.

Origins of the Crisis

1. The main underlying cause of the Eurozone debt crisis is that countries in the **Eurozone's periphery persistently did not play by the currency union's rules**. In particular, whereas the Maastricht Treaty had proscribed member countries from running budget deficits in excess of 3 percent of GDP, Greece, Ireland, and Portugal all ran budget deficits well above 10 percent of GDP. Similarly whereas the Maastricht Treaty had required that member countries keep their public debt below 60 percent of GDP, the Eurozone's peripheral countries have seen their public debt levels rise to well above 100 percent of GDP.

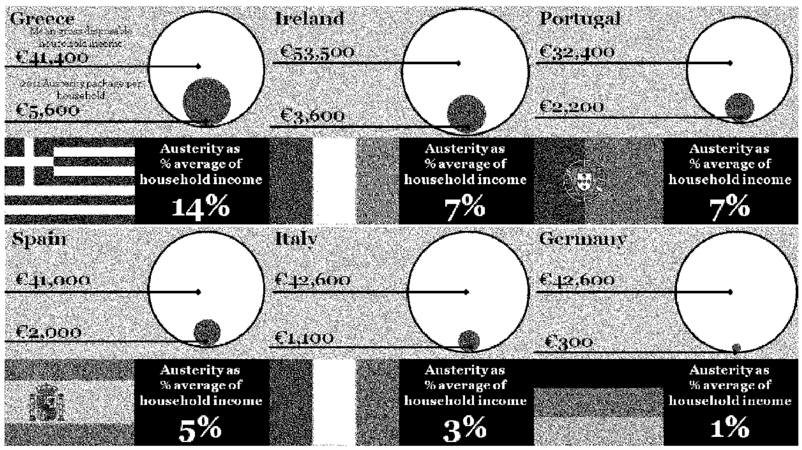
   In addition to compromising their public finances, the peripheral countries have lost a great degree of external competitiveness as a result of relatively high domestic inflation. This has contributed to very large external current account deficits in the periphery and very high external debt to GDP ratios.

Economic Imbalances in the European Periphery



2. The essence of the peripheral countries' problem is that stuck within the Euro **they are not able to devalue their currencies as a means of boosting their exports**. Attempting to comply with the IMF-EU programs of massive fiscal austerity without the benefit of devaluation to redress their internal and external imbalances is producing very deep recessions in these countries. That in turn is eroding these countries' tax bases and is sapping those countries' political willingness to stay the IMF course. It is also not helping these countries reduce their very high public debt to GDP levels.

European Austerity Measures in Relation to Income

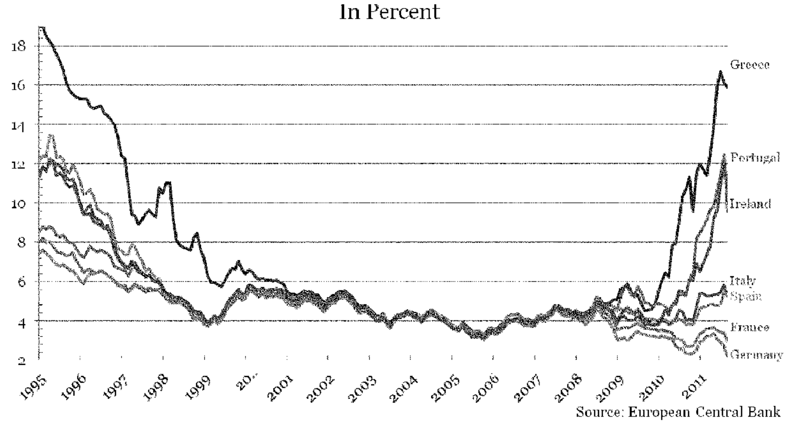


3. The seriousness of the present Eurozone debt crisis is that it has the potential for causing a full blown banking crisis in Europe's core countries. While the Eurozone periphery might not constitute a large part of the overall European economy, the peripheral countries are highly indebted. The total sovereign debt of Greece, Ireland, Portugal, and Spain is around US $2 trillion. A large part of that debt sits uncomfortably on the balance sheets of the French and the German banks.

The Euro Crisis is intensifying

4. Over the past few months, there has been **a marked intensification of the Eurozone debt crisis** that could have major implications for the United States economy in 2012.

Long-Term Government Bond Rates
Interest Rates on 10-year Government Bonds
In Percent



Among the signs of intensification are the following:

a. The Greek economy now appears to be in virtual freefall as indicated by a 12 percent contraction in real GDP over the past two years and an increase in the unemployment rate to over 15 percent. This makes a substantial write-down of Greece's US $450 billion sovereign debt highly probable within the next few months. Such a default would constitute the largest sovereign debt default on record.

b. Contagion from the Greek debt crisis is affecting not simply the smaller economies of Ireland and Portugal, which too have solvency problems. It is now also impacting Italy and Spain, Europe's third and fourth largest economies, respectively. This poses a real threat to the Euro's survival in its present form.

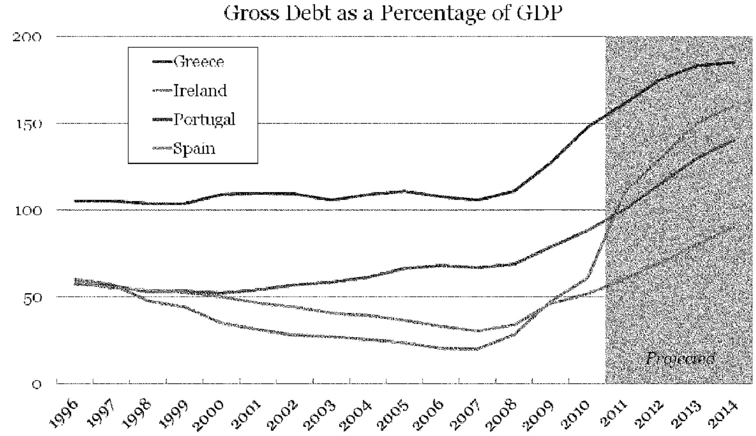
c. The Eurozone debt crisis is having a material impact on the European banking system. This is being reflected in an approximate halving in European bank share prices and an increase in European banks' funding costs. French banks in particular are having trouble funding themselves in the wholesale bank market.

d. There are very clear indications of an appreciable slowing in German and French economic growth. It is all too likely that the overall European economy could soon be tipped into a meaningful economic recession should there be a worsening in Europe's banking crisis. A worsening in the growth prospects of Europe's core countries reduces the chances that the countries in the European periphery can grow themselves out of their present debt crisis.

5. The IMF now acknowledges that Greece's economic and budget performance has been very much worse than anticipated and that **the Greek economy is basically insolvent.** The IMF estimates that Greece's public debt to GDP ratio will rise to at least 180 percent or to a level that is clearly unsustainable. The IMF is proposing that the European banks accept a 50-60 cent on the dollar write-down on their Greek sovereign debt holding. This would have a material impact on the European banks' capital reserve positions.

Government Debt – Select Eurozone Countries

Gross Debt as a Percentage of GDP



Source: OECD

6. The European Central Bank (ECB) is correctly warning that a Greek default would have a devastating effect on the Greek banking system, which has very large holdings of Greek sovereign debt. This could

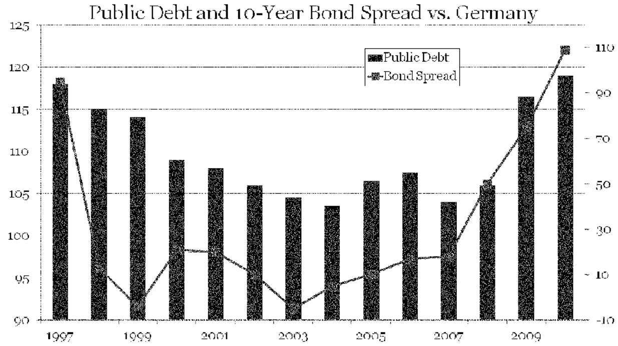
necessitate the imposition of capital controls or the nationalization of the Greek banking system. The ECB is also rightly fearful that **a Greek default will soon trigger similar debt defaults in Portugal and Ireland** since depositors in those countries might take fright following a Greek default. This has to be a matter of major concern since the combined sovereign debt of Greece, Portugal, and Ireland is around US $1 trillion.

7. Since July 2011, **the Italian and Spanish bond markets have been under substantial market pressure**. This has necessitated more than US $100 billion in ECB purchases of these countries' bonds in the secondary market. An intensification of contagion to Italy and Spain would pose an existential threat to the Euro in its present form given that the combined public debt of these two countries is currently around US$4 trillion.

8. While to a large degree European policymakers are right in portraying Italy and Spain as innocent bystanders to the Greek debt crisis, **Italy and Spain both have pronounced economic vulnerabilities**. Italy's public debt to GDP ratio is presently at an uncomfortably high 120 percent, while it suffers from both very sclerotic economic growth and a dysfunctional political system. For its part, Spain is presently saddled with a net external debt of around 100 percent of GDP, it still has a sizeable external current account deficit, and it is still in the process of adjusting to the bursting of a housing market bubble that was a multiple the size of that in the United States.

Italy's Public Debt is High

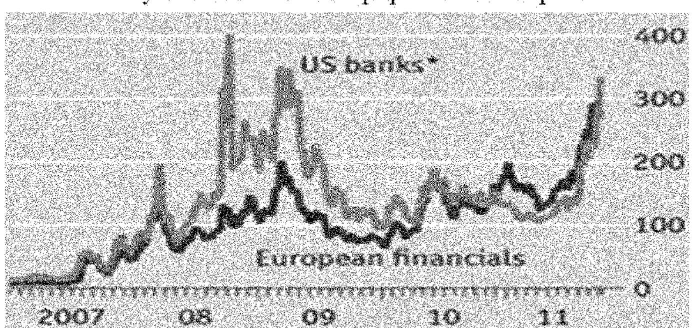
Public Debt and 10-Year Bond Spread vs. Germany



9. Sovereign debt defaults in the European periphery would have a major impact on the balance sheet position of the European banking system. The IMF estimates that **the European banks are presently undercapitalized** by around US $300 billion, while some private estimates consider that the banks are undercapitalized by more than US $400 billion. It is of concern to the European economic outlook that there are already signs of the European banks selling assets and constraining their lending to improve their capital ratios.

