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THE EUROZONE CRISIS AND IMPLICATIONS FOR THE UNITED STATES

HEARING

BEFORE THE

SUBCOMMITTEE ON
INTERNATIONAL MONETARY
POLICY AND TRADE

OF THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

OCTOBER 25, 2011

Printed for the use of the Committee on Financial Services

Serial No. 112–76

U.S. GOVERNMENT PRINTING OFFICE

72–617 PDF WASHINGTON : 2012

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

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THE EUROZONE CRISIS AND IMPLICATIONS FOR THE UNITED STATES

Tuesday, October 25, 2011

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON INTERNATIONAL
MONETARY POLICY AND TRADE,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:04 a.m., in room 2128, Rayburn House Office Building, Hon. Gary Miller [chairman of the subcommittee] presiding.

Members present: Representatives Miller of California, Dold, Manzullo, McCotter, Huizenga; McCarthy of New York and Carson.

Also present: Representatives Lynch and Green.

Chairman MILLER OF CALIFORNIA. The hearing will come to order.

The hearing today is entitled, "The Eurozone Crisis and Implications for the United States." I ask unanimous consent that Mr. Lynch of Massachusetts and Mr. Green of Texas, both of whom are members of the Financial Services Committee, be permitted to sit in with members of the subcommittee today for the purposes of delivering a statement, hearing testimony, and questioning the witnesses.

We have limited the opening statements to 10 minutes for each side, based on agreement with the ranking member.

I recognize myself for as much time as I might consume.

Today's hearing is focused on the Eurozone's debt crisis and its potential impact on the U.S. economy. Despite the financial assistance provided by the European Union (EU), and the International Monetary Fund (IMF), Greece, Ireland, and Portugal plunged into deep recessions during the past year. The economies of Spain and Italy are fragile, while the German and French economies are also starting to show signs of strain.

In the past year, there has been a series of credit rating downgrades for many EU members, often following the rounds of stress tests on systemically important European banks. These rating agencies have warned about the risk associated with the global interconnectedness of European banks and the potential risk of investing heavily in government bonds. The EU must take bold and aggressive action to ensure this crisis is addressed and contagion in the international capital markets is prevented.

We meet as Eurozone leaders prepare to convene in Brussels tomorrow to hopefully arrive at some agreement about how to ad-

dress the worsening debt crisis. There is no question that this is a difficult and fragile situation.

Over the weekend, work was done to come to an agreement. We expected finalization of a plan to resolve the crisis on Sunday, but the target had to be changed to Wednesday. It is our hope that things will be finalized tomorrow so that Europe will be set on a path to recovery as quickly as possible.

Our hearing today will consider the impact of the crisis in Europe on the United States. While the solution to the Eurozone crisis must be a European one, the United States is not insulated from the problems in Europe. The Eurozone debt crisis has significant implications for the U.S. economy. The U.S. economy is highly dependent on trade with the EU and will suffer if our largest trading partner cannot fix its economy.

Our economic relationship with Europe is significant. It exceeds $4 trillion. More than 20 percent of U.S. goods are exported to Europe, totaling more than $400 billion. Thirty-five percent of U.S. service exports are to Europe. Seventy percent of foreign direct investment (FDI) in the United States is from Europe. This is a result of jobs for U.S. workers, and it is a very important one.

If the crisis leads to even slower growth in the Eurozone and a general weakening of the euro against the dollar over the long term, this could have a severe impact on trade by depressing demand for U.S. exports.

In addition, the market is interconnected, and lack of market confidence can become contagion. We have already seen the impact of the crisis on U.S. stock prices. We are also concerned about the exposure of our U.S. financial institutions into the crisis.

There is no question there will be a U.S. consequence to further decline in the Eurozone. It is in our interest that there be a swift and effective resolution to the crisis in Europe. Stability in the Eurozone is very important to U.S. economic interests, and we should play a constructive role where appropriate.

As we look at this issue, we need to be concerned about the U.S. exposure to foreign sovereign debt in Europe. However, we must ensure that the U.S. Government is not using taxpayer money to bail out foreign governments or bank institutions, as taxpayers should not be on the hook for failure of foreign governance.

Today's hearing is focused on the European policy options under consideration for containing the crisis, the impact of problems in Europe on the U.S. economy, particularly related to future trade flows and job growth in the United States. Our first witness from the Treasury Department will be able to shed light on the role the United States has played in the European policy deliberations and steps European officials are contemplating to stabilize markets and reduce uncertainties in Europe.

Given the Administration's involvement in the talk in Brussels, our subcommittee's oversight role is important. We want to know who the United States is meeting with and what is coming out of these meetings. We want to know what kind of commitments the Administration is making during these meetings. In addition, we are concerned about the impact of any commitment on U.S. taxpayers. Overall, I hope this hearing sheds some light for our mem-

bers on what the appropriate U.S. role should be during the crisis and how to protect U.S. taxpayers from exposure.

Our second panel of witnesses will help members understand how instability in Europe can affect the U.S. economy and transatlantic trade because of the dependence of the U.S. economy on the EU economy. We want to understand the implications of the U.S. economy, particularly with respect to the exposure of U.S. banks and nonbank entities such as hedge funds. We want to understand the impact of our U.S. companies, particularly regarding their exports. We are concerned about the impact on jobs in this country and the risks this crisis poses to our own economic prosperity.

Given the significant economic and financial relationship between the United States and Europe, the United States has a substantial stake in the resolution of this crisis. How Europe manages this issue it currently confronts will directly impact the United States economy. This crisis poses a significant threat to global economic stability overall.

Again, I want to be clear that this is a European problem that must be solved by Europe. That said, there is no question that our economy will be impacted by the success or failure of the measure to resolve the crisis, which is why the committee will follow progress on Europe closely. We must work to insulate U.S. taxpayers by ensuring that U.S. funds are not on the hook for any resolution measures, and we must work to insulate our own economy, given our trade and financial markets' interconnectedness with Europe.

I want to thank the witnesses for being here today and for being able to present a good and honest, forthright testimony of what is going on; and I yield to the ranking member for 3 minutes.

Mrs. McCarthy of New York. Thank you, Chairman Miller, for holding this important hearing to examine the European economical crisis and what the potential impact could be for the United States.

The global financial crisis that we are continuing to recover from set the backdrop for what have become unsustainable debt levels and unsustainable financial positioning for a number of Eurozone countries.

What has become the Eurozone crisis first started with the solvency debt crisis in Greece in early 2010. Fear and concern over the potential fall of Greece and how that could spread to other countries set in across European and U.S. markets' participations. European leaders responded to the situation in Greece, followed by Ireland and Portugal, through a mix of financial assistance through a newly created crisis fund and several spending reductions.

The policy responses implemented thus far have been reviewed by many in the international community as far too short. Long-term solutions are necessary to address slow economical growth, lack of investment confidence, and undercapitalized banking systems which plague many of the Eurozone countries. If Europe cannot contain the crisis, given our strong economical relationship with the European Union it could pose a significant risk to our economical recovery efforts.

The President and the Administration officials have been consulting with their European counterparts, encouraging bold and aggressive action to stifle potential spread to other countries and the international markets. As we await the details of the final agreement by the European leaders, media sources report solutions may include a leveraged European Financial Stability Facility as well as new financing instruments for the International Monetary Fund.

I look forward to hearing our witnesses today as we examine the impact European's economic problems may have on our own efforts towards economic recovery. Given the panel's expertise, I am interested in hearing their thoughts on what the European crisis strategy should be and ultimately how they pursue economical recovery.

With that, I yield back my time.

Chairman MILLER OF CALIFORNIA. Thank you.

Vice Chairman Dold is recognized for 4 minutes for an opening statement.

Mr. DOLD. Thank you, Mr. Chairman, and I certainly want to thank you for holding this important hearing.

I also want to thank you, Mr. Collyns, and the rest of our panelists for your time and testimony here today.

Since the end of World War II, the United States has maintained a very close and mutually beneficial relationship with Europe. For many decades, our political, military, cultural, and economic connections have served vital American economic and national security interests. In the process, the European Union, as a whole, has become our largest trading partner, with over $4 trillion in annual commercial trade, while the European Union alone accounts for over 20 percent of all American exports.

Our financial and capital markets have become highly interconnected with the European Union's financial and capital markets. The United States has become the largest source of foreign direct investment in Europe, and Europe has become the largest source of foreign direct investment in the United States. As a result, European economic conditions necessarily have a meaningful impact on American jobs, exports, and economic prosperity. So as Europe goes through these difficult economic problems, the United States has a vital national interest in how those European economic problems are resolved.

For example, if Europe's solutions don't inspire market confidence or if they impose too many losses on creditors, then American investors and financial institutions will be negatively impacted, which will negatively affect American jobs and economic growth. If Europe's solutions don't promote European economic growth, then we could see significantly diminished trade with Europe, which again could negatively impact American jobs and economic growth.

Meanwhile, according to the Bank for International Settlements, American financial institutions have over $600 billion of direct and indirect exposure to the most challenged Eurozone countries. So for America's benefit and for Europe's benefit, we need to see Europe resolve its economic issues as quickly and as effectively as possible without exposing American taxpayers to undue risk.

I look forward to hearing from Mr. Collyns and our other witnesses on how Europe's economic problems could impact the Amer-

ican economy, especially with respect to trade, investment, and jobs. I also look forward to discussing the European policy options that are under consideration and America's role in those policy deliberations; and, finally, I think that many people are interested in hearing about the International Monetary Fund's participation in resolving the Eurozone's economic issues and how the IMF can provide meaningful support without exposing the American taxpayers to undue risk.

Again, I want to thank you, Mr. Chairman, for holding the hearing. I want to thank our witnesses for their time and testimony, and I yield back.

Chairman MILLER OF CALIFORNIA. Thank you.

Mr. Lynch, you are recognized for 2 minutes.

Mr. LYNCH. Thank you, Mr. Chairman, Ranking Member McCarthy, and members of the subcommittee for holding this critically important and timely hearing. I want to thank you also for your courtesy in allowing me to attend and participate. I want to thank the witnesses for their willingness to come forward and help this committee with its work.

I have been increasingly concerned for some time now about the growing sovereign debt crisis in Europe and its effect on the American financial system and the global economy in general. That is why I wrote to Chairman Bachus back in July requesting a hearing on this very issue, on the effect of the Eurozone crisis on U.S. banks, and that is why I asked to join this subcommittee for today's hearing.

I commend the chairman and the ranking member for starting what I hope will be an ongoing conversation in this Congress about the economy's preparedness to cope with the growing sovereign debt crisis in Europe. As the chairman noted earlier in his remarks, the U.S. and Eurozone economies are more globally interconnected and intertwined than ever before.

The relationship between the United States and the European Union is particularly interdependent. The U.S. and EU combined make up about 25 percent of global trade and 40 percent of GDP and hold assets between 60 and 70 percent—excuse me, and hold a share of 60 to 70 percent of the world's banking assets between them.

As we have seen during our own financial crisis, closely intertwined financial markets come with both benefits and risks, one of those risks being the rapid and unpredictable spread of financial contagion in times of financial stress.

While it is clear that the U.S. financial system's direct exposure to troubled European economies appears manageable, our indirect exposure through derivatives, contracts, and other credit commitments is considerably less clear. The Bank for International Settlements estimates that the U.S. banking institutions' indirect exposure to Greece, Ireland, Portugal, Spain, and Italy alone could total as much as $550 billion, while the indirect exposure of other financial institutions, such as money markets, insurance, pension funds is completely unknown.

In short, we know the problem is bad. We just don't know how bad it is. I hope we can get a little clarity today about how bad the problem is and what we are doing to address it before the Euro-

pean sovereign debt crisis becomes another American economic crisis. I look forward to having a constructive conversation with the witnesses here today about steps Congress might take to address this crisis.

I thank the chairman and the ranking member, and I yield back.

Chairman MILLER OF CALIFORNIA. I would like to welcome our first witness today. The Honorable Charles Collyns serves as the Department of Treasury's Assistant Secretary for International Finance. In this position, Secretary Collyns is responsible for leading Treasury's work on international monetary policy, international financial institutions, coordinating with the G7, G8, and G20 in regional bilateral economic issues.

Previously, Secretary Collyns served as the deputy director of the research department at the IMF where he led the team responsible for preparing the World Economic Outlook report. Secretary Collyns received a doctorate in economics from Oxford University after obtaining first class honors as an undergraduate at Cambridge University.

Normally, we have a summary of 5 minutes, but I would like you to take as much time as you deem appropriate to make your presentation, and you are now recognized.

STATEMENT OF THE HONORABLE CHARLES COLLYNS, ASSISTANT SECRETARY FOR INTERNATIONAL FINANCE, U.S. DEPARTMENT OF THE TREASURY

Mr. COLLYNS. Thank you very much, Chairman Miller, Ranking Member McCarthy, and distinguished members of the subcommittee. Thank you for this opportunity to discuss recent developments.

Chairman MILLER OF CALIFORNIA. You might want to pull that microphone closer. It is not picking up very well.

Mr. COLLYNS. Europe's financial crisis poses the most serious risk today to the global recovery. As members of this committee have noted, the United States has deep trade, investment, and financial links with Europe; and stability in Europe is crucial for our exports and for American jobs.

It is clear that the Europeans have the resources and capacity to deal with the challenges they face. European leaders have made progress over the weekend towards designing a comprehensive framework for tackling this crisis; and leaders will meet again tomorrow, aiming to reach agreement on this framework well before the G20 summit in Cannes next month. This agreement will need to be implemented quickly and firmly.

Stepping back for a moment, the macroeconomic and financial challenges faced by several European countries since the 2008 financial crisis have exposed serious structural tensions within the European monetary union. Recent experience has revealed the need for a stronger mechanism to ensure financial fiscal discipline, for more flexible markets that allow countries to adjust competitiveness and achieve their growth potential, and for an adequate crisis response toolkit to respond to economic and financial stress.

In response to these challenges, Europe has taken wide-ranging action, both to strengthen national policies and to reinforce the overall framework for the euro area. At the country level, over the

last 18 months, much of the region has embarked on accelerated fiscal consolidation, growth-oriented structural reform, and banking sector repair. This is an extremely challenging agenda, and completion will require determined efforts over a sustained period of time.

In parallel, European leaders have pledged to do whatever it takes to ensure the future of the euro. They have provided financing, together with the IMF, to Greece, Ireland, and Portugal as these countries undertake very difficult reforms.

Moreover, leaders have recently expanded the effective financial capacity of the main European crisis facility, the European Financial Stability Framework, the EFSF, and have broadened the ways in which these resources can be deployed.

Meanwhile, the European central bank has played a crucial role providing liquidity to banks and buying sovereign bonds in the secondary market; and to prevent future crises, the Europeans have agreed to governance reforms that include a broader array of surveillance tools and enforcement devices to improve fiscal discipline. They have also agreed on a permanent crisis resolution mechanism.

In recent days, the Europeans have been working hard to design credible and effective approaches to mobilize the increased resources and greater flexibility of the EFSF with the aim of reaching agreement at the leader summit tomorrow and delivering a comprehensive plan to address their crisis by the Cannes G20 summit in early November.

This plan will need to have four parts:

First, Europe needs a powerful firewall to guard against contagion concerns to ensure that governments outside the periphery can borrow at sustainable interest rates while they bring down debts and strengthen growth.

Second, European authorities will need to ensure that their banks have sufficient liquidity and stronger capital to maintain the full confidence of depositors and creditors and, if needed, access to a capital backstop.

Third, Europe will need to craft a sustainable path forward in Greece as it implements its difficult fiscal and structural reforms.