US and European Banks' CDS Spreads

Five-year credit default swap spreads in basis points



*US Banks represents the average of 6 large banks

Source: Markit; the Economist

Implications for the United States Economy

10. Considering that the European economy accounts for over 30 percent of global economic output, **a deepening of the European crisis could very well derail the US economic recovery**. In principle, a deepening in the European economic crisis could impact the US economy through three distinct channels:

    a. A renewed European economic recession would diminish US export prospects to an important market for US goods.

b. A weakening in the Euro against the dollar, which would very likely flow from a European banking crisis and from questions about the Euro's survival in its present form, would put United States companies at a marked disadvantage with respect to European companies in third markets.

c. In much the same way as the US Lehman crisis of 2008-2009 severely impacted the European economy through financial market dislocation, a European banking crisis would materially impact the US economy both through the financial market channel and through a generalized increase in global economic risk aversion.

11. Secretary of the Treasury Geithner has correctly asserted that the United States financial system has relatively limited direct exposure to the Greek, Irish, Portuguese, or Spanish economies. However, this assertion overlooks the fact that **the US financial system is hugely exposed to the European banking system**, which in turn is directly exposed to the European periphery. Among the indicators of this heavy exposure are the following:

a. According to the Fitch rating agency, short-term loans by US money market funds to the European banking system still total over US $1 trillion or more than 40 percent of their total overall assets.

b. According to the Bank for International Settlements, the US banks have exposure to the German and French economies in excess of US $1.2 trillion.

c. According to BIS estimates, US banks have written derivative contracts on the sovereign debt of the European periphery in excess of US $400 billion.

d. The recent Dexia bank failure in Belgium has revealed close interconnections between European and US banks.

What is to be done?

12. European policymakers are presently engaged in an effort to put forward **a comprehensive plan to address the crisis** ahead of the forthcoming G-20 Summit on November 3-4, 2011. After many months of denial, they now recognize the severity of Greece's solvency problem and the serious risks that a disorderly Greek default would pose to the European economy. The plan that the Europeans intend to finalize by Wednesday, October 26 is to comprise the following three pillars:

    a. A revision to the IMF-EU program aimed at putting Greece's public finances on a sustainable path. The proposed revision would include the requirement that Greece's bank creditors accept a very much larger write down on their Greek loans than the 21 percent haircut that was earlier agreed upon in July 2011.

    b. The erection of a credible firewall around Italy and Spain by substantially leveraging up the European Financial Stability Facility (EFSF). Many market analysts believe that the Europeans will need to have a financial bazooka of at least US $2.75 trillion if they are to prevent the Greek crisis from engulfing Italy and Spain.

    c. The recapitalization of the European banking system with a view to creating an adequate cushion for the European banks to absorb the losses from a Greek default.

13. Over the past eighteen months, the European policymakers' response to the Eurozone debt crisis has been one of "too little, too late" to get ahead of the crisis. There is the real risk that the efforts presently underway will also fall short of what is needed to finally defuse this crisis. Among the areas of concern are the following:

    a. It remains to be seen whether Greece's bank creditors will voluntarily accept the large debt write downs that are now being proposed by European policymakers.

    b. It is not clear whether European policymakers will succeed in leveraging up the EFSF to the required US $2.75 trillion. Nor is it clear whether they will be able to do so in a manner that allows those resources to be readily used to effectively prop up the Italian and Spanish bond markets without excessive interference by the German Bundestag or without IMF conditionality.

c. There is the danger that leaving it up to the banks to improve their capital over the next 6 to 9 months will result in increased bank asset sales and credit restrictions. This could result in an intensification of Europe's incipient credit crunch that would increase the odds that the European economy experiences a meaningful double dip recession.

The US Role in resolving the Crisis

14. To date, the **US has supported the Europeans through the IMF, in which the US has a 17 percent stake, and the through the Federal Reserve**. Over the past eighteen months, in each of the massive IMF-EU bailout programs for Greece, Ireland, and Portugal, the IMF has provided around one third of the total funding. Meanwhile, the US Federal Reserve has made amply available to the European Central Bank large amounts of US dollar funding through enhanced US dollar swap lines.

15. A number of considerations would suggest that beyond exhorting European policymakers to be more decisive of their handling of the crisis **there is little more that the United States should be doing** to support the Europeans in resolving their crisis. Among these considerations are the following:

   a. The essence of the problem confronting Greece, Ireland, and Portugal is one of solvency rather than one of liquidity. Providing additional funding to these countries to essentially help them kick the can down the road does little to resolve these countries' solvency problems.

   b. Providing funding to help prop up the Italian and Spanish sovereign bond markets would be putting US taxpayers' money at risk given the troubled economic fundamentals of these two countries.

c. In light of the United States own budgetary problems, it is not clear why additional US taxpayers' money should be used to either bailout countries in the European periphery or to support European banks. It would seem that much in the same way as the US did not seek European support to help it resolve the 2009 US banking sector crisis, the Europeans should now use their own budget resources to resolve their own sovereign debt and banking crises.

Mr. BURTON. Thank you very much.
Mr. Stokes.

STATEMENT OF MR. BRUCE STOKES, SENIOR TRANSATLANTIC FELLOW, GERMAN MARSHALL FUND OF THE UNITED STATES

Mr. STOKES. Chairman Burton and Ranking Member Meeks and distinguished members of the committee, it is a distinct honor and a privilege to appear before you today. My remarks today, of course, represent my own opinions and not the views of the German Marshall Fund of the United States.

I would like to focus my remarks, if I could, not on how we got into this mess and not even on what the U.S. could do directly to help Europe with its problems, but how we can both work together to both help grow the Transatlantic economy out of the dilemma we now face in a way that is of mutual self-interest to both Europe and the United States.

I think it is particularly timely that you have called this session today, Mr. Chairman, after the European summit about the euro crisis. It is far too early, I think we all agree, to have a definitive decision about what has been decided last night and whether Europe can stem its bleeding and start to heal its own wounds.

But experience has taught us that at every juncture of this unfolding saga, the European actions have been a day late and a euro short, so I think we have every reason to be skeptical. And we can only hope for the best.

As you mentioned, Mr. Chairman, America has a huge stake in Europe finally resolving its crisis. I don't need to belabor you with the numbers. But clearly, we have intertwined economies. And as Ben Franklin once said, we may all hang together, or we are going to hang separately here. So we have to work together on this crisis, because a European lost decade would do profound damage to the U.S. economy.

To date, much of the discussion in Washington about the euro crisis has been about how to defend ourselves against contagion from Europe's sovereign debt problems, but to turn the old American football maxim on its head, in this case, I suggest you use it: The best defense would be a good offense.

The great recession has demonstrated once again that the economic fates of Europe and America are inextricably linked, stubbornly high unemployment on both sides of the Atlantic and flagging consumer and investor confidence has shaken the Transatlantic marketplace more than any other event since the Great Depression. The need for closer economic cooperation to overcome these problems, I submit to you, has never been greater.

Americans and Europeans are both telling their elected leaders that they need jobs, and they need growth. Our mutual debt overhang and the near exhaustion of monetary policy means both Washington and Brussels must look elsewhere to address their citizens' needs. The most promising and immediate way to do this is by launching a Transatlantic jobs and growth initiative, anchored in an effort to remove all taxes on and barriers to Transatlantic trade and investment. Never has such an initiative been more timely, nor more necessary.

The benefits of such an effort would be significant. A study last year by the European Center for International Political Economy in Brussels estimated that the elimination of all EU tariffs on U.S. goods would boost American exports to Europe by $53 billion. In 2009, a European Commission study found that eliminating non-tariff Transatlantic trade barriers would add more than $50 billion to the U.S. economy.

These estimates are a reminder that Transatlantic barriers to trade and investment may be small compared to the barriers we face in other parts of the world, such as China, but their removal will pay significant dividends. To put these prospective benefits in context, the payoff from eliminating Transatlantic trade barriers exceeds the likely economic benefit to the United States from completion of the Doha round. It also exceeds the potential economic benefit to the United States of TPP, the Trans-Pacific Partnership, which we are now negotiating.

How can we possibly leave these benefits sitting on the table while we pursue less substantial, more elusive payoffs elsewhere? Interest in a Transatlantic jobs and growth initiative is growing. The U.S. Chamber of Commerce has called for the elimination of all barriers to goods traded between Europe and the United States as a first step toward a full fledged Transatlantic free trade agreement. The U.S. Coalition of Services Industries has suggested pursuit of a Transatlantic free trade area in services. The Transatlantic Business Dialogue has long advocated the establishment of a barrier free Transatlantic market. The Transatlantic Policy Network, made up of Members of Congress, the European Parliament and Transatlantic business leaders, has recently called for a growth and jobs initiative that would lead to the creation of a Transatlantic market by 2020.

And late in September your counterparts in the European Parliament called for a comprehensive Transatlantic growth and jobs initiative. I might add, the German Marshall Fund is also helping to facilitate a task force led by the Swedish trade minister and your former colleague, Representative Jim Kolbe of Arizona. Early next year, it will add its own recommendations to these calls for creating jobs and growth through greater Transatlantic trade and investment.

So how might we proceed? At the U.S.-EU Submit November 28th, President Obama and his European counterparts should instruct their teams to come up with a Transatlantic jobs and growth initiative. This initiative should be ready to be signed in mid-May 2012 at the G–8 submit in Chicago. The initiative should have multiple pillars. These could include but would not necessarily be limited to elimination of all tariffs, free trade in services and an investment agreement. Most important, these efforts should run in parallel but not be dependent upon each other. We can eliminate tariffs rapidly so we should do so. If it takes longer to hammer out an agreement on services, that should not hold us back from harvesting the benefits of eliminating taxes on goods.

Mr. Chairman, the current economic crisis presents a unique opportunity for political leadership. Americans and Europeans, both as consumers and investors, want jobs. They want growth. And I submit to you, above all, they want a reason to hope. What they lack is a sense of direction and purpose. A Transatlantic jobs and growth initiative is a way to turn the euro crisis into an economic opportunity for all Americans.

Thank you and I look forward to your questions and comments.

[The prepared statement of Mr. Stokes follows:]

A Transatlantic Jobs and Growth Initiative

Testimony before the House Committee on Foreign Affairs
Subcommittee on Europe and Eurasia
"The Eurozone Crisis: Destabilizing the Global Economy"
October 27, 2011

Testimony:

Bruce Stokes
Senior Transatlantic Fellow for Economics
German Marshall Fund of the United States
Washington, D.C.

Chairman Burton, Ranking Member Meeks and Distinguished Members of the Committee:

It is a distinct honor and a privilege to appear before you.

My remarks today represent my own opinions and are not the views of the German Marshall Fund of the United States.

It is particularly timely that we meet the day after another European summit about the euro crisis. It is far too early to know whether the measures announced yesterday will stem the bleeding and start to heal Europe's wounds. But experience has taught us that--at every junction in this unfolding saga--European actions have been a day late and a euro short. We have every reason to be skeptical. And we can only hope for the best.

America has a huge stake in Europe finally resolving its crisis. American banks have a trillion dollars in European exposure. Europe is America's largest trading partner. Europe generates more than half the earnings of the overseas affiliates of U.S. companies. And hundreds of thousands of Americans work for European firms. A European "Lost Decade" would do profound damage to the U.S. economy.

To date, much of the discussion in Washington about the euro crisis has been about how to defend ourselves against contagion from Europe's sovereign debt problems. But to turn the old football maxim on its head, in this case the best defense would be a good offense.

The Great Recession has demonstrated once again that the economic fates of Europe and America are inextricably linked. Stubbornly high unemployment on both sides of the Atlantic and flagging consumer and investor confidence have shaken the transatlantic marketplace more than any other event since the Great Depression. The need for closer economic cooperation to overcome these problems has never been greater.

Americans and Europeans are both telling their elected leaders that they need jobs and growth. Our mutual debt overhang and the near exhaustion of monetary policy means both Washington and Brussels must look elsewhere to address their citizens' needs. The most promising and immediate way to do this is by launching a "Transatlantic Jobs and Growth Initiative" anchored in an effort to remove all taxes on and barriers to transatlantic trade and investment. Never has such an initiative been more timely, nor more necessary.

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To put these prospective benefits in context: the payoff from eliminating transatlantic trade barriers exceeds the likely economic benefit to the United States from completion of the Doha Round. It also exceeds the potential economic benefit to the United States of TPP--the Trans-Pacific Partnership--now under negotiation.

How can we possibly leave these benefits sitting on the table while we pursue less substantial, more elusive payoffs elsewhere?

Interest in a Transatlantic Jobs and Growth Initiative is mounting. The U.S. Chamber of Commerce has called for the elimination of all barriers to goods traded between Europe and the United States--as a first step toward a full free trade agreement. The U.S. Coalition of Services Industries has suggested pursuit of a transatlantic free trade area in services. The Transatlantic Business Dialogue advocates the establishment of a Barrier-Free Transatlantic Market. The Transatlantic Policy Network, made up of members of Congress, the European Parliament and transatlantic business leaders, has recently called for a growth and jobs initiative that would lead to the creation of a Transatlantic Market by 2020. And, in late September, your counterparts in the European Parliament called for a "comprehensive Transatlantic Growth and Jobs Initiative".

I might add, the German Marshall Fund is helping facilitate a task force led by the Swedish trade minister and your former colleague Rep. Jim Kolbe that early next year will add its own recommendations to these calls for creating jobs and growth through greater transatlantic trade and investment.

So, how to proceed:

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- This Initiative should be ready to be signed in mid-May 2012, at the G8 summit in Chicago.
- The Initiative should have multiple pillars: these should include, but would not necessarily be limited to, elimination of all tariffs, free trade in services and an investment agreement.
- Most important, these efforts should run in parallel, but not be dependent on each other. We can eliminate tariffs rapidly. We should do so. If it takes longer to hammer out an agreement on services, that should not hold us back from harvesting the benefits of eliminating taxes on goods.

Mr. Chairman, the current economic crisis presents a unique opportunity for political leadership. Americans and Europeans want jobs, they want growth and, above all, they want a reason to hope. What they lack is a sense of direction and purpose from their leaders.

A Transatlantic Jobs and Growth Initiative is a way to turn the euro crisis into an economic opportunity for all Americans.

Thank you. I look forward to your questions and comments.

Mr. BURTON. Do you have a proposal? I would like to have that to be able to disseminate that to my colleagues.

Mr. STOKES. I would be happy to do that.

Mr. BURTON. Because that might be food for thought.

When we draft some legislation, that might be helpful.

Mr. STOKES. Terrific.

Mr. BURTON. Obviously, it is not going to happen right away; it is going to take some time.

The first thing I wanted to ask you about is, and it is very interesting, after listening to you, how the stock markets jumped up 300 points or so today because of the announcement yesterday. Talk about building hopes on dreams. I mean I think it is great, but from what you all said, it is pretty obvious that there is a long way for us to go or for the world to go.

According to the information that we got from the CRS, Congressional Research Service, we have about $2.08 trillion in direct exposure and potential exposure to Europe from the countries of Portugal, Ireland, Italy, Greece, Spain, Germany and France. And I was interviewed on television a while ago, and they said, well, why are you including Germany and France, because they don't have any problem? But Germany and France, according to CRS, have a great deal of exposure to these other countries, Portugal, Ireland, Italy, Greece and Spain. And as a result, if they go belly up, then it is going to have an impact on them as well.

So I guess the first question I would like to ask is, what do we do? I just got back from Greece, and you just said, Mr. Stokes, that we ought to have this Transatlantic initiative and that there ought to be the ability to create jobs so that there will be more purchasing. I don't know how that is going to work.

I had people I was with over there from the government that were having their salaries cut by 40 percent, their retirement cut by 40 percent, and that is just the first tranche. I mean, according to what happened yesterday, there are going to be additional cuts in economies in Greece and these other countries, and I don't know how they are going to be able to expand their economy when these cuts take place. I mean, how can a person or a country that has a 40-percent cut in the incomes of people or in their retirement, how can they afford to buy products or even produce products and expend them and sell them around the rest of the world? The solution is kind of a Gordian Knot.

And what we wanted to find out from you today is, first of all, what is our exposure? And second, what can we do, without exposing ourselves further, to stimulate a solution to the problem? And I will ask any of you to answer that question. It is a tough one. Go ahead.

Mr. LACHMAN. First, let me take your question on exposure. That is the right way of looking at it, is if the United States has loaned money to French and German banks that are themselves exposed to Greece, Portugal and Ireland, we are exposed to Greece, Portugal and Ireland. So our exposure to the German and French banking system is of relevance, even though we don't—even though we haven't made loans to Greece and Portugal and Ireland. By lending to the banks in France and Germany, we have got that exposure.

So the crisis in the periphery can lead to a major European banking crisis. Officials at the European Central Bank worry about if Greece defaults, then we are going to get a whole wave of defaults and the European banking system is going to have its Lehman moments, and that would really impact us. I think on your second question, that goes to the heart of the matter in terms of Greece.

We have got to realize that over the past 2 years, Greece's GDP has already fallen by 12 percent. Their unemployment is already at 16 percent. The main driver in that process has been a savage approach to the budget, massive cuts all around, raising revenues to the tune of something like 5 full percentage points of GDP in a single year at a time that the country is already in recession, that is driving it further into recession. What Greece has now got to look forward to under the IMF EU program is more fiscal austerity in even worse circumstances. So it shouldn't be any great surprise if the Greek economy collapses any further in 2012.

The way out of the solution from Greece's point of view is problematic from the rest of Europe's point of view, is that Greece has to write down its debt in a major way. A start was made last night toward that. But that is not nearly sufficient if Greece is, after all of these cuts in this restructuring, Greece's debt is still going to be 120 percent of GDP. That is far too high for—after a restructuring. But Greece is probably going to have to leave the euro at some stage, that it has a very much depreciated exchange rate; that would boost both its export sector and its tourist sector, would allow Greece to become a more viable economy. I am not saying that that is an easy path for Greece to follow, but what I am saying is that for Greece not to follow that path is a sure recipe for a deep depression, not for 1 year, not for 2 years, but probably for the whole decade.

Mr. BURTON. Go ahead.

Mr. STOKES. Just a couple of points, Mr. Chairman.

One, I think to echo Desmond's point that he made in his testimony, it is not clear that we understand our total exposure. If you talk to the Fed or you talk to the IMF, they aren't sure who holds a lot of this insurance that banks have taken out on their debt.

Now, it may well be they know and they just aren't about to share it because it would move markets. But it does seem to me that certainly in closed session, that is something that Congress should press them on, because at least people like yourself and the committee need to know what our real exposure is, and if they don't know, to find out what needs to be done to find out so that we don't have an AIG experience.