And, finally, European leaders must tackle difficult governance challenges to address the root causes of the crisis and ensure that every member state pursues economic and financial policies that support growth.

Let me emphasize that the successful resolution of the current European crisis matters deeply to us here in the United States because our country has no bigger, no more important economic relationship than we have with Europe. While the direct exposure of the U.S. financial system to the most vulnerable countries in Europe is limited, we have substantial trade and investment ties with Europe, and European stability matters greatly for American exporters and for American jobs.

Already, the crisis has slowed growth significantly in Europe and around the world as increased uncertainty has reduced risk appetite, undermined business and consumer confidence, and reduced household wealth. These developments clearly pose very serious downside risks to the outlook for the U.S. economy and job creation. It is thus vitally important to the United States that Europe

is able to address its issues effectively and in a timely fashion. For this reason, the Administration has closely engaged with European leaders to encourage them to move forward in an effective way. At the same time, our supervisors have for some time been working closely with U.S. financial institutions to identify risks and to improve their ability to withstand a variety of possible financial contagion stress events emanating from Europe.

In managing global risks, one key challenge is to ensure sufficient financing in crisis situations. The European countries themselves are appropriately contributing the bulk of financing for countries in the Eurozone periphery.

In addition, the IMF has played an important role as a source of financing and as a source of expertise in the effort to contain the crisis. With its long experience and independent judgment, the IMF sets strong economic conditions for its loans, which help return countries to sustainability. By promoting greater stability and safeguarding against a more abrupt deterioration of economic conditions, the IMF supports the global economy and with that, U.S. growth, jobs, and exports. In addition to its involvement in Europe, the IMF has continued to offer financial support more broadly to countries all around the world at a range of income levels.

In closing, we appreciate the leadership and support of this committee on these key challenges, and we look forward to working with Congress as we engage with our international partners.

Thank you.

[The prepared statement of Assistant Secretary Collyns can be found on page 36 of the appendix.]

Chairman MILLER OF CALIFORNIA. Thank you very much.

Dealing with Greece specifically right now is a very small percentage of the EU, which everybody recognizes; and it seems apparent that there is some form of a write-off going to take place as far as some of the debt that they currently owe, which has to take place, the resolution of that, before you can move on to Italy and Spain. You stated in your testimony that you believe the EU leaders are finally ready to come to an agreement, but what if it doesn't occur in the next few days? What downside is there to that not taking place?

Mr. COLLYNS. There is clearly deep commitment from the European leaders to reaching a strong agreement over the next few days, because there is a deep understanding that failure could have very damaging consequences within the euro area. Although Greece itself is a relatively small share of the European economy, there has already been a considerable contagion affecting other countries in the euro area from events in Greece, and European leaders have realized the serious dangers if they do not act sufficiently quickly. The longer action is delayed, the more the dangers increase.

That is why we do think that they are going to take actions in a comprehensive way over the next few days to put in place a framework for protecting the rest of the euro area from potential contagion from events in Greece, strengthening the capacity of Eurozone sovereigns to continue to access markets at reasonable rates, and making sure the European banking system is adequately

capitalized and adequately funded, while at the same time continuing—

Chairman MILLER OF CALIFORNIA. But on that capitalization, I think the concern is that our downturn, our banks held real estate, theirs hold sovereign debt. The ones now who have invested in Greece know they are going to take some form of a loss.

Mr. COLLYNS. Right.

Chairman MILLER OF CALIFORNIA. Are they moving rapidly to make sure there is adequate capitalization for their banks so they don't tend to pull their head in like a turtle and say we are not going to get further involved based on the debt we currently hold?

Mr. COLLYNS. European banks have already taken significant action to strengthen their balance sheets, both writing down the value of Greek debt and also raising additional capital earlier this year. Despite this, we do think that they do need to take substantial additional action to strengthen their balance sheets, in particular to further boost their capital.

The concern that markets have is not only just with exposure to Greece but also exposure to other sovereigns that have come under pressure, and for this reason we understand that agreement is likely as part of this comprehensive package on an approach to ensure adequate bank capitalization and to provide a path to raise European bank capital to at least 9 percent core Tier 1 capital relative to risk-weighted assets, which would be a strong capital base.

Chairman MILLER OF CALIFORNIA. What role has the Administration played in the negotiations so far and what, if any, commitments have they made on the part of the American taxpayers to this issue?

Mr. COLLYNS. The Administration has been closely engaged with the Europeans at all levels.

Mr. LYNCH. Mr. Chairman, could I ask that the witness move his microphone a little closer to his mouth? I am really having a hard time hearing him.

Chairman MILLER OF CALIFORNIA. Just be proud of who you are and belt it out.

Mr. LYNCH. There you go.

Mr. COLLYNS. The Administration has been closely engaged with European officials at all levels. The President himself has regular contact with his counterparts in Europe to raise the deep concerns that we have in the United States. In the Treasury, we have continuing conversations. Secretary Geithner has visited Europe many times. In international meetings like the recent G20 meeting, the situation in Europe dominates the conversation. I—along with Under Secretary Brainard and our whole European team—am in constant conversation by phone and visiting Europe.

We feel that we can play a constructive role by sharing our own experience in the United States that we gained in dealing with our own financial crisis. We think there are some useful lessons that Europeans can learn.

I think the Europeans themselves are very interested in our perspectives and our views, and they welcome our close participation, but our participation does not involve any commitments of U.S. taxpayer money. We believe that the IMF can play a very impor-

tant role in supplementing European financial resources, and through the IMF, the United States can be very supportive.

The United States has a substantial financial commitment to the IMF, but involvement in the IMF does not put a material risk on U.S. taxpayers. The U.S. taxpayers have never lost any money from our financial commitments to the IMF. The IMF has preferred creditor status, which means that the IMF is always paid first before any other creditor; and the IMF, in fact, has a very strong track record of being repaid by countries that do run into continuing difficulties.

We also believe that the very strong commitment of the European leaders and the very strong commitment to European finances demonstrates the very strong likelihood that the Europeans will achieve success and that, ultimately, countries in Europe will be able to meet their financial commitments. So we are not concerned about exposure of U.S. taxpayers.

Chairman MILLER OF CALIFORNIA. Germany has been moving at a very cautious pace, which I understand. I hope that pace picks up rapidly in the next day or two.

The ranking member is recognized for 5 minutes.

Mrs. MCCARTHY OF NEW YORK. Thank you.

Thank you for your testimony. I want to go on to two questions.

The European Financial Stability Fund that is going to be replaced in the year 2013 by a permanent lending facility, the European Stability Mechanism, ESM. Do you anticipate the ESM framework will complement the Dodd-Frank Act reforms that we have here? And going back to some of the issues that you had talked about with the IMF, if the IMF creates additional crisis assistance mechanisms, how would that impact its lending capabilities for the future?

Mr. COLLYNS. The ESM will basically be a device for providing financing to sovereigns that run into difficulties. It will have a somewhat different structure than the current EFSF, but essentially it will undertake the same activities that the EFSF does. So it is not directly related to the implementation of the financial regulatory reforms in Europe similar to the Dodd-Frank reforms in the United States.

Nevertheless, the Europeans are certainly taking actions to implement regulatory reforms that largely parallel the reforms that we are implementing here in the United States; and certainly we in the U.S. Treasury are closely engaged with European counterparts to make sure that, as we move ahead in the financial regulatory area, we are maintaining a level playing field and ensuring that we are achieving high-standard regulatory regimes in Europe as well as in the United States.

In terms of the IMF's resources, the IMF has already committed substantial resources to the Eurozone periphery countries, to Greece, Ireland, and Portugal. Nevertheless, those commitments are still a relatively small share of the IMF's total available financial resources. There remains a very substantial arsenal of financial resources to the IMF which it could use if needed to extend financing to European countries or countries around the world.

We think the IMF does play a very constructive role in Europe but it is equally important that that role continues to be in the con-

text of a strong and comprehensive commitment by the Europeans to dealing with the problems. The Europeans themselves have the financial resources to deal with this crisis. The IMF has a supplementary role. It cannot substitute for European financial resources.

Mrs. MCCARTHY OF NEW YORK. Good, I have another minute.

Following up on that, when the emerging markets are able to adequately fill potential gaps created by reduced European investments in the U.S. economy, the emerging markets, will they be able to support it? If the EU is having a tough time, can they fill that spot?

Mr. COLLYNS. Certainly, the emerging markets are playing an increasingly important role in generating momentum for the global economy. I think around 80 percent of global growth over the past year or so has been, in fact, contributed from emerging market economies like China, India, and Brazil, as opposed to advanced economies like the United States, Europe, and Japan.

We think the emerging markets could play an even stronger role going forward by shifting the balance of their economies, relying less on exports to other countries, and boosting the strength of domestic demand in their own economies; and we, at the same time as we have been working with the Europeans to resolve the European crisis, we have also been working hard at the G20 to encourage the emerging economies to take steps to ensure that their own growth momentum is sustained by boosting their own domestic demand momentum and by adopting more flexible exchange rate regimes, which we think are fully consistent with and would encourage the shift in the pattern of global demand growth.

Mrs. MCCARTHY OF NEW YORK. Thank you. My time has expired.

Chairman MILLER OF CALIFORNIA. Vice Chairman Dold is recognized for 5 minutes.

Mr. DOLD. Thank you, Mr. Chairman.

Secretary Collyns, thank you again for being here.

I would like to discuss, if I could, just your thoughts on the International Monetary Fund's role in resolving the European crisis. Could you tell me and tell us, the panel, how the IMF is assisting the European countries and how the IMF's participation benefits the United States and, if you could, the degree to which the IMF participation exposes the American taxpayers to potential losses?

Mr. COLLYNS. The IMF is playing a crucial role in Europe through a variety of channels. The most obvious one, of course, is the financial channel. The IMF has contributed around a third of the financial resources that have been provided.

Mr. DOLD. Can you give me just a rough estimate of what a third is?

Mr. COLLYNS. A third is around maybe $150 billion. It is around a third of the total commitments by the European economies.

The IMF is also playing a crucial role in the design of the adjustment programs, and it plays a crucial role as an independent partner with the European countries to make sure that the adjustment programs are strong and well-designed and able to address the fundamental issues. So we are, in the Treasury, strong proponents of the IMF playing this role.

As I mentioned before, the IMF can play and has played a critical part in sustaining global financial stability through this crisis

management role without exposing U.S. taxpayers to the risk of material losses. The IMF has a very strong record of getting repaid by countries, given its preferred creditor status. We believe that the IMF can continue to play this very strong role, but, as I have said, it needs to be in conjunction with the European commitment to the right policies and the European commitment of adequate financing.

Mr. DOLD. Secretary Collyns, from the U.S. economic perspective, what do you think are the most sensitive issues in resolving the Eurozone's economic problems, from our perspective?

Mr. COLLYNS. From our perspective, the key issue is really containing the contagion effects. As investors are concerned about possible implications of what is happening in the relatively small countries in the periphery, what are the implications for larger countries in Europe that have relatively slow rates of growth and relatively high rates of public debt? These are countries that are much more significant in terms of their trading relations and financial relations with the United States. If there were to be a further deterioration in investor confidence in these countries, that would clearly have a very dangerous impact on U.S. financial markets and global financial markets. So the key instrument that is needed is to create imposing firewalls that break the connection between difficult—counters the difficult situations like Greece with the stronger countries that are closer to the Eurozone core.

We know the Europeans are working hard. We have heard about various devices that they are looking for to leverage the resources that they have set aside in the FSF to build this firewall. So a very important task in the days ahead is to provide a mechanism that will work effectively, that will be a mechanism that the markets can work with to continue to provide adequate fiscal resources, adequate financing to meet countries' fiscal needs.

Mr. DOLD. Secretary Collyns, there are those who believe the reason why the focus has not been on the United States is because of the problems in Europe right now and that we are going to be next. Do you believe that the United States has a similar spending problem as Europe does? And how would you compare Europe's problems to our problems? What are the similarities and what are the main differences?

Mr. COLLYNS. The United States clearly has a serious fiscal issue over the medium term.

Mr. DOLD. "Medium term" being defined as what?

Mr. COLLYNS. The Administration has committed to a very substantial reduction in the fiscal deficit over the next few years. Under the President's plan, the fiscal deficit will be reduced very sharply over the next 3 years, and it will be put on a path that will lower the public-debt-to-GDP ratio consistent with our commitments to the G20 at the Toronto Summit.

At the same time, however, the United States does not face the short-term fiscal pressures that are faced by some countries in Europe. We believe that there is an important role for providing additional fiscal support to the U.S. economy over the next year or so to maintain the momentum of the present recovery.

The present recovery is not as strong as we would like. The progress on raising employment and reducing the unemployment

rate has not been as strong as we would like, and we think it would make sense to provide some additional fiscal support to slow the pace of the fiscal consolidation.

In Europe, there are other countries outside the periphery that also have maintained the confidence of markets and where the imperative of fiscal consolidation is not as urgent. A country like Germany, for example, although its debt-to-GDP ratio is quite high, it does have room to—within the constraints of its own debt rate, it has room to let automatic stabilizers work to support the German economy, which will play an important part in sustaining the momentum of growth in Europe.

So fiscal issues are certainly important in the United States over the medium term, but if we are able to put in place a convincing and credible approach to dealing with these issues, that would also provide us with room to taking steps to support our economy in the short term and supporting American jobs.

Mr. DOLD. Thank you, Mr. Chairman. My time has expired.

Chairman MILLER OF CALIFORNIA. Mr. Carson is recognized for 5 minutes.

Mr. CARSON. Thank you, Mr. Chairman.

Mr. Collyns, in the wake of the 2009 financial crisis, the United States passed comprehensive financial regulatory reform designed to promote transparency, monitor systemic risk in the financial system, and ensure that U.S. financial institutions can withstand shocks to the system. How have these reforms improved the ability of U.S. regulatory authorities and financial institutions to mitigate the impact on the U.S. financial market of economic turmoil in Europe?

Mr. COLLYNS. I think the financial reforms have played an important part in strengthening the resilience of the U.S. financial system and helping to contain potential risk coming from Europe in a number of different ways. One is that Europe—the United States' banks are much more strongly capitalized today than they were before the 2008 financial crisis.

Chairman MILLER OF CALIFORNIA. You need to move the microphone a little closer. We are having trouble hearing up here.

Mr. COLLYNS. The largest U.S. banks now have average Tier 1 core capital to risk-weighted asset ratio of over 10 percent, substantially higher than it was back in 2008. There has also been a major reduction in reliance on market funding, on wholesale funding to fund U.S. bank lending, and a substantial improvement in the liquidity situation of American banks. All of this is consistent with the stronger capital, liquidity, and funding requirements put in place by Dodd-Frank.

In addition to this, Dodd-Frank has put in place important mechanisms to make sure that U.S. regulators work closely with U.S. banks to anticipate potential risk events. In particular, the Financial Stability Oversight Committee, the FSOC, has met frequently to assess potential risks, and supervisors have benefited from the insights of this work to work closely with financial institutions here in the United States to strengthen the financial institutions' capacity to deal with potential risk events coming out of Europe.

Mr. CARSON. What is the role for the G20 in coordinating policy responses?

Mr. COLLYNS. The G20 has played an important part and continues to play an important part, and one area where its role is crucial is in the financial regulatory area. The Dodd-Frank legislation has put in place very strong, very high standards of regulatory requirements in the United States, but it is important that the leading financial centers around the world also adopt high-standard regulatory framework consistent with what we are doing in the United States, and the G20 has played an important part in making sure that this is achieved.