Mr. BURTON. Pardon me for interrupting, but we just met with some of the officials from the Treasury Department, and we were not able to at that particular moment get any additional information other than what we already had. And they kind of downplayed the situation, saying that over the next several months, when Europe and the EU work out these kinks and come up with a final plan, that the solution or the situation could get a whole lot better.

They didn't allay a lot of my fears, and that is why I wanted to have you gentlemen here today, so we could get the independent view from outside our Government.

Mr. STOKES. Two other points. One to your point about, why would we assume that there could be demand in places like Greece in the immediate future. And I think that is absolutely right; there is not going to be. I was trying to lay out a strategy, it seems to me, if we are trying to somehow at some point in the future help restore growth in Europe. But I think in the immediate term, we have to assume that Europe is in for a prolonged period of stagnation, if not recession.

And that leads me to my third point, which seems to me a valid point for this committee to be focusing on, is what are the foreign policy implications to the United States of a Europe that is stagnating or actually having a lost decade in terms of our ability to work with Europe on a range of issues from Russia to other parts of its periphery, to the global public goods issues of defense and foreign aid and things of that nature? How do the Chinese take advantage of this? I think all of those are legitimate concerns that we all need to be more worried about.

Mr. BURTON. Well, what I would really appreciate, and you gentlemen are the experts, and you have the expertise and the background to come up with potential solutions, and those of us in the Congress are neophytes when you start talking about world economics, we just obviously don't know the answers. And when you talk to the people in the government, as you said, it is kind of a veiled answer with a lot of hyperbole without any real juice. So what I would really appreciate, and I really mean this, I would like to have you and your think tanks to come up with, as well as the Heritage Foundation, to come up with some potential solutions, even if it is not of an immediate nature, something that might take 5, 10 years. Because from what I see in my small amount of wisdom, this thing is not going to go away any time soon, and it is going to have an impact on us.

Now, the other question I wanted to ask is, the President has been calling Sarkozy and the German leader every day or two talking to them about this. And Sarkozy said that he is planning to go to China to talk to them about these bonds and the potential purchasing of these bonds. You are shaking your head there, so I would like to hear your response after I ask the question. And they are also talking about Japan purchasing some of these bonds.

What puzzles me is if financial institutions and individuals are taking a 50-percent haircut on Greece and the problem is not served, you still have 120 percent of GDP, what is the incentive for anybody to buy the bonds, knowing the fiscal problems that exist, not only in Greece but these other countries? And if these countries do buy the bonds, what is the incentive? Is it going to be a high rate of interest, which is going to be a very difficult thing to deal with? And is the United States in some way going to be involved in purchasing some more of this problem? And that is really concerning me, because as I looked at these figures from CRS, and I know I am covering a lot of ground, so please bear with me, because this is not an easy issue, and you see that we have got a total by, in CRs' opinion, of exposure of over $2 trillion, how in the world could we involve ourselves by buying more of that debt? And can the Fed and the Treasury Department circumvent Congress as it has in the past with the first two tranches to buy these bonds?

Is there a way that they can do that and circumvent Congress? I know I am covering a lot of ground here.

Mr. KIRKEGAARD. Well, starting with your first question regarding the Chinese and potential Asian involvement in these type of bonds, I will say that I think these type of headlines should basically be discarded in my opinion.

Mr. BURTON. Well, then where is the money going to come from, because they are talking about taking this up to $1 trillion?

Mr. KIRKEGAARD. Well, I would say that every talk coming out of Europe in the last day or so, since last night, about turning the EFSF into a bazooka, whether you do it with leverage or you do it with Chinese or other bricks or oil investments or whatever you choose to do, is a side show. It is not essentially in my opinion going to be credible. Because the money, in my opinion, is not going to be there. Because China has a long history of essentially meeting with various European leaders and promising maybe a lot—there are a lot of headlines in the press—but they basically never commit. The only major assets that China buys, euro-denominated assets that China buys, are essentially safe German Government bonds as well as a relatively small amount of these EFSF bonds. The idea that China is going to pour hundreds of billions of dollars into this new investment vehicle I regard, frankly, as a fantasy.

Mr. BURTON. How about Japan?

Mr. KIRKEGAARD. Again, I think the Japanese might be willing to do it. But again, it is not to the tune that is required. If the idea here that we want to turn this into a bazooka, something that can intimidate and have the respect of markets, that is where the number of the 1.4 trillion euros comes from. It is not—the money isn't going to be there. And I think the biggest illusion, and this is essentially where I come back to the side show that I talked about, is that the Europeans are trying to basically create the illusion that the European Central Bank is going to hand over to this new leveraged EFSF, this new bazooka, if you like, these new entities, such that the European Central Bank no longer has to be directly involved. But the reality is very different. The reality is that the European Central Bank is going to remain very directly involved as the ultimate financial backstop for the euro area as a whole, and essentially, all these both of these two new options, the leveraged bond insurance scheme that they have talked about, as well as this new special investment vehicle that is open for interested private and public investors, as I said, I don't think we should expect very much of that. But it doesn't actually matter very much because the ECB is going to remain involved. The one thing that we were sure about last night was that there will be no handover.

Mr. BURTON. How can the European Central Bank come up with the funds that are necessary? I mean, I am——

Mr. KIRKEGAARD. Well, the European Central Bank is a central bank. They can create money. That is the ultimate——

Mr. BURTON. How do they create money? They don't have the ability to print money like we do in our Treasury, do they?

Mr. KIRKEGAARD. Yes, they do. They call it a security markets program in which they can basically——

Mr. BURTON. So they can inflate the money supply?

Mr. KIRKEGAARD. If they wanted to.

Mr. BURTON. Okay. I am sorry, go ahead.

Mr. LACHMAN. Well, I would agree with Mr. Kirkegaard that the Europeans don't have a bazooka in place, and that is cause for great concern about Italy and Spain over the longer run, whether Italy and Spain aren't going to be tested by the markets in the way in which they were in July, which would really be a big headache for Europe. But the issue on the ECB is while theoretically the ECB could behave like the Federal Reserve and print money and go out and buy bonds and engage in quantive easing, the major shareholder of the ECB, namely Germany, thinks that that is the road toward deflation, debasing the currency, all sorts of problems, that we have already had two governors of the ECB of German origin, Axel Weber and Juergen Stark, leave the ECB precisely for those kind of reasons. The president of the Bundesbank doesn't think it is a good idea. The President of Germany thinks that the ECB is on the wrong track. So the notion that the ECB is going to go up there and print the money, I just don't see that the German are going to allow it. And that was part of the deal yesterday with Mrs. Merkel that the Bundestag indicated that they were dead set against converting the EFSF into a bank that would then be able to borrow from the ECB. So there are serious political constraints on the ECB from the German——

Mr. BURTON. I will go back to you, but they have had huge inflation problems in past history in Germany.

Mr. LACHMAN. Absolutely.

Mr. BURTON. And assuming that the European Central Bank does inflate the currency supply, it would seem to me that the big kahunas over there, i.e. Germany, would say, "Hey, no."

Go ahead.

Mr. KIRKEGAARD. Maybe I should just clarify. When I say that the ECB is going to be the final backstop, I am not saying that—I am certainly not suggesting that I believe the European Central Bank is going to go out and do what we understand as quantitative easing here in the United States.

What I suggest is that the ECB will do what is necessary to calm a financial panic, which means that they will effectively put a floor under the—or they will cap what, for instance, Italian yields can go up to. Currently Italian yields are somewhere between 5.5 and 6. When they reached 6.2 or 6.3 in early August, the ECB intervened, bringing them back down again.

Mr. BURTON. How long can they do that?

Mr. KIRKEGAARD. Well, they can essentially continue to do that for as long as they want. They would prefer not to do that. But what I am suggesting is that they can do that to the extent they won't be able to drive it back down to say a spread of, or a yield of say 300 or 400 basis points, so that the economic pressure will remain very heavily on the Italy and especially the Italian Government, but from the perspective of the ECB, this is actually leverage. This is something that the ECB arguably, in my opinion, believes is necessary to force the Italian Government under Silvio Berlusconi to do the kind of structural reforms that the ECB has been calling for the Italian Government to do for many, many years. They basically are effectively painting Mr. Berlusconi into a corner.

And the other thing is that when they do these emergency interventions, and I think we should try to keep things in perspective, because they have done this already, they have expanded their balance sheet with about 1—or just 1.6 or maybe about 2 percent of euro area GDP. The Federal Reserve and the Bank of England have expanded their respective balance sheets, you know, 13 or 14 percent of GDP. So the relative magnitudes of ECB interventions are quite small, much, much smaller, and they are also sterilized. So the expansion area effect on the monetary supply isn't there, or essentially not there at least. So I don't think that there is any immediate inflationary risk involved with this. And the really key issue here is the ECB is the only institution that has that capacity, and they use this power strategically to put pressure on elected politicians in Europe to do the kinds of reforms that they believe are necessary for the European——

Mr. BURTON. I don't know, that just sounds like a stretch to me that they are going to be able to control all that. But then you guys are the experts, and I am not.

Now, let me ask the big question, how do we protect America, and is there anything we can do to protect America? Because we have this potential 2 trillion, and it is probably a lot more than that—because of what you said awhile ago, I think it was you, Desmond, where you said that 45 percent of our money market funds are invested in Europe. My gosh, that is trillions and trillions of dollars. So if they go south, how do we protect ourselves? I mean, the financial institutions, what is the answer?

Mr. LACHMAN. Well, I think that the answer is at least to try to be transparent about it to recognize what the problem is, to come up with solutions that would be of a prudential side. I think the same thing would be true of economic planning in general. If we really do have the risk that Europe is going to be into recession and that it is going to impact our economy, it doesn't make sense for us to be basing our budget projections, for instance, on very rosy scenarios that the Congressional Budget Office is coming up with. This really would underline how much more serious our long-run budget problems are. It would also inform how we would deal with foreign stimulus in the short run.

All of these kind of issues I think really have to be looked at rather carefully that one really has to take into account that Europe accounts for a third of the global economy, that if Europe runs into trouble it is almost certain to impact us in a very hard way, and we should be basing our policy on that basis. I don't think that we can do much to stop this event in Europe occurring, that that is way beyond what we can do or what we should do, but we should at least base our policies on the likelihood that we are going to be hit by European shock in 2012.

Mr. BURTON. You think it is going to be in 2012.

Mr. LACHMAN. I should just mention that I spent a career at the International Monetary Fund looking at fixed exchange rate systems. And I think I know when an exchange rate system is approaching its end game; that this is really occurring in Europe.

If you look at what has occurred over the last 18 months, this is accelerating that what we are getting both in the periphery, we are getting what we call austerity fatigue that the people—there is so much more budget adjustment that they can do. Yet in the core countries, the richer countries of the north—and I am not just thinking about Germany. I am thinking about the Netherlands. I am thinking about Finland. I am thinking about Austria. I am thinking about Slovakia. They are suffering from bailout fatigue. Their taxpayers feel that they have been lied to by the politicians, that in May 2010, this was only going to be a one-shot deal. Then we get Ireland in December. Then we Portugal in April. Then we get another round—this is endless.

The taxpayers, 70 percent of the German population is against bailouts. You know, that this is what is occurring, that as this crisis continues, what you are going to get is you are going to get more austerity fatigue in the periphery; you are going to get more bailout fatigue in the core. And that doesn't, in my view, make for a happy outcome.

Mr. STOKES. If I might just amplify what Desmond said in terms of our own condition. It seems to me that at the end of the day, we will do what we need to do for the U.S. economy, based largely on our domestic needs. But as we move forward, I think the prospect of stagnation in Europe has to inform more of our discussion than it has in the past.

And this is going to run counter to some of the things that we seem to now hold dear to our heart about trying to cut the budget. It may in fact mitigate against cuts in our budget initially, just because we may need the stimulus.

It does, it seems to me, impact on what we do about promoting exports. I think we are going to have to do more to try to promote exports because if Europe is stagnant, the dollar may rebound, and that would hurt our exports.

Mr. BURTON. You think the euro is going to devalue?

Mr. STOKES. I say that, but there is no explanation as to why the euro is as strong as it is now. But that may well be because money is flowing back into Europe from European banks overseas to try to fortify their positions. That won't last forever.

And I think we also, to answer your question, how do we unwind this? We have to do it very carefully because if we pull our money out of Europe in a very defensive and dramatic way, we could really send things spiralling downward.

Mr. BURTON. I am going to ask you a pretty tough question here. You may not have the answer.

I am on the Government Reform and Oversight Committee as well, and we had Secretary Paulson before the committee and Geithner. And I believe they misled us. But nevertheless, I think I could even prove it. But I don't think I will go into the details.

But the thing is, there was a financial institution, and it eludes me which one it was, and Paulson allegedly talked to the chairman of the board and told them they had to do certain things to purchase another entity and if they didn't do it, that the CEO was going to lose his job. And I think the CEO ultimately did lose his job. It was later on.

I just wonder, do you think it is possible that the administration through the various agencies of government, Treasury and so forth, could literally force financial institutions to buy these euro bonds to try to help void up the situation over there?

Mr. LACHMAN. If they did, I think that that would be terribly misguided.

Mr. BURTON. I am sure of that.

Mr. LACHMAN. Why expose them to further losses? We have got a sufficient exposure to Europe without our buying additional bonds.

Mr. BURTON. So you would not see that under any circumstances?

Mr. LACHMAN. I would think that if they coerced—it is another thing if markets are operating and they decide——

Mr. BURTON. No, I am not talking about markets.

Mr. LACHMAN. I think that a coercive purchase would be rather foolish because part of the problem is that we are dealing with solvency problems and that what has been going on for a long time is we are kicking the can forward just by financing. So to engage in this kind of operation, one is just continuing the process of kicking the can further down the road, only to have a bigger crisis down the end.

Mr. BURTON. Let me ask you one more time, each one of your think tanks, if you could—the chairman of the Ways and Means Committee is a friend of mine and Appropriations. I would be happy if you could give us some suggestions on things we can do to try to protect the American economy and our currency, either legislatively or through talking to the various agencies of government. If you could get that to me, I will make sure it gets to the proper people.

Our committee oversees Europe and Eurasia from a number of standpoints, but fiscally, we are not the ones to make these suggestions or changes. But I will get it to them.

Now, let me ask you one last question, why is the stock market up 300-plus points today, because everything you have told me makes it sound to me like we are still building this castle on a house of cards? And I just don't understand it, because there is no real solution. They haven't even come up with a plan.

Mr. STOKES. As a friend of mine on Wall Street once said to me, Bruce, you have to understand these trades are made by over-caffeinated 24-year-olds, who basically trade on the headlines. They don't even read the details. And not only do they trade on the headlines, but they trade on how they think the other 24-year-olds are going to trade on the headlines. In other words, it is about how other people will react, not even whether they think the headline is right.

So I think we won't know whether this is sustainable for another week or so, when people begin to actually delve into the details.

Mr. KIRKEGAARD. I would just add to that, it certainly shows the European leaders were very good at playing down expectations in the market for the actual deliverable, so that when they came up with what they came up with last night, which I was, I will say, I was personally marginally surprised on the upside; clearly, the market was surprised substantially on the upside. So it is clever expectation management to a certain extent in my opinion as well.

But I agree with what Bruce said; we won't ultimately know whether last night's deal was really worth anything until we see the fine detail or until we know what, for instance, Silvio

Berlusconi and others are actually going to do what they said they were going to do.

Mr. BURTON. Well, I just met with the Treasury Department people before this. They didn't want to testify in an open session. But Berlusconi sent a 7-page letter, I guess, explaining how and why and what he would do to comply with the EU and their demands. And it remains to be seen.

The other thing that they said, from the Treasury, was that—I asked well, who is going to buy these bonds? And they both mentioned both China and Japan. And you seem to have a different opinion about that. And if that is not the case, I still wonder where in the world they are going to get the money. And you keep going back to the European bank—Central Bank. Anyhow, go ahead.

Mr. LACHMAN. I think that you could get outside money by the way in which they are doing it, because what they are doing is they are taking $250 billion euros, and they are using that to provide insurance that they will take the first loss. So what they are doing is they are offering to take the first 20 percent of any loss on bonds purchased.

So, for instance, if you buy an Italian bond, you know that if the Italian bond goes from 100 to 80, you don't lose; you pick up the 5-percent interest rate. So that is a reasonable deal in the case of Italy, where it is unlikely that Italy is going to devalue by more than 20 percent. So you could get people to buy on that basis.

What you are doing, though, is you are putting the German and the French taxpayer at huge risk, that this is like a structured product where the German and the French have got the equity tranche of a CEO, which isn't a good idea for them to have. But if you are the Chinese, you can feel comfortable having the mezzanine or the AAA rated part of that structure.

Mr. STOKES. And I think, to amplify Desmond's point, I mean, what Desmond was saying, in essence, the money is going to come from the Germans. And whether the Germans like that or not, and there is no political support for that, the Germans can afford to do this. They have to make a calculation about whether it is in their self-interest to do it or not. And their leadership has certainly not convinced their public that it is in their self-interest. And I think that we have to continue to pressure them to say look, there is money in Europe to deal with a lot of this problem and you haven't mobilized all of your own resources. And I think we need to continue to press them on that.

Mr. BURTON. I want to thank you very, very much and your testimony has been very, very enlightening. And I will make sure—and I would like to have your opening statements and all of the details of it, and I am going to make sure that our colleagues on the financial institutions committees get a copy of that and make sure they read it.

With that, thank you very much. We will stand adjourned.

[Whereupon, at 3:15 p.m., the subcommittee was adjourned.]

APPENDIX

Material Submitted for the Hearing Record

SUBCOMMITTEE HEARING NOTICE
COMMITTEE ON FOREIGN AFFAIRS

U.S. HOUSE OF REPRESENTATIVES
WASHINGTON, D.C. 20515-0128

Subcommittee on Europe and Eurasia
Dan Burton (R-IN), Chairman

October 26, 2011

You are respectfully requested to attend an OPEN hearing of the Committee on Foreign Affairs' Subcommittee on Europe and Eurasia, to be held in **Room 2172 Rayburn House Office Building (and available live, via the WEBCAST link on the Committee website at http://www.hcfa.house.gov):**

DATE: Thursday, October 27, 2011

TIME: 2:00 p.m.

SUBJECT: The Eurozone Crisis: Destabilizing the Global Economy

WITNESSES: Panel I

Mr. Jacob Funk Kirkegaard
Research Fellow
The Peterson Institute for International Economics

Desmond Lachman, Ph.D.
Resident Fellow
American Enterprise Institute

Mr. Bruce Stokes
Senior Transatlantic Fellow
German Marshall Fund of the United States

By Direction of the Chairman

The Committee on Foreign Affairs seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202/225-5021 at least four business days in advance of the event, whenever practicable. Questions with regard to special accommodations in general (including availability of Committee materials in alternative formats and assistive listening devices) may be directed to the Committee.