The G20 has also provided a forum in which challenges to global stability such as those coming out of Europe are discussed and where key countries, emerging market countries can also express their concerns. So, for example, in G20 meetings, the situation in Europe is discussed extensively, and the concerns that are expressed, it is not just the United States that is expressing concerns but also the large emerging market countries are also expressing their deep concerns and I think helping the Europeans understand the critical importance of addressing their issues in a fundamental and decisive way.

Mr. CARSON. Thank you.

Thank you, Mr. Chairman. I yield back.

Chairman MILLER OF CALIFORNIA. Mr. McCotter, you are recognized for 5 minutes.

Mr. MCCOTTER. Thank you very much.

Just a quick question: How does what is happening in the Eurozone and the policy prescriptions that are being put forward differ from what the United States did during the TARP situation back in 2008?

Mr. COLLYNS. In some respects, there are similarities, but there are also important institutional differences, of course, between the United States and Europe. Important similarities are that this is a crisis of confidence and a crisis that has led to a huge increase in uncertainty with potentially very negative impact if not contained, both here in the United States and in Europe. What is needed, therefore, is an overwhelming, powerful response to reduce concerns, to reduce the uncertainty, to reassure investors that the situation is being contained.

In Europe, it has been more difficult to put this decisive response in place because of institutional constraints. There are 17 members of the Eurozone, and they all need to reach agreement on steps to establish and develop these crisis resolution mechanisms. That has taken time, and politics is always complicated, but now we are talking about the politics in a multiplicity of countries.

There is also a difference in the role of the European central bank, the ECB, from the role of the Federal Reserve (Fed). During our financial crisis, the U.S. Treasury and the Fed were able to work very closely together and very quickly to develop effective tools to reassure markets that funding would continue to be available.

The ECB's legal constraints have meant that there could not be such a close relationship between the ECB and European treasuries, and for this reason the mechanisms that are being created now to reassure markets that funding will be available need to be more complicated and have taken more time to design.

Mr. MCCOTTER. In discussing those differences, one of the reasons that Europe seems to be having difficulty with this is because, unlike the United States where we have a union of 50 sovereign States governed by a Federal Government, the individual nations of the EU seem to be having trouble, I think very understandably so, with the concept of their taxpayers bailing out the investors for problems that were caused by other nations' lack of fiscal discipline. In the United States, that was clearly a much lower hurdle to get over for the Federal Government to do, rather than trying to corral 50 different State legislatures to agree to do that.

But doesn't the central principle of what they are trying to do in the EU equate with what was done in the TARP? In short, whether it is by individual nations of the EU or done in the United States by the Federal Government, the way they are trying to solve this crisis of confidence is to essentially tell investors to the greatest of their ability that you will not lose money under any circumstance and that the taxpayers will cover it if you run into this. Is that not the case?

Mr. COLLYNS. That is certainly the case. That is particularly relevant for the creation of this firewall that we have discussed.

But I think the problems in Europe go well beyond the construction of the firewall. There also needs to be fundamental economic reforms in a number of countries in Europe, Greece being the most prominent example, a commitment to massive fiscal consolidation and to deep-rooted reforms that restore dynamism to the Greek economy. Ultimately, the European crisis cannot be resolved until countries around Europe are able to convince markets they are going to be able to achieve the fiscal adjustments and the economic reforms that restore sustainability.

Mr. MCCOTTER. If I may, Mr. Chairman, just a quick point.

One of the problems that Greece experienced, much like it once did during the time of the Athenian city-state, was when people realized they could avail themselves of the public treasury for their own benefit, and the absence of fiscal discipline that you see out of a country like Greece where they have an exploding public sector and an anemic private sector are not necessarily constrained to Europe.

Thank you.

Chairman MILLER OF CALIFORNIA. I like starting with Athenian democracy, working through the Roman Republic. We could go on. It would be a great way to start this. I like that.

Mr. Lynch, you are recognized for 5 minutes.

Mr. LYNCH. Thank you, Mr. Chairman, and Ranking Member McCarthy. Again, this is a very important hearing.

Mr. Secretary, one of the next panel witnesses, Desmond Lachman from the American Enterprise Institute, has raised some interesting questions; and he points out that now the IMF is acknowledging that Greece's economic and budget performance has been very much worse than originally anticipated. He points out that there has been a 12 percent contraction in Greece's real GDP over the last 24 months, their unemployment has increased to over 15 percent, and that the situation there makes a substantial write-down of Greek sovereign debt in the amount of about $500 billion highly probable within the next few months. So in many analysts'

minds it is not a question of whether Greece will default but when. That would be the largest such default in history.

The IMF is proposing that the European banks accept a 50 to 60 cents on the dollar write-down on their Greek sovereign debt holdings, and that would have a material impact on European banks' capital reserve positions. So what I am worrying about is whether these European banks or have these European banks or will these European banks be required to mark to market their Greek debt before the recapitalization plan goes forward. Because that obviously represents a delta or a difference between what they are saying their capitalization will be versus what we determine it to be after stress tests and after properly marking down this Greek debt. And do we have any sense of the real strength, the real health of these European banks?

Mr. COLLYNS. The European banks have already been significantly marking down—

Mr. LYNCH. But the IMF now is saying, given today's situation, they are looking for a 50 to 60 cents on the dollar write-down of Greek debt.

Mr. COLLYNS. Right. Markets have already been pricing in a very substantial discount on—

Mr. LYNCH. But the banks aren't marking to market their assets. That is the problem. The markets are discounting them, but the banks—the banks are not showing that markdown on their balance sheets. So if you are going to stuff those banks full of money to save them, there would be a lot more money involved than what the banks are saying. That is the problem I have.

Mr. COLLYNS. Right. The banks have, in fact, been making progress in marking down their exposure to Greece on their balance sheets. They haven't gone all the way.

Mr. LYNCH. Not nearly, though. Fifteen percent. Not 50 percent.

Mr. COLLYNS. Over time they are moving—in the recapitalization effort exercise that is now under way, this exercise will take into account sovereign risk in assessing banks' need for capital, and that assessment of sovereign risk will be based on market valuations rather than book value valuations of bank capital. So this exercise should be much more effective in boosting bank capital than previous exercises that the Europeans have undertaken over the past—

Mr. LYNCH. Don't you think your analysis is unrealistically rosy from what we are seeing? Just look at the data, look at what is happening, look at the contraction in the economies, look at the slowdown even in some of the core countries like Germany and France.

I am not—look, I am not trying to take you to task for anything. I think you are doing a great job. I just think that we are not being realistic with what is coming down the road, and that is inhibiting our ability to prepare for that. That is all I am saying. I am not trying to be the bearer of bad news. I just know what the numbers tell me. And you try to prepare for that instead of constructing this.

From what we have seen so far and the response from the European Union—and God bless them, it is difficult because they are not unitary like we are, as Mr. McCotter pointed out before. They

don't have a single Fed and a single Treasury totally committed to one program; it has been rather fragmented.

But all I am saying is that we can't build our expectations or our course of action based on the very rosy scenarios that you are playing out here. Someone has to sound the alarm, and I think your folks at Treasury are probably the people to do that. And if you don't, then you are letting us walk this—we are walking right into this, and we are not taking, I think, reasonable precautions under the circumstances.

Mr. COLLYNS. We are certainly expressing our grave concerns based on our perceptions of the downside risks. We don't just look at baseline scenarios that may be optimistic, but rather we try to think, well, what could go wrong, and how do we take steps to make sure that the downside risks are not realized, both by encouraging the Europeans to take more forceful action to deal with their problems and by making sure that we have adequate defenses here in the United States, and particularly the U.S. financial system is adequately protected from potential risk events. That is the crucial part of what the FSOC has been doing.

Mr. LYNCH. Have we done an assessment on what our exposure is?

Chairman MILLER OF CALIFORNIA. The gentleman's time has expired.

Mr. LYNCH. I am sorry. Thank you, Mr. Chairman. Thank you for your tolerance.

Chairman MILLER OF CALIFORNIA. You and I have the same concern. I wish Germany would use more of a Panzer approach to getting this done, but they are very cautious on that kind of concept. But them moving rapidly wouldn't hurt the market.

Mr. Huizenga, you are recognized for 5 minutes.

Mr. HUIZENGA. Thank you, Mr. Chairman. I appreciate the opportunity to be here. And I apologize; I had a bill up in front of another committee and I had to testify on that, so I wanted to try to catch up based on some notes and some things that were handed to me. I just thought if you could address a little bit about U.S. exposure, whether there is direct exposure or exposure through other organizations that were involved in IMF, for example, and what that may mean to the taxpayer.

Mr. COLLYNS. U.S. direct exposure to the weakest countries in the periphery to Greece, Portugal, and Ireland is really quite minimal. Financial institutions have been aware of the risks, they have been lowering their exposure, and the residual risk is very small.

The concern is that there is a deep interconnectiveness more broadly between the American financial system and the European financial system. The exposure to financial institutions in the European core is very large indeed, and these are institutions that themselves are exposed to risk in the European periphery. So any increase in volatility and market uncertainty about the financial institutions in the European core very quickly translates into increased uncertainty in U.S. financial markets.

We have seen that playing out over the past couple of months, and this is an area where U.S. financial supervisors have been working very closely together with U.S. financial institutions to try to identify these risks and contain the risks, an important topic

for—an important focus for the FSOC as they consider the financial system.

Mr. HUIZENGA. It seems to me that exposure and risk might be two different things to a way—I understand the mitigation of the risk, but do we have exposure through the IMF or through some other organizations? If and when—because I think I agree with my colleagues here as well. I am very concerned about what may be happening and how does that translate, and then adding into that some of the requirements that may be coming under Basel III and those types of things, how does that all play into their ability to recover?

Mr. COLLYNS. The U.S. Government has minimal direct exposure. We do not lend significant sums to countries like Greece. We are supportive of the IMF playing a significant role in helping Europe to deal with this crisis. The IMF has provided around a third of the financing for countries like Greece, Ireland, and Portugal. The United States makes a financial contribution to the IMF; however, this financial contribution does not put the U.S. taxpayer at material risk.

The IMF has preferred creditor status, which means it gets repaid first. In the past, the record of repayment to the IMF has been excellent. The U.S. taxpayer has never lost a cent through its exposure to the IMF. So the IMF is an ideal vehicle for us to make sure that the European programs are well designed, based on the IMF's role joining on its long experience and expertise in dealing with financial crises, while at the same time providing a certain amount of financing.

Mr. HUIZENGA. We have just over a minute, and I am wondering if you could touch on Basel and what that may mean as they are trying to recover?

Mr. COLLYNS. Basel III is very important to improve the capital adequacy standards in banks in the United States and in Europe in reducing reliance on—excessive reliance on market funding and improving liquidity. As banks have moved towards strengthening their positions in these respects, their exposure to potential risk is correspondingly reduced. So we think that Basel III is already playing an important factor. The rules themselves do not yet come fully into effect, but financial institutions are anticipating in advance the requirements that they will face.

Mr. HUIZENGA. In my closing seconds here, you just used a phrase, "excessive reliance on market funding." So you are expecting that there needs to be government funding as opposed to the market?

Mr. COLLYNS. No. By market funding, I mean wholesale funding rather than deposit funding. Banks need a stable funding base based on consumer deposits, retail deposits, and other resources that can be relied upon to be stable rather than using wholesale funding from the market to an excessive degree that could expose a bank to risk in a volatile financial market. I am certainly not talking about official funding for banks, either in the United States or in Europe.

Mr. HUIZENGA. Thank you.

My time has expired. Thank you, Mr. Chairman.

Chairman MILLER OF CALIFORNIA. That concludes our first panel. The Chair notes that some members may have additional questions for this witness which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to this witness and to place his responses in the record..

We have many more questions, and you have a lot of answers. We just don't have the time. Secretary Collyns, thank you for your testimony today, and the panel is dismissed. Thank you, sir.

Now, I invite the second panel to come forward. I would like to welcome our witnesses.

Mr. Peter Rashish is vice president for Europe and Eurasia at the U.S. Chamber of Commerce. Mr. Rashish leads a team focused on advancing the broad and deep economic and commercial relationships that exist between the United States and the European Union in developing new opportunities in the continent's emerging markets.

Dr. Desmond Lachman is a resident fellow at the American Enterprise Institute focusing on the global macroeconomy, global currency issues in multilateral lending agencies. Previously, Dr. Lachman served as deputy director to the IMF Policy Development and Review Department. In this role, he was active in staff formulation of the IMF policies. Dr. Lachman has written extensively on the global economic crisis, the U.S. dollar, and the strains in the European area.

Mr. Douglas Elliott is a fellow at the Brookings Institute and focuses on issues surrounding both public policy and private financial institutions. Mr. Elliott was an investment banker for 2 decades principally with JPMorgan and was president and principal researcher for the Center on Federal Financial Institutions.

I would like to welcome you all here today. And, Mr. Rashish, you are recognized for 5 minutes.

STATEMENT OF PETER RASHISH, VICE PRESIDENT, EUROPE AND EURASIA, U.S. CHAMBER OF COMMERCE

Mr. RASHISH. Thank you. Chairman Miller, Ranking Member McCarthy, and distinguished members of the House Financial Services Subcommittee on International Monetary Policy and Trade, my name is Peter Rashish, and I am vice president for Europe and Eurasia at the U.S. Chamber of Commerce. The transatlantic commercial relationship is by far the largest in the world, with the United States and the European Union surpassing $4.3 trillion in trade, investment, and sales by foreign affiliates of companies in one another's markets. U.S. companies have over $1 trillion invested in the EU. In Ireland alone, the stock of U.S. FDI totaled $165 billion at the end of 2009, which is more than the United States has invested in China, India, Russia, and Brazil combined. EU investment in the United States supported 3.6 million jobs in 2008. Its investment in California alone supported 287,000 jobs, while its investment in New York supported 255,000 jobs.

These figures make it plain that the fate of the U.S. economy is intimately entwined with the fate of the European Union and the

Eurozone. Because of the deep level of integration between our two economies, we will sink or swim together.

The collapse of the Eurozone would not only mean the end of the common currency and the efficiencies that it has brought to the European economy, but would also likely lead to the disintegration of one of the EU's crowning achievements, the single market enacted in 1992. Without the single market and its four freedoms of movement of people, goods, services, and capital, not only would Europe's economy suffer, but U.S. companies would no longer be able to benefit from operating across a barrier-free internal EU market just as European firms do.

While Europe's political commitment to finding a solution to the crisis is strong, it is struggling to identify the right policy tools that contain financial contagion, shore up the banking system, and rein in fiscal deficits, while at the same time boosting economic growth. Without economic growth, no amount of budgetary austerity or financial rescue programs will provide a long-term solution to Europe's economic woes.

Where can Europe find the economic growth it needs which would ensure that the United States continues to reap the enormous commercial benefit from its trade and investment with the European Union? One avenue is for the EU and its member states to pursue structural reforms of their economies that would liberate growth.

Another path is for Europe to invigorate its push to complete its internal market. While most barriers to trade across the EU have fallen, an important number remain in the services sector. The creation of the single market has led to a surge in intra-EU investment, and this internal dynamism has been a key source of the EU's economic growth. The elimination of the remaining barriers in a single market would have major benefits for its economy, but also for ours.

There is, however, one area that until now has been neglected as a source of increased economic growth in the EU, and for that matter in the United States, and that is the trade relationship between these two commercial partners. If the two transatlantic economic powers want to inject more dynamism to their economies in a non-inflationary way, there is one quick step they could consider: Agree to eliminate all tariffs in transatlantic trade.