COMMITTEE ON FOREIGN AFFAIRS

MINUTES OF SUBCOMMITTEE ON *Europe and Eurasia* HEARING

Day *Thursday* Date *October 27th* Room *2172*

Starting Time *2:00* Ending Time *3:15*

Recesses ☐ (__ to __) (__ to __) (__ to __) (__ to __) (__ to __) (__ to __)

Presiding Member(s)

Dan Burton

Check all of the following that apply:

Open Session ☑
Executive (closed) Session ☐
Televised ☑

Electronically Recorded (taped) ☑
Stenographic Record ☑

TITLE OF HEARING:

The Eurozone Crisis: Destabilizing the Global Economy

SUBCOMMITTEE MEMBERS PRESENT:

Dan Burton, Gregory Meeks

NON-SUBCOMMITTEE MEMBERS PRESENT: *(Mark with an * if they are not members of full committee.)*

None

HEARING WITNESSES: Same as meeting notice attached? Yes ☑ **No** ☐
(If "no", please list below and include title, agency, department, or organization.)

STATEMENTS FOR THE RECORD: *(List any statements submitted for the record.)*

Dan Burton, Prepared Statement; Jacon Funk Kirkegaard, Prepared Statement; Desmond Lachman, Prepared Statement; Bruce Stokes, Prepared Statement; Congressional Research Service Memorandum "The Eurozone Debt Crisis."

TIME SCHEDULED TO RECONVENE ______
or
TIME ADJOURNED *3:15*

Subcommittee ~~Staff Director~~ Professional Staff Member

Congressional Research Service

MEMORANDUM October 25, 2011

To: House Committee on Foreign Affairs, Subcommittee on Europe and Eurasia
Attention: Jesper Pedersen

From: Paul Belkin, Analyst in European Affairs (x7-0220)
Derek Mix, Analyst in European Affairs (x7-9116)
Rebecca M. Nelson, Analyst in International Trade and Finance (x7-6819)

Subject: **The Eurozone Debt Crisis**

This memorandum responds to your request for an overview of the Eurozone debt crisis and U.S. involvement in the crisis, in preparation for the upcoming subcommittee hearing. Please contact us if you have questions or would like additional information.

Overview

Over the past two years, the Eurozone has been grappling with a sovereign debt crisis that threatens financial stability in Europe and beyond. The crisis has posed the biggest threat to the euro since it was introduced as a common European currency a decade ago.[1] Three Eurozone countries—Greece, Ireland, and Portugal—have had to borrow money from other Eurozone countries and the International Monetary Fund (IMF) in order to avoid defaulting on their debt. There are serious on-going concerns about potential contagion of the crisis to much larger Eurozone economies, namely Italy and Spain; and a threat of a major banking crisis in Europe should Eurozone governments default on their debt. The effects of the crisis are also starting to slow growth in European economies, including Germany and France.

The debt crisis is an economic and financial crisis, but it is also a political crisis that has forced European leaders to confront long-standing disagreements over the nature and future of the 27-member European Union (EU). The euro sits at the heart of European integration; it has great political and symbolic importance to those who believe in the vision of an "ever closer Union" of European states. As a result, many European policymakers hold a deep commitment to defending and preserving the Eurozone. For these leaders, the prospect of an unraveling Eurozone is an unthinkable catastrophe for the European Union. At the same time, the crisis has severely tested the political solidarity of the EU member states and strained the capacity of the EU's leadership and institutional structures to devise a lasting solution.

[1] The euro has been adopted as the common currency of 17 countries (Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, Netherlands, Portugal, Slovakia, Spain, and Slovenia) in the 27-member European Union (EU).

The crisis is also of considerable importance for the United States. The U.S. and EU share the largest and most deeply integrated bilateral trade and investment relationship in the world. Owing to their extensive economic linkages, many analysts assert that the two sides are crucially important for each other's prosperity. As U.S. Treasury Secretary Tim Geithner testified to the Senate Banking Committee in early October 2011, "Europe is so large and so closely integrated with the U.S. and the world economies that a severe crisis in Europe could cause significant damage to growth here and around the world."[2]

Since the early stages of the crisis, the Obama Administration has repeatedly called for a swift and robust response from Eurozone leaders. As the crisis entered another critical juncture in the summer and fall of 2011, President Obama and U.S. officials have become increasingly vocal in their calls for European leaders to address a situation that the President says is "a source of grave concern."[3] Secretary Geithner attended a meeting of Eurozone finance ministers in September 2011 to urge stronger policy responses, and President Obama has spoken with German Chancellor Angela Merkel and other European leaders with increasing frequency about the crisis.[4] European reactions to the U.S. appeals have been mixed; some Europeans have pushed back against perceived U.S. criticism while pointing out the United States' own economic problems. In any case, while the United States wields an influential voice on the issue, it ultimately has limited ability to affect policy decisions made by and among the EU member countries and institutions.

Causes of the Crisis

The Eurozone debt crisis began in early 2010 when international financial markets were shaken by concerns that the fiscal positions and debt levels in a number of Eurozone countries were unsustainable. Many analysts agree that the crisis was caused in part by a set of common challenges facing some Eurozone countries. For example, some point to an inflow of capital over last decade into countries such as Greece, Ireland, Italy, Portugal and Spain (the GIIPS), which enjoyed greater access to cheap credit after adopting the euro. In some of these countries, the influx of borrowed money was not sufficiently used for productive investments in the economy that could generate the resources with which to repay the debt. Meanwhile, the global financial crisis of 2008-2009 and ensuing recession strained public finances, with increased government spending on social programs such as unemployment benefits, and lower tax revenues. Some observers also point to lax enforcement of the Eurozone rules governing deficit and debt limits. There are also factors that contributed to the build-up of debt which are specific to each country, however. For example, Greece is accused of having mismanaged public finances, Ireland had a large banking and housing bubble, and Portugal has had anemic growth and a lack of competitiveness.

Policy Responses

In large part, the European response to the Eurozone crisis has been a mix of financial assistance (in the form of loans) and austerity measures. Financial assistance has been provided by the other Eurozone governments and the International Monetary Fund (IMF) to Greece, Ireland, and Portugal. These financial

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[2] Congressional Quarterly, "Senate Banking, Housing, and Urban Affairs Committee Holds Hearing on the Financial Stability Oversight Council Annual Report as well as Votes on a Few Pending Nominations," October 6, 2011, http://www.cq.com/doc/congressionaltranscripts-3957612.

[3] Remarks by President Obama and President Lee of the Republic of Korea in a joint Press Conference, October 13, 2011. Available at www.whitehouse.gov.

[4] See Statements on White House home page, www.whitehouse.gov and "Obama, Merkel Discuss European Debt Problems," *Reuters*, October 14, 2011.

assistance packages are summarized in **Table 1**. The funds are disbursed in phases, with each disbursement contingent on austerity measures and reforms designed to improve the competitiveness of the recipient economy. The cornerstone of the European response is a new crisis lending facility, the €440 billion (about $606 billion) European Financial Stability Facility (EFSF), funded by the Eurozone member states to provide financial support to Eurozone countries that need it. The EFSF is expected to be replaced by a permanent lending facility, the European Stability Mechanism (ESM), after it expires in 2013.

Table 1. IMF-EU Assistance for Greece, Ireland, and Portugal

	Date Agreed	European Financial Assistance	IMF Financial Assistance	Total Financial Assistance
Greece	May 2010	€80 billion	€30 billion	€110 billion
		(about $110 billion)	(about $41 billion)	(about $152 billion)
Ireland[a]	December 2010	€45 billion	€22.5 billion	€67.5 billion
		(about $62 billion)	(about $31 billion)	(about $93 billion)
Portugal	May 2011	€52 billion	€26 billion	€78 billion
		(about $72 billion)	(about $36 billion)	(about $107 billion)
Greece[b]	July 2011	€109 billion		€109 billion
		(about $150 billion)		(about $150 billion)

Source: IMF press releases.

Notes: Figures denominated in euros converted to dollars using exchange rate on October 17, 2011: €1 = $1.3776 (Source: ECB). However, it should be noted that currency swings have been underway during the crisis and the dollar conversions have also fluctuated accordingly. Figures may not add due to rounding.

a. The headline number used by the IMF and in news reports for Ireland's total financial assistance package was €85 billion. This includes €17.5 billion from Ireland's cash reserves and other liquid assets. Resources used by national authorities in the crisis response are not included in the table above.

b. Pending ratification by participating countries.

The May 2010 Greece package prevented an initial disorderly default. In summer 2011, however, it became clear that the program was not working as planned and Greece again veered towards default. Some argue that the plan was failing due to much sharper economic contraction than expected, while others maintain that Greece's failure to implement far-reaching reforms was the root cause.

In July 2011, European leaders announced a second set of measures for Greece, including more financial assistance and more austerity. For the first time, it was also announced that private bondholders would share in the crisis response, and would participate, on a voluntary basis, in bond exchanges and bond rollovers to lower Greek debt payments over the short-term. The plan was to reduce the net present value of Greek bonds by 21%, to be achieved by lowering interest rates and/or extending maturities, not by reducing the outstanding principal of the loan.

European leaders also announced plans to increase the flexibility of the EFSF, so its funds could, for example, be used to purchase government bonds on secondary markets or to recapitalize banks. These plans have recently been approved by each of the Eurozone member states. Approval of the second assistance package for Greece is expected in weeks ahead, and the plans for the Greek bond restructuring are on-going.

In addition, the European Central Bank (ECB) has played an active role in responding to the crisis over the past two years. Since the onset of the crisis, the ECB started, for the first time, buying bonds of European countries under market pressure on secondary markets in an attempt to stabilize bond yields. The ECB has also provided unusually flexible liquidity support to banks in the Eurozone.

Continuing Concerns about the Crisis

Despite the new policy responses announced by the Europeans in July 2011, markets continued to express concerns about the sustainability of the debt of several Eurozone governments. Rising bond spreads have exacerbated debt problems in some Eurozone countries, and questions about the ability of Eurozone banks to absorb losses on government bonds have also been raised.