While these tariffs are low between the United States and the EU, because of the enormous size of the economic relationship, even small steps can yield very large gains in prosperity. According to a report by a Brussels-based think tank, the European Center for International Political Economy, such a transatlantic zero tariff initiative—elimination initiative would increase combined U.S.-EU GDP by $180 billion over 5 years. That is more added growth than we would receive from the completion of the Doha Round of multilateral trade talks.

Now, while the Doha Round is facing serious obstacles to its completion, a transatlantic zero deal could be agreed to quickly as the kinds of issues that have in the past held up bilateral trade pacts such as social, labor, and environmental standards shouldn't be a factor between the U.S. and the EU.

The U.S. and the EU should be ambitious and not stop at eliminating tariffs. They should be aimed at opening up their services markets to each other, create a single investment area, and pursue compatible regulatory regimes. Such an initiative does not have to be a traditional free trade agreement, based upon what is called a single undertaking, and which could take years to complete if progress in one area is dependent on how far negotiators have gone in another area. But to avoid the unfulfilled solemn declarations that have characterized the U.S.-EU relationship in the past, the two sides should commit themselves in a legally binding way to the achievement of a barrier-free transatlantic market.

On November 28th, the United States and the European Union will hold a summit meeting in Washington in which President Obama will welcome European Council President Van Rompuy and European Commission President Barroso. An announcement at the summit of a bold transatlantic initiative for jobs and growth, including elimination of tariffs on trade, would inject a sorely needed sense of confidence into both the U.S. and EU economies and would produce significant gains to both sides. Such an agreement would not in itself free the EU and the Eurozone of the task of finding lasting solutions to the current crisis, but it would create prospects of growth in Europe without which the crisis will likely endure.

The U.S. Chamber of Commerce looks forward to working with the members of the subcommittee to seek the full benefits of the transatlantic economy for American workers and companies. Thank you very much.

[The prepared statement of Mr. Rashish can be found on page 56 of the appendix.]

Chairman MILLER OF CALIFORNIA. Thank you.

Without objection, the written statements of all of the witnesses will be made a part of the record. I should have announced that beforehand, but I didn't.

Dr. Lachman, you are recognized for 5 minutes.

STATEMENT OF DESMOND LACHMAN, RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE

Mr. LACHMAN. Thank you very much, Mr. Chairman, for inviting me, and thank you, Ranking Member McCarthy.

What I propose to do is divide my remarks into four groupings: first, I want to talk about the intensification of the crisis in Europe; second, I want to touch on the implications for the United States; third, I want to discuss what the Europeans are doing to address this crisis and why I think their efforts might fall short; and fourth, I just want to touch on the United States' role, what the appropriate role for the United States is in this crisis.

Turning first to the intensification of the crisis, there is little doubt in my mind that we have seen a substantial and very disturbing intensification of this crisis that is all too likely to create real problems for the U.S. economy in 2012. Among the indications of an intensification of the crisis are first, that Greece looks like it is on the cusp of defaulting. This would be the largest default, sovereign default, in history. It would involve something like $450 billion.

I think that one really has to dismiss the notion that Greece is a small economy. The fact that it is a small economy doesn't mean that it is highly indebted. A lot of that debt is sitting on the banks of the core countries in Europe, which could really have serious concerns. We have already seen contagion to Portugal and Ireland. If we include Portugal, Ireland, and Greece, we are talking about $1 trillion of debt, a lot of that with the banks.

What is of real concern in terms of the intensification is that this crisis has now spread to Italy and Spain. The Europeans are trying to create the narrative that Italy and Spain are innocent bystanders of the crisis, when, in fact, they have deep problems. Italy has serious budget problems. Spain is very exposed externally.

We have seen strains in the European banking system that are of concern. If they get a big hit now, this is going to cause a real credit crunch. And the IMF is estimating that the shortage of capital of the European banks is around about 200 billion euros, whereas market estimates are about 300 billion euros.

Finally, in terms of intensification, what we are seeing is France and Germany moving into a downturn. If we get intensification of the crisis, that is going to cause Germany and France to move into a meaningful recession, which will really complicate the issues for the Eurozone.

Being brief on the implications for the United States, my two fellow panelists have touched well on the trade channels and the investment channels. I would emphasize the exposure that we have to the banking side through our banks. While the Administration is indicating that we don't have too much in the way of direct exposure to the periphery, the exposure of our financial system to the European banking system, which does have enormous exposure to the periphery, is huge, and therefore I would say that our financial system has very big exposure. What I am referring to is our money market funds have something like $1 trillion lent to the European banks, the U.S. banks have about $1 trillion of exposure to Germany and France, and our banks have written a lot of CDS and other derivative products, which really expose us enormously if things go wrong.

In terms of what is to be done, the agenda in Europe is to try to deal with the Greek situation in a definitive way, to try to ensure that banks are properly capitalized, and to erect a firewall around Italy and Spain. I have my doubts as to how effective they are going to be this time around. The whole of this crisis has been characterized by a "too little, too late" response, and I think that this is going to be another indication of that.

There are indications that the banks are resisting the 50- to 60-cent writedown that the Europeans are proposing on them. It is not clear whether the Europeans are going to come up with $2 trillion that would erect a firewall around Italy and Spain, and that money is certainly not going to be nonconditional money..

And I have misgivings about the way in which the bank restructuring is being done in France and Germany and the core countries in the sense that this is all too likely to provoke a credit crunch. As banks are given time to raise capital on their own, what they are going to do is they are going to opt for deleveraging rather than raising the capital that will dilute their shareholdings.

Finally, in terms of the U.S. role, the United States has been providing support both through the Federal Reserve as well as through the IMF. It is not clear to me that the United States should be doing a whole lot more. The problems in Europe are ones of solvency rather than liquidity. I am not sure that throwing more money at this provides a solution. We would certainly be putting taxpayers' money at risk, I am not sure that is a good idea. The Europeans did not help us in bailing out our banks in 2008–2009. I am not sure that I understand the logic of why the United States should now help them.

Finally, I would say that relying on the IMF is not the most indicated course. They haven't covered themselves with glory in the way in which they have dealt with this crisis. And I take issue with the fact that using the IMF to lend more to these countries doesn't expose the U.S. taxpayer to risk. I would just note that in these countries the IMF has never lent as much money to a country as Greece. The lending to Portugal and Ireland has been huge to date, so I wouldn't take much comfort in the track record that in the past, the IMF has always been repaid. When you have exposure of this size, you really are taking risks with U.S. taxpayers' money.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Lachman can be found on page 50 of the appendix.]

Chairman MILLER OF CALIFORNIA. Thank you.

Mr. Elliott, you are recognized for 5 minutes.

STATEMENT OF DOUGLAS J. ELLIOTT, FELLOW, ECONOMIC STUDIES, BROOKINGS INSTITUTION

Mr. ELLIOTT. Thank you, Chairman Miller, Ranking Member McCarthy, and members of the subcommittee.

The euro crisis is deeply concerning, in part because the path it follows is likely to be the main determinant of whether we go back into recession. If Europe were to be shaken by a series of nations defaulting on their government debt, I am convinced that the continent would plunge into a severe recession. Their recession would trigger a recession here because of a number of links across the Atlantic. I think everyone before me has done a great job of talking about these links, so I am going to just touch on them very briefly and then move on to other parts of this.

Trade: We export about $400 billion to Europe. We have about $1 trillion of foreign—of direct investment of things we own in Europe. The financial flows, we have about $5 trillion of lending and other commitments to Europe as a whole. A good chunk of that is the U.K., but the U.K. is also very closely tied to the Eurozone. And then, as we have talked about, there are the effects on business and consumer confidence partly that come through the financial markets. We saw in August how badly we could be hit once people get scared about Europe.

Now, let me be clear, I believe Europe will probably muddle through, ugly as the process has been and will continue to be, and frightening as it has been; however, the problem is there is perhaps a 1 in 4 chance that something really bad will happen that would lead to a series of national defaults that run from Greece, Portugal,

Ireland, Spain, and take Italy as well. There is also a small chance of an even worse outcome in which one or more countries leave the euro.

Now, my 1 in 4 probability estimate is very rough. There are many different ways that things can go wrong, because we have 17 different countries, each with their own political, social, and economic systems. So there are a lot of ways things can go wrong. Each of them has a low probability, but there are just so many of them that they add up to give me certainly very serious concern.

I think the actions that are going to be announced this week in Europe are generally positive, but I agree with Desmond that it is once more a case of saying they are going to do a lot more than they actually are. I have serious concerns about what has been proposed so far. The three steps they are taking are interlinked, and because they have political constraints that are really very binding, they are not doing enough on any of them. For instance, they are going to try to lever up the EFSF so they have something closer to 1 trillion or 2 trillion of euros to deal with the potential problems; however, because they are not willing to commit the base amount of money that they put in, they are not willing to increase that, it makes it hard for them to do anything terribly effective with the EFSF.

They are talking about providing insurance so that if you own, say, a new Italian bond, you know at least 20 percent of it will be paid. Given that Greece is about to have a 50 percent hit, that is not going to bring substantial new investors in, so I think it is an ineffective way of doing it that is being forced by not being willing to increase the 440 billion euros of base commitment of real money.

This also means they don't have a lot to do for the banks, so they are trying to shoot for about 100 billion euro recapitalization. The IMF thinks the losses on the sovereigns on market terms is 200 or 300 billion euros. There is $1 trillion of capital already there, so $100 billion is only a 10 percent increase. And there is a staggering $27 trillion of assets in the European banking system. So you are talking about the 100 billion euros is less than half a percent of the total amount of assets. Now, the assets are generally pretty safe, but there is just a lot of them if they go wrong.

So all these things tie together, and they are not, I think, going to be doing enough to deal with them. So whatever happens this week, I think we need to be prepared in case the crisis worsens. We should continue to encourage the Europeans to do what they need to do, and I think they need to do a lot more. We should continue to provide the U.S. dollar swaps through the European Central Bank that will allow them to provide banks with dollar funding. And our regulatory agencies should continue to monitor very closely our financial exposures, but not do it in a way that causes a panic reaction that makes the Europe situation worse.

And I do think that we ought to be prepared, if needed, to have the IMF provide substantial further assistance. The Eurozone has the joint resources to do what they need to do, but it is very helpful to have the IMF. It shows the markets there is more funding available; it brings the ability to place conditions, which, as a third party, the IMF can more easily do; and the technical aid they can

provide, which is substantial, gets listened to much more readily if they provided money as part of it.

So this is a European problem. They need to provide the backbone of the solutions, but it is strongly in our interest to help in any reasonable way that we can.

Thank you. I look forward to your questions.

[The prepared statement of Mr. Elliott can be found on page 40 of the appendix.]

Chairman MILLER OF CALIFORNIA. Thank you.

In my previous statement. I wasn't trying to underestimate the impact of Greece. My comment was associated with the fact that they are approximately maybe 2 percent of the EU, yet if it is not handled properly, it can be a significant impact; and that the EU has to somehow move rapidly to capitalize, whether the joint financing, resources, or however they do it, to make sure there is liquidity in the banks so the banks, if that is not done beforehand, and they take the hit on Greece, they might be very reluctant based on their own interests to not get further involved, especially with a situation that might occur with Italy and Spain.

That was my concern. If they do not hit rapidly and Greece hits first, there might not be motivation on the part of the banks to move rapidly to help others if they know they are going to take a further hit on that.

And I guess my question would be to all of you, what would happen to the U.S. recovery if European countries simultaneously implement all of the austerity programs, and what can we do to protect the U.S. economy and U.S. exports if that occurs? We will start with Mr. Rashish, and work right across.

Mr. RASHISH. Thank you, Mr. Chairman.

I think that one thing we can make sure to do is keep our markets open to trade and investment. It is certainly not the time, if there ever is a time, to close them when our major partner is going through the challenges we see right now. We want to encourage companies from Europe and around the world to invest in the United States. We want to pursue an export-oriented policy of our own.

But I think what is attractive about trade policy in this context is that it is something we can do together, in fact we need to do together, with the European Union. The European Commission negotiates trade policy at the European level for all of the 27 member states, including all of the 17 euros and member states. And if you look at our trade policy agenda, I think that we have now—the good news is we have passed the three free trade agreements, we have the Trans-Pacific Partnership which is still on the table, but I think that there should be some room for us to think about some additional trade policy initiatives, and I think that one with the European Union recommends it.

So I would say, why not look at the policy tools we have at our immediate disposal which don't have any implication for the taxpayer, don't have any implication for budgets, but which instead would liberate growth in the United States and Europe? And that is why we put forward this idea of a zero tariff initiative.

Chairman MILLER OF CALIFORNIA. Thank you.

Mr. Lachman?

Mr. LACHMAN. I think your question really goes to the heart of the problem in Europe, which is that the IMF is imposing a massive amount of austerity on countries in a fixed exchange rate system. When you do that amount of austerity, and I am thinking about countries like Greece, Portugal, Ireland, and Spain, what you have to expect is deep recessions in those countries. We have seen that already in Greece, we have seen it in Ireland, we are going to see it in Portugal, and we will see it in Spain. That has a material impact on those countries' growth prospects, and it also has a material impact on the European banking system, and through that, we get recessions in France and Germany.

I think the implications for the United States should be that there is a sense of realism in making our policy decisions, that we shouldn't be making our policy decisions on the basis of a rosy global scenario that is going to help the United States get out of its difficulties. I think that rather this, in my mind, would have a bearing on how quickly one does the withdrawal of stimulus from the U.S. economy. That would be one aspect that one would have to look at.

But the other aspect is when one does one's budget projections, one should be basing this not on the rosy scenarios that the CBO is doing, but rather on what is likely to happen in terms of growth over the next year or two because of the European crisis. What that would argue for is a much more serious effort at medium-term budget consolidation, because what this is going to do is to cause our budgets to really blow out.

Chairman MILLER OF CALIFORNIA. What my concern is, and it is not being talked about much, is we looked at what happened to U.S. banks in 2008. When they lost trust, when they lost faith, they quit lending to each other. A similar situation could occur in the EU if Greece takes a huge hit first before they capitalize improperly. And I guess I will let you try to respond, Mr. Elliott. You are the one who is left, and I am out of time.

Mr. ELLIOTT. Actually, it works out because I am principally a financial sector expert, so you have asked me something that I do focus a lot on.

First of all, I want to echo something Desmond said. I am quite worried that the banks may be pushed to restore their capital ratios by shrinking at a time when we don't want them to be shrinking. So your concern about austerity measures and private sector initiatives that all move in the same direction of slowing the economy down is a very valid one.

Chairman MILLER OF CALIFORNIA. And they are not moving rapidly to solve the problem. That is my concern.

Mr. ELLIOTT. No, they really are not. I would like to see a significantly larger fund available to infuse capital because this would give them an incentive to keep doing the business and the ability to do it.

In terms of the United States, it is difficult to be 100 percent sure, but I do think our financial system is a lot stronger than it was a couple of years ago. I do think we are much better prepared to handle the shocks that will come out of this, but certainly we ought to do everything we can to keep ourselves with a stable financial system.

Chairman MILLER OF CALIFORNIA. Thank you very much.

The ranking member is recognized for 5 minutes.

Mrs. MCCARTHY OF NEW YORK. Thank you.

Mr. Elliott, just going back to something that you said a little bit earlier, with the factors that are going on with the euro on a zone agreement, that measures a country's credit worth, what it is worth. If not, should there be something in place so that the 17 countries that are coming together—so that everybody actually knows? Like we have the Federal Reserve system. Some people disagree with that. But when you are trying to deal with 17 countries and the solvency of those individual countries, how can they all come together when you basically only have 1 or 2 countries that possibly might be able to help them out?

Mr. ELLIOTT. That is a really central question. My belief is that because the governments have not moved fast enough to show the markets that they will take this seriously, they have blown several chances now by doing the minimum to get past the immediate crisis, that the market is going to force a great deal of fiscal integration where they act more like one country. There are multiple ways that can be done. There are so-called euro bonds that would be backed by joint and several guarantees of all the countries. If the European Central Bank could simply step up very considerably its purchases of government bonds in the secondary market, you would come to the same effect. Or you could make this stabilization fund a lot bigger so that it could provide that. So there are various mechanisms.

What I believe will have to happen is that the European leaders will have to come to the edge of the abyss. Things will have to get considerably worse than they are now so that they see that they can either lose the next election by doing something their public is reluctant to do, or they can lose the next election by letting Europe fall apart. So they might as well at least do the right thing.

Mrs. MCCARTHY OF NEW YORK. But when you talk about that, and I am sure there are many Members here in Congress saying the same thing, but our country also, in my opinion, is in trouble, and yet we don't seem to be really doing a lot. To me, I thought when you came to Congress, you made the tough votes to do what is best for the country, and if that means losing an election, so be it.

Mr. ELLIOTT. I think the good and the bad thing is that the U.S. situation has a longer fuse. I think the European fuse is very short right now.

Mrs. MCCARTHY OF NEW YORK. Mr. Rashish, with the significant saddling of the Eurozone countries and the urgent need to recapitalize the European banking system, how do you think this will impact the U.S. trade relationship with Europe in the near future? And just one other thing. I asked this question before. Do you also see the underdeveloped countries filling that gap at that particular time?

Mr. RASHISH. Thank you, Ranking Member McCarthy. Let me, if I might, just quickly add something to what Mr. Elliott said. I think one distinction to the United States and the European Union is that we are institutionally mature, whereas the European Union is still building its institutions. It started out with the coal and

steel community in the early 1950s, so the common market, they moved to the single market, then they passed the euro.

And I think that one of the distinguishing features is that in Europe, you still have a large number of people both at the level of the public and the level of the leadership who are very strongly committed to creating a stronger European cooperation for the good of all, and I think that motivates a lot of the decisions that are being made, it motivates a number of the leaders, and it motivates the public. And I think that impetus to create more cooperation at the European level for the good of all is something that shouldn't be underestimated as a driving force.

I think that if things go well, historians may look back at this time as one of those sort of crucibles where the European Union tested itself, and it came up—found that it had the strength to do what it needed to move to that next level of European cooperation. So let me just say I think that is one thing that distinguishes the United States from the European Union.

And my colleagues have spoken eloquently about the nature of the banking and financial interrelationships. Clearly, if you are going to increase trade, you are going to have to make sure the financial sector is enabling and there is going to be liquidity for our companies to take advantage of that. But I think that we need to be able to do more than one thing at a time.

I think that the Europeans need to find the solutions to their problems that are outlined here today, and at the same time, I think that in terms of what the United States can contribute, I think certainly, and I am not sure "contribute" is the word, but in terms of the U.S. role, I think that at the same time as the Europeans are doing things on their level of financial policy and institution building, one of our roles can be in trade policy and to take initiative, a joint initiative, with the Europeans in our common interest to liberate economic growth through trade.

Mrs. MCCARTHY OF NEW YORK. With that I yield back.

Chairman MILLER OF CALIFORNIA. Vice Chairman Dold, you are recognized for 5 minutes.

Mr. DOLD. Thank you, Mr. Chairman.

Dr. Lachman, if short-term loans by the U.S. money market funds to the European banking system exceed $1 trillion, or more than 40 percent of their overall assets, how could a European meltdown affect the average American?

Mr. LACHMAN. Basically, what we could get if there were to be defaults in European banks if they didn't honor their loan commitments to the money market funds, we could be back into the situation that we were in 2008–2009 where money market funds were to break the buck, so the consequences would be extremely serious, to say the least. So hopefully, the Europeans aren't going to allow that to happen. But the fact that money market funds have as much as 40 percent of their assets loaned out to Europe is not a very comforting thought.

Mr. DOLD. Okay. I would agree.

Mr. Elliott, we talk about a plan about how to get out of the mess that Europe is in right now, and they are trying to solve this issue. You mentioned that a badly designed plan could do more harm. And so what types of provisions do you think should be in-

cluded in any final plan? But more importantly, what serious considerations are being given right now to things that should not be part of a plan?

Mr. ELLIOTT. Sure. Let me start with the latter since that seems to be the core of your question.

I do worry, as I know Desmond has also mentioned, that the way that the bank recapitalization is being designed is likely to send very strong incentives, very strong messages that you are better off shrinking, because right now it is very expensive to raise new equity capital in Europe. If you are a bank, and their system again has $27 trillion of assets, they have a lot of assets there, it is going to be a fairly compelling argument to say, well, let us just be 10 percent smaller, and then maybe we don't need the additional capital. Because again, the $100 billion is about 1/10th of the current capital. So shrinking by 10 percent would be a very bad outcome. That is one thing.

I mentioned in passing this idea of providing insurance from the fund for, say, 20 percent of the value of the new government debt. I just don't think that is going to do any good, so it will tie up the funds that could be better employed in other ways without really solving that problem.

In terms of what should be there, I think they need to bite the bullet and just say that they have failed to this point to do what has to be done, this is maybe their fourth try, and they have to really show that the Eurozone is standing together, and multiple mechanisms, as I mentioned a minute ago, to do that, but they just have to bite the bullet.

Mr. DOLD. What can we do here in the United States, what can the Administration do, in order to try to help facilitate that?

Mr. ELLIOTT. It is really limited. It is like watching a family member who is about to marry somebody they really shouldn't marry. You can provide advice, but there is not a lot more you can do.

Mr. DOLD. Let me just take that another step further, and, Dr. Lachman or Mr. Rashish, please chime in if you would like. But what can we do in the United States—recognizing the issues that are over in Europe right now and how potentially disastrous they could be, what can we be doing here in Congress to try to help insulate that crisis for the American taxpayer?

Mr. LACHMAN. I think that what one can do is base one's policy on realistic assumptions. I would agree with Mr. Elliott that there is not much one can do about a dysfunctional political union where the problems, the political problems, are huge; that I don't think that it is a question of dithering leadership, I think that it is a question that you have electorates that really don't have their heart in wanting to bail out countries, you have really very deep divisions on how the burden should be shared politically, that the Germans have a different view of the world than the French do. These are very deep differences that I am not sure that there is a whole lot that we can do to resolve them.

The point is they have gotten themselves into a currency arrangement that made very little sense. They didn't play by the rules for 10 years. I don't think that you can expect a very easy solution. These problems have been building for a long, long time.

And in my career at the International Monetary Fund, I have never seen such huge public financing, balances and external imbalances, in a fixed currency arrangement than we have in Europe, which doesn't give me much hope that this is going to have a happy outcome.

Mr. RASHISH. The one thing I would add to that is that the United States can in various fora, the G20 and bilaterally with the European Union, make the case that it is in our economic interest, the U.S. economic interest, and frankly in the Europeans' own economic interest, that, in addition to austerity measures to consolidate budgets, that the European Union member states and the Union as a whole need to take steps to liberate economic growth by, for example, getting rid of a number of barriers in the services sector by liberalizing labor markets and the professions. There are a number of steps that individual member states can take and that the European Union can take across its single market which would be growth- friendly, and I think that is certainly a point we should be making.

Mr. DOLD. Thank you so much, Mr. Chairman. My time has expired.

Chairman MILLER OF CALIFORNIA. Mr. Carson, you are recognized for 5 minutes.

Mr. CARSON. Thank you, Mr. Chairman.

This question is for the entire panel. What is it about the nature of the Eurozone institution that makes this crisis especially difficult to manage?

Mr. ELLIOTT. If I may, what they did is they agreed to merge their monetary policy and to have a common currency, but they didn't do what you have to have to create the preconditions for it, which is you either have to have a group of countries that are very similar so that the right policies will be right for everyone, or you have to agree to operate in a much more closely integrated manner. So they set up a system in which each country could manage its own fiscal policy, decide what its budgets were, and, within very loose limits, follow divergent policies. And that simply doesn't work within one's zone. That is now recognized.

So the real question will be, can they overcome the political limitations to come to an approach in which they have much more commonality? I want to say briefly, remember, the Constitution we are on, which is so beautifully designed, is our second Constitution. We had the Articles of Confederacy for a few years with the same problems. A bunch of States didn't want to be one Federal Union. So it doesn't surprise me they are dealing with this now, but they have to make some hard decisions.

Mr. LACHMAN. I would agree that initially the mistake was to get into a currency union without having the political union right there to start to support it. That was the original sin, but then they spent 10 years flouting their own internal rules. They had a Maastricht Treaty that required countries not to run budget deficits in excess of 3 percent of GDP. That didn't stop Greece having a budget deficit of 15 percent of GDP, Ireland 14 percent of GDP, Portugal and Spain close to 10 percent of GDP. Once you build up those imbalances in a fixed exchange rate system, it is too late to

be talking about how we should have more political union and a better structure.

You really have to address those imbalances, and it is very difficult to do that without having the benefit of a devalued currency that promotes export growth as an offset to the kind of fiscal adjustment. These countries are having to do 4 or 5 percentage points of fiscal adjustment in a year right in the middle of a recession. This just doesn't work.

Mr. RASHISH. If I may pick up on the history lesson Mr. Elliott was recounting, if you look at the United States, I believe I am correct that we didn't have our Federal Reserve until the second decade of the 20th Century, so it was over 100 years after our founding. It has only been about 60 years that the European Union in any shape as it has been around. So while there is no question that the current challenges they face are enormous, I think if we look at it in that perspective, I think that they have made a lot of progress and that their record is that they have always met the challenges they face, although this is the most serious one that they are facing, that they have ever faced.

Mr. CARSON. Thank you all. Thank you, Mr. Chairman. I yield back.

Chairman MILLER OF CALIFORNIA. I want to thank the—oh, Mr. Lynch, I was going to ignore you, wasn't I? I will cut you a reasonable deal. How about 5 minutes?

Mr. LYNCH. That is great. Thank you, Mr. Chairman. I appreciate that. Thanks for your kindness again, and I also thank the ranking member for your courtesy in allowing me to participate.

I want to thank all the witnesses. This is all very thoughtful testimony that you have offered here today and very helpful. I am not always in agreement, but I think very thoughtful and extremely helpful.

Mr. Lachman, in your—Dr. Lachman, I am sorry, in your testimony you point out, I think very astutely, that if what we think is going to happen here, if we do have a Greek default, then I think immediately Portugal and probably Ireland would be destabilized to a certain extent. And if we had a further contagion, we worry about Spain and Italy. The end result for us is that we would see a destabilized currency there. I don't know how they reconcile that, but it would certainly undermine the euro. And some have written, I think you have all written at some point, about the euro as we know it would no longer be sustainable if you had all these peripheral countries and then the core countries also impacted.

I am looking at the U.S. interest here, and in that environment with defaults going on, the European economy is going to retrench somewhat. That is going to affect us as an exporting Nation, but it is also going to affect us, as Dr. Lachman has pointed out, from a currency standpoint. We are going to have a very strong dollar by doing nothing; by just not defaulting, we are going to have a very strong dollar. They are going to have a very weak currency. It is going to put our producers at a strong disadvantage. And I think then it is going to have a real impact on jobs here in the United States as those facts play out.

What is it that we could do to try to adopt provisions that might mitigate some of those circumstances in such a short amount of

time, because that is the problem that Greece has—I think that is the problem that the EU has—is this has to turn around in a fairly short period of time. Even the austerity measures that have been adopted or at least are being debated, those measures will take a long time. Right now I think, as Dr. Lachman has pointed out, the Greek public debt is about 180 percent of GDP, or growing to 180 percent of Greek GDP. That is simply unsustainable, and it is going to take them a while to bring that down. Just like in our country we are struggling with this supercommittee, and we are going to drop some reductions, but it is going to take us a while to do that. But are there steps that we might take to cushion that impact in the face of these defaults in Europe if they do occur? Dr. Lachman?

Mr. LACHMAN. I am pretty sure that the defaults do occur just given the very size of the ratio of their public debt to GDP has reached. IMF is putting this at 180 percent. We know that the safe level, prudent level of public debt is below 80 percent. So a debt writedown in Greece of something like 60 percent is almost a certainty.

If you get that default in Greece, what that is going to do is have huge damage on the Greek banking system, which has to get nationalized. You are going to get capital flight. You will then get the contagion to Portugal and Ireland, which will then have a material impact on the European banking system that it is very likely to weaken the euro against the dollar. I think that is very likely an economic area. Having a banking crisis, very weak growth, is almost certain to have a weak currency.

I am not sure that the United States can do much in terms of that currency arrangement, but I would think that what it does is it heightens the concern about other countries in Asia that are manipulating their currency. We should really be putting pressure on those current countries to help this adjustment program. But I am not sure that we can do very much about the bilateral United States-euro exchange rate. The United States is very much likely in those sort of circumstances to become the safe haven that it was in 2008–2009. All of the money would pour into the United States. Certainly, it would not be going to Europe.

But I think that what should be done is pressure should be—greater pressure should be exerted on China to play a constructive role in the international adjustment process. That would be my suggestion.

Mr. LYNCH. Thank you very much.

Thank you, Mr. Chairman.

Chairman MILLER OF CALIFORNIA. Thank you.

Mr. Manzullo, you are recognized for 5 minutes.

Mr. MANZULLO. I am sorry that I could not be here until just now to glean the rest of your testimony, but I have an intriguing question. Perhaps it is more philosophical than financial or practical. But early, maybe in the past year, there were talks or at least thoughts that Greece would get out of the Eurozone and go back to the drachma. I would like your thoughts on that. I don't think that is going to happen, but I think that it could pinpoint some of the problems that are going on that would be an alternative. But

whomever would like to handle it? Maybe none of you would like to handle it.

Mr. LACHMAN. No, I should mention that I wrote a Financial Times piece 2 years ago indicating the reasons why Greece would exit the euro; and, sadly, events have already borne that out.

Basically, the problem is that Greece, having as large a public sector deficit problem as they have, you can't reduce that in a fixed exchange rate system without promoting an enormous recession. Greece's economy has already contracted by 12 percent. They still have a budget deficit that is 10 percent of GDP. If they persist in the IMF approach of not devaluing their currency, not writing down the debt, but simply engaging in savage fiscal austerity, they are going to drive that economy totally into the ground. It is creating political unrest. It is making it very difficult for them to meet the budget targets.

The logical thing for Greece to do would be to write down its debt by 50, 60 percent, but they would also be well advised to exit the euro. That would at least give the economy a chance to grow through exports, through improving the tourist sector. Otherwise, I am afraid that Greece is condemned to a decade of not only deep recession, but this is more like a depression.

Mr. MANZULLO. Anybody else?

Mr. ELLIOTT. Yes, if I may—and I am a financial sector expert more than an economist. So let me just say, Dr. Lachman is in a minority among the economists I have spoken with, as I think he would admit. That doesn't mean he is wrong.

Mr. MANZULLO. He seems like a nice guy.

Mr. ELLIOTT. No, he is, and a tremendously smart guy. I just wanted to try to provide a little balance in the sense that most economists that I speak with and read think that the transitional cost would be really awful. Because there are so many things you have to get exactly right in making that change, it is extremely unlikely to work out quite that way. You also have political constraints.

The damage of them coming out of the euro to the rest of the Eurozone is quite considerable partly because of contagion issues. The people then have to start worrying in Portugal, etc., as to whether they will find themselves with escudos again instead of euros, and that can create a lot of flight.