Many economists are now arguing that the Europeans need to:

- deal with an insolvent Greek government by providing more debt relief to Greece (i.e., imposing larger losses on holders of Greek bonds) than announced in July 2011;
- recapitalize European banks so they can withstand losses on Greek bonds; and
- increase the financial resources of the European rescue fund (the EFSF) so that it can adequately defend larger Eurozone countries facing market pressures from contagion effects.

Some economists point out that these policy measures, while necessary, only address the short-term dynamics of the crisis. They argue that slow growth and lack of competitiveness in the GIIPS economics are long-term problems that need to be addressed in order to prevent similar dynamics from occurring in the future.

The Eurozone crisis was the central focus of discussions at the G-20 finance minister meetings on October 14-15, 2011. The finance ministers said in a joint statement that the crisis needs to be "addressed decisively to restore confidence, financial stability, and growth." At an EU summit in Brussels on October 23, EU leaders reportedly discussed the details of a new "comprehensive" solution that would include agreements on how to re-capitalize banks, leverage up the EFSF to prevent further contagion, and impose further write-downs on holders of Greek bonds. After prolonged and difficult negotiations, the leaders indicated that a package of new measures could be announced at a special follow-on summit planned for October 26. The Eurozone crisis is also expected to be a major item on the agenda of the G-20 summit in Cannes, France on November 3-4, 2011.

Prospects, Challenges, Political Dynamics

As noted, European responses to the crisis—while unprecedented in size and scope—have thus far fallen short of what many economists and the Obama Administration believe will be necessary to restore full investor confidence in the Eurozone. Analysts point to several factors that have limited and could continue to constrain Europe's response. These include:

- a complex and at times cumbersome European institutional framework in which key decisions are reached largely through political consensus among the 27 EU members or 17 members of the Eurozone;
- underlying public skepticism throughout Europe on the appropriate role and democratic legitimacy of European institutions in responding to the crisis;

- broad disagreement—particularly between the Eurzone's largest economies, Germany and France—on many aspects of the crisis response, including on whether and under what conditions individual Eurozone members and institutions like the European Central Bank (ECB) should provide financial assistance to the monetary union's weaker performing economies; and
- ongoing debates over how to spur economic growth in Europe's most poorly performing countries, including over the extent to which European states should integrate national fiscal policies.

Many analysts expect that these factors will continue to prevent European leaders from reaching a single, far-reaching or "comprehensive" solution to the crisis and that Europe is more likely to continue to "muddle through" step-by-step, with agreements coming only after prolonged political debate and process.[5] Whether such a process will succeed in relieving market pressure on major European economies remains to be seen.

Although European leaders have consistently affirmed their commitment to take all necessary steps to maintain a solvent and united Eurozone, they have repeatedly struggled to reach agreement on key elements of the crisis response. Driving the debate has been an apparent reluctance in Germany and other more prosperous EU member states to "bail out" lesser performing economies. German Chancellor Angela Merkel, in particular, has faced criticism for failing to demonstrate clear German support for other Eurozone member states. Some analysts have suggested, for example, that a more a decisive sign of support for Greece from Merkel in early 2010 would have reassured markets and left more room for governments in other struggling Eurozone member states to enact necessary fiscal reforms. German officials have countered that the prospect of guaranteed "bail-outs" would create a dangerous moral hazard, removing leverage and leaving little incentive for poorly performing and profligate governments to enact politically unpopular reforms. Perhaps more significantly, Chancellor Merkel faces considerable domestic opposition to providing German financial assistance to other Eurozone members. Although they have thus far approved bilateral support for Greece and the EFSF valued at over €230 billion (about $320 billion), German politicians from across the political spectrum have shown rising discomfort with Germany's commitments, particularly as domestic economic growth has begun to slow.

Additional disagreements at the forefront of European policy discussions include the appropriate role of the European Central Bank in addressing the crisis and the extent to which private investors should be expected to take losses on Greek and other sovereign debt. With respect to the ECB, France and others have argued that the bank should take on a more active role—akin to the U.S. Federal Reserve—by continuing to support struggling European economies through bond purchases or by lending money to the EFSF. Germany has consistently opposed expanding the bank's narrow mandate—traditionally focused almost exclusively on limiting inflation—arguing, for example, that "central banks should not be called upon to finance states."[6]

In recent months, German officials have increasingly argued that private-sector holders of Greek debt should take losses in an effort to reduce the country's unsustainable debt levels. While many economists agree that this is necessary, there is concern about how and whether European and other banks that are currently holding large amounts of Greek debt could handle such losses (for exposure data, see Figure 1).

[5] See, for example, Marcus Walker and Charles Forelle, "Europe's Options: Few, and Shrinking," *Wall Street Journal*, October 22-23, 2011.

[6] German finance minister Wolfgang Schaeuble, as quoted in Marcus Walker and Charles Forelle, "Europe's Options: Few, and Shrinking," *Wall Street Journal*, October 22-23, 2011.

In addition, some fear that a significant Greek debt restructuring could lead nervous investors to further drive up interest rates on Spanish and Italian bonds, causing the crisis to spread to some of Europe's largest economies.

Debates on the immediate responses to the crisis are also rooted in diverging longer-term visions for the EU's Economic and Monetary Union (EMU). Until now, European leaders, and particularly the Merkel government, have emphasized the need for governments to reduce budget deficits and debt levels, largely through far-reaching fiscal austerity measures. Germany has even advocated the adoption of balanced budget amendments in all Eurozone countries. However, some economists have questioned what they consider this almost singular focus on austerity, arguing that severe budget cuts further impede economic growth and that policymakers should focus more on restoring economic competitiveness, particularly to the countries on Europe's southern periphery.[7]

The dynamics of the crisis have increased tensions between European publics and political elites and caused political instability in Eurozone member states. Besides Germany, considerable segments of the population in countries such as the Netherlands, Finland, Austria, and Slovakia say they oppose the "bailing out" of what are often perceived as the profligate governments of southern Europe, arguing that those countries should be allowed to default. On the other side of the coin, in countries such as Greece, Ireland, and Spain, there has been strong public backlash against a political class accused of adopting austerity measures that are only exacerbating economic disparities and leading to increased unemployment levels. During the course of the crisis, governments in Portugal, Ireland, and Slovakia have fallen as a direct or indirect result of it; the Socialist government of Spain was compelled to call an early election for November 2011 (which it is widely expected to lose); and the Greek government is faced with an unenviable state of nearly constant emergency.

The crisis is also sapping European public support for the euro; according to the German Marshall Fund's *Transatlantic Trends 2011* survey, conducted in May and June 2011, 53% of those polled in 12 EU countries believed the euro was bad for their national economy. On the other hand, 67% still believed that membership in the European Union was good for their national economy.[8]

U.S. Involvement

Since early in the crisis, the Obama Administration has been supportive of the EU and IMF decisions to support Greece and other vulnerable Eurozone economies and has consistently urged Eurozone governments to act boldly to support their common currency. As noted above, the Obama Administration has increased its engagement on the crisis since concerns peaked again in the summer and fall of 2011. The Administration has reportedly opposed proposals to create new facilities at the IMF to help respond to the Eurozone crisis, however.

There has been concern among some Members of Congress about the use of IMF resources in the crisis. Some Members are concerned that the United States, as the largest shareholder in the IMF, is helping "bail out" profligate developed countries, particularly true in light of the legislation passed by Congress in 2009 extending a $100 billion line of credit to the IMF's supplementary resource facility, the New Arrangements to Borrow (NAB). Other members have argued that IMF intervention has been important to stemming contagion of the crisis. Additionally, they argue that because IMF assistance takes the form

[7] See, for example, Martin Wolf, "First Aid is not a Cure," *Financial Times*, October 11, 2011.

[8] The German Marshall Fund of the United States, *Transatlantic Trends, Key Findings 2011*, p. 19, http://www.gmfus.org/publications_/TT/TT2011_final.pdf.

of loans at market-based interest rates, and that there is a strong record of countries repaying IMF loans, U.S. taxpayer dollars were not put at risk in the IMF program with Greece.

In 2010, concerns among some Members of Congress about Greece's program ultimately led to the adoption of an amendment to the Dodd–Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203). Among other things, this legislation directs the U.S. representative at the IMF to oppose loans to heavily-indebted middle- or high-income countries that are unlikely to repay the IMF. In 2011, legislation was introduced in the House and the Senate to rescind the United States's 2009 contributions to the IMF (H.R. 2313; S.Amdt. 501; S. 1276). The Senate voted down this legislation in June 2011.

In response to the Eurozone crisis, the U.S. Federal Reserve (Fed) in May 2010 announced the re-establishment of temporary reciprocal currency agreements, known as swap lines, with several central banks. These swap lines had been previously used during the global financial crisis and aim to increase dollar liquidity in the global economy. They are designed to minimize exchange-rate and credit risk to the Fed. The swap lines re-established in May 2010 to increase liquidity in the Eurozone were set to expire in January 2011 but have been extended until August 2012. These swap lines had not been used heavily during the Eurozone crisis, but started being used again in mid-August 2011 in response to the needs of European banks for dollars.[9] The amount outstanding on the swap lines as of October 12, 2011 was $500 million.

Implications for U.S.-EU Trade and Investment

The bilateral economic relationship between the EU and the United States is the largest and arguably the strongest in the world. Together, the United States and the EU account for about 40% of world GDP, 25% of world trade, 60% of world foreign direct investment flows, and 60%-70% of world banking assets and financial services.[10] Economic turmoil in Greece and the broader Eurozone could have negative implications for the U.S. economy.