In addition to the direct effect of that, it has a political issue, which is right now something like 4 percent of Greece's GDP comes from regional aid from the rest of the EU. If the rest of the EU is really annoyed with Greece because they have just broken out of the euro and caused all these other problems, that regional aid may or may not continue. There is a whole series of reasons to be concerned about the change in addition to the potential benefits that Dr. Lachman has mentioned.

Mr. RASHISH. I would also add that it is key whether it is Greece alone. Because if it does lead to several countries leaving the Eurozone, then what you are going to have is a kind of very hard currency area, in fact, dominated by Germany and the Netherlands and Austria and Finland, who have very strong economies; and the lower exchange rates and interest rates, let alone the purchasing power that you had in the south of Europe because they had the

euro, is going to go away. And so, the ability of a country like Germany to be the export superpower, which has really been the main fuel for its growth, is unlikely to continue. And I think that would have a very serious impact on the performance of the European economy as a whole. So I think we need to think about how it would impact all the different members of the Eurozone and what it could do to the competitiveness of the main drivers of growth right now.

Mr. MANZULLO. Dr. Lachman?

Mr. LACHMAN. If I may say, I heard these arguments in December 2000, just before Argentina broke from the convertibility plan. I heard similar arguments about the time of the ERM in 1992 when that broke up. I wasn't around during the gold standard, but those were the kind of arguments that ran around before countries left gold in the 1930s. So I think that there are political dynamics.

It is not necessarily going to be the most rational choice for the country, but when countries are in as dire straits as Greece does when its politics gets very polarized, when we see the kind of street action that you get in Greece, you have to expect politicians to be suggesting alternatives to the hair shirt kind of approach that is being offered to them by the IMF and EU.

We have just seen 2 years GDP has literally imploded. Offering that—if that is the future you are offering, people are going to want to take chances with a different kind of policies, and I think that that is the reason why I see them both defaulting and, in time, leaving the euro.

Mr. MANZULLO. Thank you.

That was an interesting question, wasn't it?

Chairman MILLER OF CALIFORNIA. Very good.

I want to thank our witnesses. You have all been very excited about answering the questions, which is very rewarding from our perspective, and you are a wealth of knowledge. I appreciate your talents, and your time that you have given us today.

The Chair notes that some members may have additional questions for this panel which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

This hearing is adjourned. Thank you.

[Whereupon, at 12:04 p.m., the hearing was adjourned.]

A P P E N D I X

October 25, 2011

Assistant Secretary for International Finance Charles Collyns
Written Testimony before the House Committee on Financial Services
Subcommittee on International Monetary Policy and Trade

The Eurozone Debt Crisis and Implications for the United States
October 25, 2011

Chairman Miller, Ranking Member McCarthy, and distinguished members of the committee, thank you for the opportunity to discuss recent developments in Europe and how we are engaging with our partners to limit risks to the U.S. economy and encourage swift resolution of the crisis.

The European financial crisis presents the most serious risk today to global recovery and the prospects for U.S. exports and American jobs. Reflecting our deep concern, President Obama has continued to press European leaders about their plans to resolve the crisis, and Secretary Geithner remains closely engaged with his European counterparts. It is clear that the Europeans have the resources and capacity to deal with the challenges they face. Leaders made progress over the weekend towards putting in place a comprehensive framework for tackling the crisis and will meet again on Wednesday to reach agreement on this framework. This agreement will need to be implemented quickly and firmly.

I will begin this morning by briefly reviewing recent developments in Europe. I will then outline how we see risks to the U.S. and global economies from the crisis, and how we are working at home and with our international partners to manage these risks.

The European Crisis

The macroeconomic and financial challenges faced by several European countries since the 2008 financial crisis have exposed serious structural tensions within the European Monetary Union. As members of a monetary union, the seventeen countries of the euro area share a single currency, a single central bank, and a uniform monetary policy stance. Within such a framework, an effective mechanism that ensures fiscal discipline is essential to underpin macroeconomic stability, but this was not achieved. Moreover, because individual member countries cannot adjust competitiveness through the exchange rate, markets must be flexible to serve this purpose so that countries can achieve their growth potential. Further, an adequate toolkit of crisis resolution mechanisms must be available to respond to economic and financial stress.

These broad systemic weaknesses have played out in different ways across the countries that have sought official sector support, which are often referred to as the eurozone "periphery." Greece's crisis stemmed from unsustainable growth in the public sector, fueled by low-cost cross-border finance that allowed very large fiscal deficits and public debt. Portugal's public debt is more moderate, but its private and bank debt is large and competitiveness has deteriorated. Even during periods of vibrant global expansion, Portuguese growth has been anemic. In Ireland, a pre-crisis environment of low interest rates and exuberant growth expectations fueled a boom in the property sector. Its collapse, along with a deep and prolonged recession, produced very large banking sector losses and structural fiscal deficits. Irish

government support for its banking system, together with large fiscal deficits, has pushed public debt to nearly 100 percent of GDP.

Meanwhile, market concerns have spread to the fiscal situation of other member states struggling with elevated public debt levels and slow growth and to the adequacy of European bank capital in the context of slowing growth in the largest euro area economies. Such contagion has led to increasing strains on funding markets for banks and larger sovereigns in the euro area, highlighting the urgency of a comprehensive and decisive response.

In response to these challenges, Europe has been undertaking wide-ranging actions both to strengthen national policies and to reinforce the overall policy and institutional framework for the euro area.

At the country level, over the last 18 months, much of the region has embarked on accelerated fiscal consolidation, growth-oriented structural reform, and banking sector repair. In many cases when original reform plans proved insufficient, these plans were further strengthened. This is an extremely challenging agenda, which is starting to show results. However, completion will require continued, determined efforts to advance reforms combined with continued financial support over a sustained period of time.

At the Europe-wide level, European leaders have pledged to do whatever it takes to ensure the future of the euro, and have advanced on a range of fronts to reinforce the stability of the euro area framework and to tackle the crisis. Through the European Financial Stability Facility (EFSF) and other facilities, and with support from the IMF, Greece, Ireland, and Portugal have been provided with official funding over a reasonable period of time to do the very difficult reform work. Following a collective decision on July 21, euro area member states have passed legislation to expand the EFSF's effective financial capacity to €440 billion ($610 billion) and have eased the financial terms of its loans. At the same time, the EFSF's authority has been broadened to include precautionary programs, lending to countries to support bank recapitalization, and intervention in the primary and secondary sovereign bond markets. Meanwhile, the European Central Bank (ECB) has played a crucial role, providing liquidity to banks and buying sovereign bonds in the secondary market to ensure depth and liquidity in markets under stress. Not losing sight of the longer-term fixes needed to prevent future crises, the European Union (EU) has also agreed to the so-called "six-pack" of reforms to the Stability and Growth Pact (SGP) through the introduction of a broader and enhanced array of surveillance tools and enforcement mechanisms, and to introduce a permanent crisis resolution mechanism, the European Stability Mechanism (ESM).

We know from our own experience in 2008 that moving from crisis to recovery depends on swift and aggressive solutions to deal with the roots of the problem and restore market confidence. We have worked hard to convey to European leaders our sense of the need for bold solutions and to provide constructive advice on how to move forward. Secretary Geithner has traveled to Europe three times in the last six weeks alone, and President Obama is frequently in contact with leaders across the region.

Over the last weekend, the Europeans have been working to agree on specific crisis resolution mechanisms that mobilize the increased resources and greater flexibility of the EFSF with the aim of delivering a credible and comprehensive strategy to address the region's challenges in

advance of the Cannes Summit. This framework, which is to be finalized on Wednesday, will need to be implemented quickly and firmly. This plan should have four parts. First, to address contagion concerns, the Europeans need to establish a convincing firewall to ensure that governments can borrow at sustainable interest rates, as they implement policies to bring down debt and strengthen the foundations for growth. Second, it will be important to take steps to ensure that European banks have sufficient funding and build capital cushions to maintain the full confidence of depositors and the availability of credit, and to ensure that banks have access to a capital backstop when needed. Third, a sustainable program will be needed for Greece as it implements its fiscal and structural reforms. Fourth, ongoing work to strengthen governance will remain essential to address the root causes of the crisis.

Risks to the U.S. Economy

We are deeply invested in the successful resolution of the current crisis in Europe because the United States has no bigger, no more important economic relationship than it does with Europe. Europe accounts for over 20 percent of U.S. goods exports and over 35 percent of U.S. service exports. Europe is the most significant "foreign source" of investment and jobs in America – the total stock of European FDI at $1.6 trillion accounts for 70 percent of all FDI in the United States.

Already, the crisis has slowed growth significantly in Europe and around the world. Amid rising uncertainty, European stock prices have lost nearly a quarter of their value in the last six months and major U.S. stock indices have declined by almost 10 percent. The volatility in financial markets has reduced risk appetite, undermined business and consumer confidence, jeopardized the availability of credit, and reduced household wealth in the United States as well as in Europe. Moreover, the continent's financial institutions have come under serious pressure; many have lost access to funding and their capital adequacy has been questioned by financial markets. These developments clearly pose serious downside risks to the outlook for the U.S. economy.

Direct exposure of the U.S. financial system to the eurozone countries most under stress is moderate but we are concerned about risks from our substantial trade and investment ties with Europe. According to the Financial Stability Oversight Council's (FSOC) Annual Report, While direct exposure to the eurozone periphery is very limited, U.S. banks' exposures to the core European banks are much larger and these banks are the primary international lenders to peripheral European borrowers. As highlighted in the FSOC annual report, the interconnectedness of financial institutions with sovereigns makes it difficult to quantify precisely all possible exposures, which in turn increases the risk that a credit event could lead to generalized declines in investor sentiment, losses of liquidity, and associated disruptions of international financial markets.

The impact on the U.S. financial system of events in Europe depends on how the peripheral European sovereign debt crisis evolves and on the resilience of U.S. financial institutions and markets. Our supervisors have for some time been working closely with U.S. financial institutions to improve their ability to withstand a variety of possible financial contagion stress events emanating from Europe. The Financial Stability Oversight Council and its member agencies will continue to carefully monitor the potential risks that could emerge from the peripheral European sovereign debt crisis.

Supporting the Recovery

Our own recovery remains fragile and all too vulnerable to disruption beyond our shores. To strengthen our economy, the Obama administration is taking actions at home to boost growth and jobs in the near-term while also putting in place a medium-term fiscal framework to reduce deficits and debt. President Obama remains committed to putting unemployed Americans back to work and continues to push numerous job-creating initiatives, including those proposed in the American Jobs Act. We are also working closely with countries around the world to ensure sustained global growth. In particular, with demand in the advanced economies likely to remain weak, it is essential for emerging markets to play a bigger role in bolstering global demand. At the recent G-20 meeting, surplus emerging market countries committed to accelerate the rebalancing of their economies toward more domestic consumption and to achieve greater exchange rate flexibility to reflect economic fundamentals. Importantly, we have worked aggressively to pressure China, in particular, to move much faster in allowing the value of its currency to appreciate more rapidly.

One key challenge in managing global risks is to ensure sufficient financing in crisis situations. In the case of Europe, European countries are appropriately contributing the bulk of financing. Europe has already committed over €286 billion ($397 billion) in support for Greece, Ireland, and Portugal, and is committing substantial additional resources to build firewalls to protect against contagion and to recapitalize banks. Eurozone and other EU member countries are also contributing through the IMF, which has provided up to one-third of the financing for crisis programs. We have welcomed the IMF's role as a source of financing and expertise in the effort to contain the crisis. With its long experience and independent judgment, the IMF sets strong economic conditions for its loans, which help return countries to sustainability.

By promoting greater stability and safeguarding against a more abrupt deterioration of economic conditions, the IMF supports the global economy, and with that, U.S. growth, jobs, and exports. Notwithstanding these commitments, the IMF continues to have a substantial arsenal of uncommitted financial resources available – $390 billion – to meet possible future needs. In addition to its involvement in Europe, the IMF has continued to offer financial support more broadly to countries all around the world representing a range of income levels.

Americans want our nation to grow and prosper, to remain secure, and to provide ongoing opportunity for their families and for future generations. To deliver this, we must not only take action domestically, but also work through international forums to leverage a robust and multilateral response to global risks. Amid the global financial crisis, we had a clear demonstration of what we can accomplish by focusing on our priorities at home and by working with our partners abroad.

We appreciate the leadership and support of this Committee on these key challenges, and we look forward to working with Congress as we engage with our international partners, challenging them to follow America's lead in undertaking the policy responses needed to strengthen the global economy.

October 25, 2011

Subcommittee on International Monetary Policy and Trade

Hearing entitled "The Eurozone Crisis and Implications for the United States"

Douglas J. Elliott
Fellow in Economic Studies at the Brookings Institution

Thank you Chairman Miller, Ranking Member McCarthy, and members of the subcommittee, for inviting me here today. My name is Douglas Elliott. I am a Fellow in Economic Studies at the Brookings Institution, although I am here in an individual capacity and not representing the institution, which does not take policy positions.

The Euro Crisis is deeply concerning, in part because the path it follows is likely to be the main determinant of whether the U.S. goes back into recession. If Europe were to be shaken by a series of nations defaulting on their government debt, I am convinced that the continent would plunge into a severe recession. Their recession would trigger a recession of our own, although a less severe one, through a number of links across the Atlantic.

First, there is trade. Over $400 billion of our exports in 2010 went to the European Union[1]. We should expect to lose a significant portion of this while Europe is in deep recession. At the same time, European firms would likely gain market share at the expense of American sales and jobs, as the Euro depreciated and difficulties in selling within Europe spurred greater export efforts. Beyond Europe, emerging market countries like China also export substantial amounts to Europe and would find their growth slowing considerably. Our exports to those nations would be hit.

Second, there is investment. US firms have over $1 trillion of direct investment in the European Union. Profits from those operations, which are significant for our global firms, would decline markedly. We also have large sums invested in other nations, outside of Europe, that would be caught up in the same synchronized economic decline.

Third, there are financial flows. US banks, and their subsidiaries, have $2.7 trillion in loans and other commitments to eurozone governments, banks, and corporations, and roughly $2 trillion more of exposure to the UK[2]. US insurers, mutual funds, pension funds, and other entities also have a great deal committed to Europe. Credit losses would set back the progress we have made in moving beyond the financial crisis. Those losses would be exacerbated by

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[1] I generally use figures for the European Union rather than the narrower eurozone, because the UK and other EU members that do not use the euro are so closely tied to the eurozone countries that I believe they would also be severely impacted.

[2] My colleague, Domenico Lombardi, has a good summary of the financial exposures in testimony he gave to the Senate, available at http://www.brookings.edu/testimony/2011/0922_european_debt_crisis_lombardi.aspx

problem loans in the rest of the world, including our own country, induced by global economic problems.

Fourth, there is the effect on business and consumer confidence. We saw a taste of this in August, when problems in Europe quickly communicated themselves to our own financial markets and to confidence levels. Individuals and businesses are already scared. They would surely pull back on spending and investment still further if the European situation went badly wrong.

The combined effects of these four channels would almost certainly be enough to put us back in recession, although it is difficult to quantify the effects precisely, especially since there are numerous scenarios for exactly how the Euro Crisis could blow up.

Europe will probably muddle through, even though the process will be ugly and frightening. However, there is perhaps a one-in-four chance of a truly bad outcome, leading to a series of national defaults that include Greece, Portugal, Ireland, Spain, and Italy. There is also a small chance of one or more countries leaving the Euro, which would create still more damage. My one-in-four probability estimate is necessarily a very rough one. There are many different ways things could go wrong, since the eurozone is made up of 17 nations with their own political, economic, and financial systems. Each risk has a low probability, but there are a multitude of those risks, so they add up. I have attached a short paper giving more details about the crisis, particularly why it is so hard to solve and how it may proceed from here. The paper can also be found on the internet at:
http://www.brookings.edu/papers/2011/0822_euro_crisis_elliott.aspx

The actions expected to be announced this week may well improve the situation, but will be far from sufficient to resolve the core problems. First, government leaders are unwilling to increase their national commitments to the European Financial Stability Facility beyond the previously agreed 440 billion euros, which is clearly inadequate to reassure markets, especially since much of that is already committed. Therefore, they are looking for ways to leverage those funds to get closer to the 2 trillion euros or so of capacity that is really needed. It appears this will be done by providing guarantees or insurance on a portion of the value of bonds issued by troubled eurozone countries. This is better than doing nothing, but is unlikely to restore markets in those countries to anything like normal operations. Knowing that the first 20% of potential losses on Portuguese or Italian bonds will be absorbed by someone else is not that reassuring when investors in Greek bonds are about to be hit with losses of 40-60%. The type of investors who would be lured by such guarantees are the ones who look for fat returns from somewhat riskier investments, which suggests that bringing them in will not appreciably reduce the interest rates paid by these governments. Instead, government bond markets need the much larger capacity and liquidity provided by the kind of investors who look for safe, liquid investments. That will not happen without solving the underlying problems or providing guarantees backed by more creditworthy countries or multi-lateral bodies.

Second, a bank recapitalization that adds approximately 100 billion euros of capital is also a step forward, but, again, will not lay investor fears to rest. The IMF recently estimated that sovereign debt problems had eaten away at least 200 billion euros of economic capital from the European banks. Adding a figure half that large is unlikely to impress markets. Looked at another way, 100 billion is about one-tenth of the approximately one trillion euros of capital already held by the 90 large European banks that would be subject to the new requirements. It also represents less than half a percentage point of the 27 trillion euros of assets owned by those banks.

The technical details of the recapitalization will matter as well. If designed badly, the plan could even do harm by encouraging European banks to cut back on lending and to sell existing assets, potentially creating fire sales such as contributed to the financial crisis in 2008. A serious credit crunch would likely plunge Europe into recession.

Third, strong-arming investors into "voluntarily" accepting losses of 40-60% on their Greek government bonds will certainly add to the risks of contagion if market concerns about other troubled eurozone countries spike again at some point.

Whatever happens this week, we would be wise to prepare, in case the crisis worsens. We should continue to strongly encourage the Europeans to take the necessary steps. We should continue to provide US dollar swaps to the European Central Bank for them to use to help their banks with dollar-based funding needs. Our regulatory agencies should continue to monitor the exposure of our financial institutions to European risks, but without making the Euro Crisis worse by over-reacting.

Finally, we should stand ready to consider ways in which the IMF might provide further assistance to Europe. The Eurozone has the joint resources to solve its own problems, but participation by the IMF brings multiple advantages. First, it increases the total pool of resources, in order to reassure extremely jittery markets. Second, it can impose some discipline on the borrowers through conditionality on its loans, which is easier for an outside party to demand. Third, it can provide quite considerable technical aid in dealing with economic restructurings, such as are needed in this case. This technical advice carries more weight when the IMF is also committing money.

This is a European problem and they will need to provide the backbone of any solution, but it is strongly in our interests to help in any reasonable way that we can.

Thank you for the opportunity to testify. I welcome any questions you have for me.

BROOKINGS

MONDAY OCTOBER 24, 2011

Why Can't Europe Get it Right the First Time... or the Second... or the Third?

Financial Markets, Financial Institutions, International Finance, Europe, European Union

Douglas J. Elliott, Fellow, Economic Studies, Initiative on Business and Public Policy

The Brookings Institution

AUGUST 22, 2011 —

The Euro Crisis has struck again, hammering not just European markets, but doing real damage to U.S. markets and to economic prospects around the world. The U.S. could easily be pushed into another recession if the eurozone collapsed. We export well over $300 billion a year to those 17 countries; virtually all of the rest of our exports go to nations that also export to the eurozone and would feel ripple effects; roughly two-fifths of our overseas assets are invested in the eurozone; and our major financial institutions have large credit exposures to eurozone banks and other businesses.

It seems remarkable to many Americans who are following this at a distance that the politicians and Eurocrats cannot find a way to end the crisis, or even to contain it for more than a few weeks or months at a time. The government responses to each phase of the crisis follow the same repeated pattern. First, deny that anything needs to be done beyond what has already been agreed and blame the markets for launching "speculative attacks" out of impatience, misunderstanding, or greed. Second, when these denials just scare the markets further, scurry to convene high-level meetings to work out some step forward that will stop the market disaster that is building. Finally, at the last possible moment, announce a major move towards further economic integration of the eurozone, focused in particular on providing more support from the solid parts of the zone to the weaker ones. However, this major move is never enough to prevent the seemingly inevitable next phase of the crisis, in part because the biggest moves require approval of 17 national parliaments, which takes time and adds uncertainty. Worst of all, each phase of the crisis is more threatening than the last. (Who would have believed two years ago that there would be serious fears expressed about France's creditworthiness?)

From a distance the responses can seem outright inept, but the core problem is really the cruel set of constraints the politicians face. For many of them, the choice appears to be between losing the next election by taking bold actions that are highly unpopular with the public or losing the next election because a failure to take such actions leads to a breakdown of the eurozone and a vicious recession. Faced with a choice of being hung or electrocuted, the leaders naturally search for another option, which consists of taking strong enough action to postpone the climax of the crisis while avoiding crossing the public mood so thoroughly that electoral defeat is guaranteed. This at least gives them the chance that external events will rescue them, the fears will prove to be overblown, or the public mood will adjust to accept the bigger steps that will ultimately be necessary. Buying time is not heroic, and may not even be leadership, but too many heroes receive their medals posthumously for heroism to appeal to most politicians.

Before walking through the detailed analysis of the mistakes that led to the present peril, I feel compelled, as a non-European, to stipulate that America also made grievous fundamental mistakes as it struggled to establish a union [1] and our recent debt ceiling debates likewise show that tough political constraints can make leaders look inept. This is

not about European stupidity or blindness. If anything, some of the problems stem from being "too clever by half," in particular by assuming that known weaknesses in the original structure would lead to future problems that would spur greater economic integration at that time.

The eurozone was established, and operated for many years, with a potentially fatal flaw. The nations combined their currencies, and therefore their monetary policy, without doing much effective to insure that their economies operated similarly enough for a single monetary policy to work. In fact, the original Stability and Growth pact that was intended to at least limit national deficit levels was gutted when it started to constrain Germany and France, the two most dominant powers in the eurozone.

This critical weakness was exacerbated over time as the markets convinced themselves that the credit risks of all eurozone governments were roughly the same, in part because the solid economies of the zone would presumably never permit the weak countries to default [2]. This set the zone up for massive problems when it became clear that diverging economies and political responses over the years had created major differences in the true creditworthiness of the different countries on a stand-alone basis and that the German public, for example, might not be keen to step up to support the Greeks in their hour of need. (It did not help, of course, that it turns out the Greeks had literally lied in important matters in their application for eurozone membership in the first place and continued lying for some time. The resultant anger came on top of the substantive problem that the German public viewed the Greeks as running an excessively generous welfare state and refusing to collect the taxes needed to support it.)

There are also strong connections between weaknesses in Europe's banking systems and the problems of sovereign debt, which make both sets of issues harder to fix. Banking crises, and the threat of them, have done severe financial damage to the public finances of some weaker countries, particularly Ireland. At the same time, banks hold large quantities of sovereign debt of the weaker countries, putting the financial system in danger from potential sovereign defaults. This is too complicated and important a topic to fully address here, but the interconnections make solving the Euro Crisis even harder.

Whatever the risks, the creation of the euro did bring many benefits. The founders of the euro believed that a common currency would move its members substantially closer together economically, making it easier, for example, to sell common products and services across European borders without currency risk. The euro also encouraged common pricing across the eurozone by making it easier for customers to see price differences, without the obscuring effects of currency differences. Some of this was psychological, but it does seem to be true that the advent of the euro brought zone members substantially closer together. Equally or more important, having a common currency and monetary policy largely removed the risk of excessive inflation that had existed in many of the member countries, pushing up interest rates, hurting their currencies, and generally harming economic performance. Most of the founders also shared a political goal of "an ever closer union", as the slogan of the EU runs. Sharing a common currency was a major step forward in this direction, if only because the zone members needed to agree on a common monetary policy and to coordinate in other ways.

Most of the founders appear to have recognized that there were economic risks in bringing countries together in a currency union when there were still so many differences in their economies, political structures, and cultures. However, the potential gains were large and they thought that they could manage any problems that arose. This was not unreasonable, since the European Union over time had developed more and stronger common structures in part through an incremental process in which difficult periods brought the response of creating or enlarging common institutions to combat the problems. Frequently, the answer to the problems of Europe came to be "more Europe."

These founders may be proved right in the end that any crises with the euro would be resolved through greater integration, which is the approach already being attempted. Unfortunately, they may end up echoing the words of King

Pyrrhus after he won a very costly battle, "one more such victory and I am undone." In the year and more since the Euro crisis erupted in earnest, the eurozone has taken a number of steps towards greater union that would have been virtually unthinkable two years ago. Taxpayers across the eurozone have provided guarantees supporting loans to Greece, Ireland, and Portugal, in exchange for which these countries have signed on to promises of quite painful changes. An even larger European Financial Stability Facility (EFSF) is pending approval by national parliaments, which is targeted to occur by late September or early October. (This will eventually be succeeded by an even broader European Stability Mechanism.) The EFSF will have a great deal of latitude to provide financial support for struggling eurozone countries, including providing funding to support banks in those countries, in exchange for what are likely to be fairly drastic policy changes. Even the initial loans contravened long-standing assurances that each nation was on its own as regards the repayment of its debts. These were not trivial assurances. It is doubtful that Germany, for example, would have been able to join the euro without those assurances to its voters.

The European Central Bank has purchased existing government bonds of Greece, Ireland, Portugal, Spain and Italy. This was to support their market prices and therefore hold down market interest rates and, hopefully, the rates these governments will have to pay for future bond issuances. This was a huge move, since it puts the ECB at risk of losing substantial sums of money if there is an eventual default on some of these bonds or if it has to sell the bonds at a time when prices are lower. The ECB has also continued to accept government bonds from the troubled countries as collateral for loans to European banks. Without this, it is doubtful that some of the weaker banks in the struggling countries could survive, since they own substantial amounts of government debt, often having no choice in the matter due to regulatory requirements. Taking these steps together, the ECB is playing a critical role, perhaps even the critical role, in supporting the financial stability of the eurozone. There are many who fear the ECB is losing a considerable portion of its independence by doing work that national governments should be doing [3].

These are strong actions. If they had been taken at the beginning of the crisis, or if mechanisms had been set in place to do these things when the euro was founded, it is unlikely that the crisis would have grown to nearly its present proportions. It would have been clear that the strong eurozone members highly valued the euro and would take extraordinary steps to ensure the zone survived, which, after all, was the market's view for most of the first decade of the euro's existence.

So, why is there still a problem, and quite a major one? Unfortunately, the governments of the strongest eurozone member states have shown a great resistance to taking each one of these necessary steps and they continue to strongly resist further steps which have become necessary. Markets understandably feared each time that the latest set of crisis responses might prove to be the limit of what the eurozone could do. This matters because none of the steps to date, big as they are, will be enough if market fears balloon much further.

Sufficiently strong and sensible government responses can put an end to the crisis. The eurozone, taken as a whole, clearly has the economic capacity to pay all of its debt. The market fears are that the weaker members of the eurozone cannot solve their debt problems on their own and that the strong countries may not provide sufficient support to overcome those weaknesses. These fears were ratcheted up considerably by the demonstration effect of seeing the main private holders of Greek debt pushed into accepting more than a 20% loss on the face value of their bonds. This may have been politically essential in order to gain consensus for the other steps to fight the crisis, but it rattled the markets. We have now gone from a situation where many investors viewed eurozone bonds as nearly riskless to one in which substantial losses are quite conceivable, even probable in some cases. Not surprisingly, markets started demanding higher interest rates to compensate for the evolving risk, rate movements that helped trigger the next phases of the crisis.

For the eurozone to avoid the true disaster scenarios, it will almost certainly be necessary for the member countries to provide a common guarantee for much, if not all, of the debt of the other member countries. (There also need to be long

run, and difficult, actions to deal with major competitiveness problems in the periphery of Europe, particularly in Greece. These are important, but lie outside the scope of this paper.) The markets are too concerned to accept anything less than an ability to rely on the economic strength of the full eurozone (or, realistically, of Germany and the other strong members.) There are multiple ways to do this, of which the leading candidate appears to be the idea of a "euro bond," also known as a "blue bond," after the predominant color of the EU flag. Blue bonds would be backed ultimately by a "joint and several" guarantee from the member countries, meaning that each accepts the full obligation to repay any other member's blue bonds if that country does not repay the bonds directly. (There are also variations of this plan in which the European Financial Stability Facility, or a similar body, would be the issuer of the bonds.) The leading proposal would limit the amount of blue bonds each member country could sell, and thereby limit the exposure of the other member countries through their guarantees. Any additional borrowing would have to be in "red bonds" that would be less creditworthy since they would have no guarantees.

The beauty of the blue bonds is that they would be highly creditworthy and would therefore allow countries to borrow easily at a very low cost, making the debt problems of the weaker countries much easier to bear. Over time, it is even possible that blue bonds might rival U.S. Treasury bonds as the perceived safest asset an investor could own. Blue bonds may also be the weakest form of fiscal integration that is still strong enough to reassure the markets. (It would be a giant step, but still not as big as some other potential approaches.) At the other extreme, a unity tax could be put in place on all eurozone citizens, with the taxes dedicated to paying down the debt of the various countries. Less drastically, eurozone governments could agree on larger transfers of aid to the weaker countries, effectively using taxes on the strongest countries to aid debt repayment by the weakest. Solutions of this more direct type, with major transfers rather than the issuance of guarantees, would be much more difficult to sell politically and are probably not feasible except as a small part of a larger approach.

Even if one accepts the economic need for greater fiscal integration, politics may render it impossible. Leaders in Germany and other strong eurozone countries are caught in a terrible vise. Their constituents do not support the necessary actions, which they perceive as being a bailout of foreigners at the expense of themselves. They also fear that the necessary actions to restructure the troubled economies will not be taken, leading to costly long-term life support from the strong economies, especially Germany. Germans do know that there would be some pain if the euro fell apart, but most of them disliked trading in their beloved Deutschmarks for euros in the first place and do not recognize quite how difficult it would be to go back again. On the other hand, the political leaders can generally see that their countries would be devastated by the collapse of the euro, even if the public cannot. This leaves them with the choice of saving the euro while angering their voters or risking a renewed severe recession that would also make them very unpopular with voters, while doing their country permanent harm. In the end, I believe that the leaders will stare into the abyss, turn back, and take the necessary measures, despite the potential for immense short-term political pain. However, this least-bad outcome is far from guaranteed, which is an underlying reason why European bond markets are so troubled.

Why would it hurt Germany so much if the eurozone collapsed? The exact mechanisms depend to some extent on the form of the collapse. Weak eurozone countries could default on their bonds, as Greece effectively has done, in which case the degree of market reaction would depend to some extent on whether the losses were at least negotiated semi-voluntarily with major market participants, as well as, of course, views about whether other weak eurozone members might default. Unfortunately, it is likely that quite a number of eurozone countries would default unless the leaders take the kind of bold action discussed later that could prevent a collapse of the eurozone. Each country that defaults increases the market pressure on the next weakest, as we have already seen after Greece defaulted.