At the start of the crisis, it was expected that austerity measures would slow growth in Europe and lead to a loss of confidence in the euro, causing a depreciation of the euro relative to the U.S. dollar. Both of these factors would depress demand for U.S. exports to the Eurozone and increase U.S. imports from the Eurozone, causing the U.S. trade deficit to widen. Likewise, slower growth rates in Europe could cause U.S. investors to look increasingly towards emerging markets for investment opportunities. On the other hand, a weaker euro could make European stocks and assets look cheaper and more attractive, attracting U.S. capital to the Eurozone.

Initially in the crisis, Eurozone "core" countries, including Germany, France, and the Netherlands, continued to have strong growth, even as growth in the GIIPS lagged, suggesting minimal impact on U.S. exports to the Eurozone. However, growth for the core countries started slowing in the second quarter of 2011, to 0.0% and 0.1% over the previous quarter in France and Germany, respectively.[11] If these trends continue, demand for U.S. exports in the Eurozone core, in addition to the periphery, could be depressed.

There are a number of factors that affect the euro-dollar exchange rate (including U.S. monetary policies, such as quantitative easing), and there has not been a clear, sustained depreciation of the euro against the

[9] Federal Reserve Statistical Release, http://www.federalreserve.gov/releases/h41/hist/h41hist13.htm.

[10] CRS Report R41411, *The Future of the Eurozone and U.S. Interests*, coordinated by Raymond J. Ahearn.

[11] Organization for Economic Cooperation and Development (OECD), *Quarterly National Accounts Dataset*, accessed October 2011.

dollar since the start of the crisis. As the crisis has continued, however, increased perceptions of risk have affected U.S. financial markets. Concerns focus on the interconnectedness of the U.S. and EU financial sectors, and the threat of the crisis spreading to larger Eurozone countries, including Spain or Italy.

Exposure of U.S. Financial Institutions

Some analysts are concerned that the Eurozone debt crisis could trigger a banking crisis in Europe, which could spread to the U.S. financial system. They argue that the impact of a Eurozone banking crisis on the U.S. financial system is highly uncertain, given the difficulty in predicting the nature of contagion from such a crisis. In his October 2011 testimony before the Senate Banking Committee, Secretary Geithner stressed that the direct exposure of the U.S. financial system to the countries under the most market pressures is very modest, but "Europe, as a whole, though, is a big deal."[12] He also indicated that U.S. financial institutions have higher capital levels than European financial institutions, putting them in a better position to suffer losses.[13]

Direct exposure of U.S. banks to the Eurozone countries that have come under the most intense market pressure to date—Greece, Ireland, and Portugal—is relatively small. According to the Bank for International Settlements (BIS), U.S. bank exposure to these three countries, including the sovereign and private sector, totals $73 billion or 2.2% of U.S. bank exposure overseas. Direct U.S. bank exposure to Italy and Spain (sovereign and private sector) total an additional $102 billion. Some of these losses could already have been absorbed in bank balance sheets if they are marking investments to market.

In addition to data on direct U.S. bank exposures, the BIS has recently started publishing data on banks' "other potential exposures" overseas, which include derivative contracts, guarantees extended, and credit commitments. It is generally believed that the BIS "other potential exposures" data capture gross exposures, rather than net exposures. Because the BIS data may not, for example, capture any hedges that U.S. banks may have in place to lower their exposure to a particular borrower, some say that the BIS overstates the risks of U.S. banks. Others argue that in a systemic financial crisis where U.S. banks' counterparties on hedging agreements could fail, gross exposures better capture the full risks to U.S. banks.

Given these caveats, BIS data suggest that U.S. banks may have higher levels of "other potential exposures" to Eurozone countries facing market pressures. In particular, where as direct exposures to Greece, Ireland, Italy, Portugal and Spain (sovereign and private sector) totaled $175 billion in March 2011, BIS figures indicate that other potential exposures for U.S. banks to these economies (sovereign and private sector) totaled $550 billion in March 2011. Again, this figure may not fully capture any hedging that has been undertaken to reduce net exposure, and analysts disagree about whether BIS data overstate or present an accurate picture of the exposures of U.S. banks overseas.

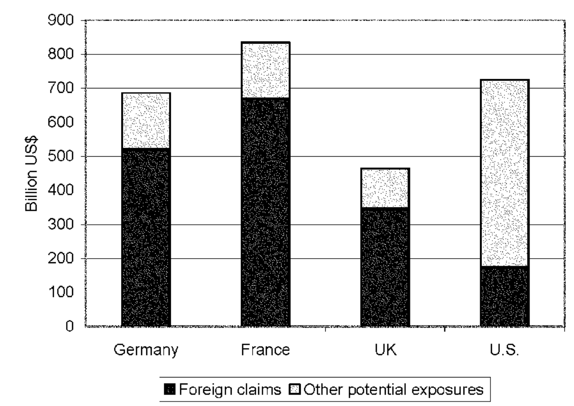
Figure 1 compares BIS data on U.S. bank exposure to the GIIPS with German, French, and UK bank exposure to the GIIPS. As of March 2011, direct U.S. bank exposure was much lower than direct German, French, or UK exposure. When considering "other potential exposures," however, U.S. bank exposure was higher than the UK banks and on par with German banks.

[12] Congressional Quarterly, *op. cit.*

[13] Congressional Quarterly, *op. cit.*.

Figure 1. German, French, UK and U.S. Bank Exposures to the GIIPS

March 2011



Source: Bank for International Settlements (BIS), *Consolidated Banking Statistics*, "Table 9E: Foreign Exposures on Selected Individual Countries, Ultimate Risk Basis," September 2011, http://www.bis.org/statistics/consstats.htm.

Notes: Exposure to GIIPS generally (government and private sector), not just GIIPS governments. "Other potential exposures" include derivative contracts, guarantees extended, and credit commitments. It is generally believed that the BIS data is for gross exposures, rather than net exposures. Also, the BIS data does not include exposures of non-bank financial institutions (such as pension funds), or the exposures of U.S. banks through secondary channels (such as U.S. banks exposed to UK banks, who are in turn exposed to Ireland)..

BIS data captures the exposure of banking institutions, and does not include the exposures of other financial institutions, such as money market, insurance, and pension funds. It also does not capture secondary exposures, such as U.S. banks that are exposed to UK banks, which are in turn exposed to Ireland. Overall, there is a high level of uncertainty surrounding the full exposure of the U.S. financial system to Eurozone countries under market pressure, and uncertainty surrounding the full implications of a default or restructuring, particularly if it triggers contagion, for the U.S. financial system.

Implications for the Broader Transatlantic Partnership

The United States looks to Europe for partnership on an extensive range of global issues. In terms of international politics, security, and economics, Americans and Europeans tend to share broadly similar values, and often tend to pursue common or compatible goals. The two sides have been cooperating closely in Afghanistan, on counterterrorism policy, Iran sanctions, Libya, the Balkans, and counter-piracy off the Horn of Africa, for example. Common transatlantic goals are pursued through the U.S.-EU relationship, on a bilateral capital-to-capital basis, or through NATO (21 EU member countries, including 12 members of the Eurozone, are also members of NATO).

The Eurozone debt crisis has exacerbated a number of trends in Europe that have caused some analysts to question the future direction of transatlantic cooperation. The crisis comes amid long-standing U.S. concerns about a downward trend in European defense spending. Although many observers have pointed to the NATO mission in Libya as a positive example of collective security action, Europe's financial problems sharpen worries about the continent's willingness and capability to project power as a global security actor in the years ahead. Similarly, in the context of political transitions in the "Arab Spring" countries of North Africa and the Middle East, questions have been raised about future trends in European foreign aid and economic assistance. More broadly, some in the United States have long looked for a more outward-focused and action-oriented Europe capable of taking a larger role in addressing global challenges. For years, however, the EU has been preoccupied with debates about its internal institutional arrangements. The Lisbon Treaty, the EU reform treaty that took effect in 2009, was supposed to settle these institutional questions while providing the EU with enhanced foreign policy tools. The Eurozone debt crisis, however, appears to have once again turned the main focus of the EU inward, leaving many U.S. policymakers wondering about the future of the transatlantic partnership.

Possible Questions

1. Please assess Europe's response to the crisis so far. What are the obstacles to more decisive policy responses in Europe? What is the level of political consensus in Europe about crisis response measures? What are the main disagreements and how significant are they? Are there any upcoming dates or events that could trigger major market disruptions and/or necessitate a major new policy response?
2. The United States has limited influence over European decision-making about the crisis, but what steps should the United States take to encourage or support the crisis response? Is there a role for the G-20 in coordinating policy responses?
3. How exposed are U.S. financial institutions to the Eurozone crisis? What are the potential broader impacts on the U.S. economy?
4. Some have spoken of a forthcoming "lost decade" of anemic economic growth and limited political cohesion in Europe. What does this mean for the broader transatlantic relationship? Might it affect the willingness or ability of the EU to serve as an effective U.S. partner in addressing some global challenges? Could the crisis spur long-stalled efforts to enhance European defense policy cooperation?
5. If the Eurozone cannot leverage up funds from the EFSF, is there a role for the IMF or surplus countries (like China) to play in providing liquidity? Where will the money come from for bank re-capitalization?
6. Some in Europe have called for a global tax on financial transactions that would raise revenue to offset the negative effects of the financial crisis and economic downturn. European leaders such as German Chancellor Merkel have criticized the United States for opposing such a tax. What are the potential advantages and/or disadvantages of such a tax?
7. What steps are being taken to spur economic growth within the EU? Are austerity measures the right approach in the short-term? Why isn't the Greece program working as envisioned? What else should countries such as Greece or Portugal do in the short-term to help grow their economies and increase their competitiveness? What should Italy do to increase market confidence in its ability to repay its debt?
8. Should the European Central Bank be playing a greater role in the crisis response? Should it, for example, play an active role in "leveraging up" funds in the EFSF? What are the differences in the French vs. German visions for the role of the ECB? What are the advantages and disadvantages of each vision?