It is also possible that one or more eurozone members would withdraw from the euro. This outcome would be very bad in the short run, although there are some who claim that Greece, for example, would be better off over time by shaking off the shackles of the euro and adopting their own monetary policy and allowing their currency to devalue. (Others

argue that the resulting inflation and weak currencies would combine with other problems to make the Greeks much worse off in the long run.) Unfortunately, we do not know how bad the outcome would be even in the short run, in part because the euro was deliberately set up without a mechanism for unwinding it. There are immense legal, political, and economic issues that would have to be resolved in this extreme case. (This lack of a mechanism was, to a large extent, a deliberate poison pill to make it impossible to contemplate backing out.) Nor do we know what the net benefits or costs would be in the long run, because of the difficulty of prediction about such a complicated change.

Despite the uncertainties, it is highly likely that Germany would be hit very badly through a combination of mechanisms if the eurozone breaks in one of these manners. The weaker countries that defaulted or even left the eurozone would surely go through a severe recession initially, no matter what the longer-term effects. Chaos would ensue until things gradually clarified, business and consumer confidence would plummet, and external funding would likely disappear for a time. Germany would be directly affected by the loss of exports to these countries and by investment losses for Germans citizens and institutions with stakes in businesses in the defaulting nations. In particular, German banks have lent large sums of money to governments and to banks in many of these weaker countries, which could trigger a credit crunch as crippled German banks cut back on their risk taking. Other countries, both in the eurozone and outside of it, would suffer similar losses of exports and investment losses, which would weaken their own economies, producing further export losses and investment losses for Germany.

If some of the defaulting countries also left the eurozone and established their own currencies, these currencies would almost certainly fall sharply in value against the euro, hurting German export competitiveness in relation to these countries. Exports are a major part of the German economy, so lost exports matter a great deal. As an illustration, Germany suffered a significantly greater loss of production than the U.S. from the initial impact of the recession caused by the recent financial crisis, because exports dried up and Germany is much more dependent on net exports than is the U.S.

Chancellor Merkel in Germany is in an unenviable position. The junior partners in her own coalition, the Free Democrats, strongly oppose blue bonds and other forms of substantial fiscal integration. The Christian Socialists, historically very close allies of Merkel's Christian Democrats, to the point of almost being the Bavarian wing of the same party, are not keen on greater fiscal integration, although they might go along in the end. The main German opposition parties, the Social Democrats and the Greens, appear supportive of greater fiscal integration, but Merkel would have to agree to major changes to other parts of her political program if she let the Free Democrats drop out of the coalition and allied herself instead with one of the opposition parties. Worse, from her point of view, blue bonds could be one step too far for the German public, leading to a dramatic repudiation in the next election.

She does have one unusual structural advantage, though. The German constitution requires a "positive vote of no confidence" to remove a Chancellor, meaning that, unlike in almost every other parliamentary democracy, a government cannot be pushed out without a new viable government being simultaneously voted in. This is important, because it is not clear that anyone else could garner a majority in the Bundestag, the more powerful of the two houses of parliament and the one that chooses the Chancellor. Therefore she may have until the fall of 2013, when the next election must be held, in order to recover from the initial blast of unpopularity [4].

Whatever the exact politics of the situation, the broad outlines are very ugly for the chancellor. The right choice may be to support a least-bad solution that would anger many of her voters. This is similar to the TARP vote in the U.S., including in the fact that the direct beneficiaries are not viewed as deserving by the public. Nobody liked American bankers when TARP was voted on and it would be difficult to find a German today who felt that the Greeks morally deserved assistance. (Again, the cheating by the Greeks on their application is extremely galling to Germans and others in the eurozone, in addition to all the other self-created problems in the Greek economy and political structure that worry the German public.)

There is another quite relevant parallel with the TARP vote. "Europe" has always garnered much more support among the elites of that continent than among the broader publics. It is unlikely that a number of the major steps towards closer union, including the establishment of the euro, would have gone forward if referendums had been required in each of the major countries. German voters, for example, were clearly loath to give up their Deutschmarks, but were not given a chance to veto the move. The parallel with TARP is that it is hard to persuade voters to do something as distasteful as providing a large aid package to people they view as undeserving, when the arguments in favor rely on accepting that the elites understand what is needed at a time when faith in those elites is at a very low ebb.

Speaking of the TARP, another reason that Europe's leaders may eventually do what is necessary to prevent a collapse is that sovereign defaults by the weaker governments could force a costly set of bank rescues by Germany and the other strong governments. (The weakest ones may not have the resources in that case to rescue their own banks, but may simply have to nationalize them and pick up the pieces and start over, effectively creating a new banking system.) German and French banks, for example, own large amounts of sovereign debt of the weaker countries in the eurozone. They also have large exposures to corporations in those countries. Widespread defaults in the eurozone would render many banks insolvent and others very shaky, threatening a severe credit crunch. Even the ECB could take large losses that would probably require a recapitalization by those countries remaining in the eurozone. So, there may be no avoiding a large bill for the taxpayer, whether to rescue other eurozone countries or to rescue German banks harmed by the defaults from those nations.

Returning to the question posed in this paper's title, the core reason that Europe has not yet gotten its response to the Euro Crisis right, despite multiple attempts, is that political constraints make it extremely difficult to do the ultimately necessary things. Even now, we cannot be certain that the key political leaders will be willing or able to take the final bold steps to halt the crisis. One can only hope that staring over a cliff at a very steep drop may produce the necessary resolve. One unfortunate corollary is that we will probably have to live through a couple more escalating phases of the crisis before the drop looks terrifying enough to persuade the leaders to put in place the ultimate solution.

Footnotes

[1] The first U.S. constitution, the Articles of Confederation, proved so flawed that a completely new constitution had to be written within a few years. This constitution, our current one, fudged major issues around the relationship between the federal and state governments and, to our shame, about slavery. As a result, we almost faced secession in the 1820's and then fought a civil war in the 1860's. So far, there are no armies rolling across European borders and the debate has been surprisingly civil considering the high stakes and divergent views.

[2] The eurozone governments always stated that there was no such guarantee, but the markets did not believe them, in part because few steps were taken to avoid a situation such as the current one, where the provision of aid, and even some guarantees, became inevitable.

[3] Acting as a "lender of last resort" is the classic role of a central bank, so this in itself is not a problem, but the theory has always been that the central bank would lend against solid collateral. Buying government securities that the market views as risky, or accepting collateral at what the market views as inflated values, does not fit with this concept. The idea of central banks taking high levels of risk of loss is anathema to most central bankers.

[4] This advantage is somewhat offset by a rolling set of state elections which could change the balance of power earlier in the Bundesrat, essentially the other chamber of parliament, representing the states. However, the Bundesrat is considerably less powerful than the Bundestag, having a say only on certain areas of legislation, albeit important ones, and in some areas only the ability to delay legislation, if the Bundestag supports it in a second vote. There is also a Constitutional Court which could conceivably block German acceptance of greater fiscal integration in the Eurozone. However, the Court has shown in the past a marked reluctance to overrule the government on items of this level of

importance regarding Europe. They may be very loath to set themselves up to be blamed for a collapse of the eurozone by invalidating government actions in this area.

Implications of the Euro crisis for the United States

(Testimony for the subcommittee on International Policy and Trade)

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American Enterprise Institute

October 25, 2011

The Euro Crisis is intensifying

1. 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. 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 Euro-zone 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.

2. 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.

3. The European Central Bank (ECB) is correctly warning that a hard 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

4. Since July 2011, **the Italian and Spanish bond markets have been under substantial market pressure**. This has necessitated more than EUR 75 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 currently around US$4 trillion.

5. 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 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.

6. 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 EUR200 billion, while some private estimates consider that the banks are undercapitalized by more than EUR300 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.

Implications for the United States Economy

7. 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.

8. 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?

9. 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 now plan 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 EUR 2 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.

10. 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 that 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 EUR 2 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

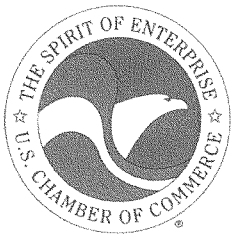
11. To date, the **US has supported the Europeans through the IMF, in which the US has a 17 percent stake, and the through the Federal Reserve**. Over the past eighteen months, in each of the massive IMF-EU bailout programs for Greece, Ireland, and Portugal, the IMF has provided around one third of the 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.

12. 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.



Statement
of the
U.S. Chamber of Commerce

ON: The Eurozone Debt Crisis and Implications for the United States

TO: Hearing of the House Financial Services Subcommittee on International Monetary Policy and Trade

BY: Mr. Peter Rashish, Vice President for Europe and Eurasia, U.S. Chamber of Commerce

DATE: Tuesday, October 25, 2011

The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest business federation, representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations.

More than 96 percent of the Chamber's members are small businesses with 100 or fewer employees, 70 percent of which have 10 or fewer employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business manufacturing, retailing, services, construction, wholesaling, and finance — is represented. Also, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. It believes that global interdependence provides an opportunity, not a threat. In addition to the U.S. Chamber of Commerce's 115 American Chambers of Commerce abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross section of Chamber members serving on committees, subcommittees, and task forces. More than 1,000 business people participate in this process.

Thank you Chairman Miller, Ranking Member McCarthy, and distinguished members of the House Financial Services Subcommittee on International Monetary Policy and Trade. My name is Peter Rashish, and I am Vice President for Europe and Eurasia, U.S. Chamber of Commerce. The U.S. Chamber of Commerce is the world's largest business federation, representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations.

The transatlantic commercial relationship is by far the largest in the world, with the United States and the European Union (EU) surpassing $4.3 trillion in trade, investment and sales by foreign affiliates of companies in one another's markets. Total U.S. exports to the EU of goods and services amount to $414 billion or about 22 percent of U.S. exports. U.S. companies have over $1 trillion invested in the European Union. In Ireland alone, the stock of U.S. FDI totaled $165 billion at the end of 2009 — more than the U.S. total for China, India, Russia, and Brazil combined. EU investment in the United States supported 3.6 million jobs in 2008. European investment in California alone supported 287,000 jobs, while its investment in New York supported 255,300 jobs. Together the United States and the EU account for over 54 percent of world GDP and 63 percent of the global stock of inward foreign direct investment and 73 percent of outward FDI.

These figures make it plain that the fate of the U.S. economy is intimately entwined with the fate of the European Union and the Eurozone. Because of the deep level of integration between our two economies, we will sink or swim together. There is no question that the unraveling of the Eurozone would not only have severe economic consequences for Europe, but for the U.S. economy as well.

Capital formation and liquidity on both sides of the Atlantic is one imperative for strong bilateral economic growth. While it is clear that the sovereign debt crisis is creating pressures on the financial services sector, there are a number of important issues below the surface that could harm the ability of businesses to tap the liquidity they need to operate and grow. With derivatives, a failure to allow corporate end-user exemptions from clearing and margin will either expose American and European businesses to more risk, or force derivatives trading to be concentrated in Asia. Similarly, a failure to address the indemnification issues for swap data repository institutions could lead to a balkanization of regulatory access to swap data on both sides of the Atlantic. At home, actions such as the Volcker Rule which are not coordinated with the European Union could lead to an un-level playing firm for U.S. firms.

The collapse of the Eurozone would destabilize fragile financial systems and also mean the end of the common currency and the efficiencies it has brought to the European market — lower inflation, interest rates, and transaction costs. The end of the Eurozone would also likely lead to the disintegration of one of the European Union's crowning achievements — the single market enacted in 1992 — as member states seek to protect their firms and shelter their economies from the effects of competitive devaluations by weaker countries leaving the common currency. Without the single market and its "four freedoms" of movement of people, goods, services, and capital, not only would Europe's

economy suffer but U.S. companies would no longer be able to benefit from operating across a barrier-free EU internal market just as Europeans firms do.

It is clear that the failure of Europe's leaders to find a lasting solution to the crisis in the Eurozone would put at risk the prosperity that the United States derives from its commercial relationship with Europe in terms of economic growth, exports, and jobs. It is also true that while Europe's political commitment to finding a solution is strong, it is struggling to find the right combination of financial and monetary policy tools that can contain financial contagion, shore up the banking system, and rein in fiscal deficits while boosting economic growth. Without economic growth, no amount of budgetary austerity or financial rescue programs will provide a long-term solution to Europe's economic woes.

Where can Europe find the economic growth it needs, which would ensure that the United States continues to reap the enormous commercial benefits from its trade and investment relationship with the European Union?

One avenue is for European Union member states to pursue structural reforms of their economies that would liberate growth — for example, lifting barriers to entry in the services sector (including retail, the professions, logistics), creating more flexibility and mobility in labor markets, and reforming pensions policies. These kinds of barriers exist in both indebted countries and more financially stable countries in the Eurozone, so reforms could benefit a wide swath of the European economy and open up significant new opportunities for U.S. firms.

Another path is for Europe to invigorate its push to complete its single market. While most barriers to trade across the EU have fallen, an important number remain in the services sector. The creation of the single market has led to a surge in intra-EU investment — from €500 billion in 1994, two years after its creation, to €4.5 trillion in 2007. This internal dynamism has been a key source of the EU's economic growth, and the elimination of the remaining barriers in its market would have major benefits for its economy — and for ours.

There is, however, one area that until now has been neglected as a source of increased economic growth in the EU and, for that matter, in the United States — the trade relationship between the two commercial partners. If the two transatlantic economic powers want to inject more dynamism into their economies in a non-inflationary way, there is one quick step they should consider: agree to eliminate all tariffs in transatlantic trade.

While tariffs are low between the United States and the EU, because of the enormous size of the economic relationship, even small steps can yield significant gains in prosperity. According to a report by the Brussels-based European Center for International Political Economy (ECIPE), a successful "Transatlantic Zero" tariff-elimination initiative would increase combined U.S.-EU GDP by $180 billion within five years. That is more added growth than either would receive from the completion of the

Doha Round of multilateral trade talks.

While the Doha Round is facing serious obstacles to its completion, a "Transatlantic Zero" deal could be agreed quickly as the kinds of issues that have held up bilateral trade pacts in the past — social, labor, and environmental standards — should not be a factor between the United States and the EU. Since one-third of transatlantic trade is between branches of the same firm, eliminating tariffs on that trade would cut costs for both U.S. and European companies and make them more competitive in global markets.

Longer term, the United States and the EU should be ambitious and not stop at eliminating tariffs. They should aim to open up their services markets to each other, create a single investment area, and pursue compatible regulatory regimes. Such an initiative does not have to be a traditional free trade agreement, based on a single undertaking, which could take years to complete if progress in one area is dependent on how far negotiators have gotten in another. But to avoid the unfulfilled solemn declarations of the past, the United States and the EU should commit themselves in a legally binding way to the achievement of a barrier-free transatlantic market.

On November 28, the United States and the EU will hold a summit meeting in Washington in which President Obama will welcome EU Council President Van Rompuy and European Commission President Barroso. An announcement at the summit of a bold transatlantic initiative for jobs and economic growth, including the elimination of tariffs on bilateral trade, would inject a sorely needed sense of confidence into both the EU and the U.S. economies and, once successfully negotiated would produce significant economic benefits to both sides.

A transatlantic trade agreement would not in itself free the EU and the Eurozone of the task of finding lasting solutions to the current crisis. But it would create prospects for growth in Europe without which the crisis will be likely to endure.

The U.S. Chamber of Commerce looks forward to working with the members of the Subcommittee to seek the full benefits of the transatlantic economy for American workers and companies. Thank you very much.

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