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THE EUROPEAN DEBT AND FINANCIAL CRISIS: ORIGINS, OPTIONS, AND IMPLICATIONS FOR THE U.S. AND GLOBAL ECONOMY

HEARING

BEFORE THE

SUBCOMMITTEE ON
SECURITY AND INTERNATIONAL TRADE AND FINANCE

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

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FIRST SESSION

ON

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SEPTEMBER 22, 2011

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C O N T E N T S

THURSDAY, SEPTEMBER 22, 2011

	Page
Opening statement of Chairman Warner	1
Opening statements, comments, or prepared statements of:	
Senator Johanns	3
Senator Bennet	3

WITNESSES

Nicolas Véron, Visiting Fellow, Peterson Institute for International Economics, and Senior Fellow, Bruegel	5
Prepared statement	28
Joachim Fels, Global Head of Economics, Morgan Stanley	7
Prepared statement	37
Domenico Lombardi, President, the Oxford Institute for Economic Policy and Senior Fellow, the Brookings Institution	10
Prepared statement	39
J.D. Foster, Ph.D., Norman B. Ture Senior Fellow in the Economics of Fiscal Policy, the Heritage Foundation	12
Prepared statement	52

THE EUROPEAN DEBT AND FINANCIAL CRISIS: ORIGINS, OPTIONS, AND IMPLICATIONS FOR THE U.S. AND GLOBAL ECONOMY

THURSDAY, SEPTEMBER 22, 2011

U.S. SENATE,
SUBCOMMITTEE ON SECURITY AND
INTERNATIONAL TRADE AND FINANCE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee met at 2:32 p.m. in room SD–538, Dirksen Senate Office Building, Hon. Mark Warner, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF CHAIRMAN MARK R. WARNER

Senator WARNER. Good afternoon, everyone. I would like to call to order this hearing of the Senate Banking Subcommittee, which topic today we have entitled "The European Debt and Financial Crisis: Origins, Options, and Implications for the U.S. and Global Economy."

Now, when we proposed this date with my good friend Senator Johanns, I am not sure we anticipated that this hearing would be, unfortunately, quite so timely as it appears to be today with the U.S. equity markets down, at last glance a moment or two ago, about 4 percent. With the Fed actions yesterday, with the continuing fears of what is happening in Europe, it is very, very appropriate, I believe, to have this hearing and to make sure that we recognize and fully appreciate how inexorably linked all of our economies are and how clearly what is happening in Europe affects the United States and our fiscal challenges directly.

I want to thank my good friend, Senator Bennet, for appearing here, and I know that Senator Johanns will be joining us in a moment, and I again would like to thank all the witnesses. I will come back to them in a moment.

Watching the markets, again, not only over the last couple of months but particularly today, it is clear that as U.S. policymakers I believe we need a greater and better understanding of both the interconnectedness and the implications of what is happening throughout the euro zone and, again, how it affects America. I think it is important, at least for the record, to restate some of the things that are obvious but that sometimes we do not focus on. We oftentimes in the Senate look at our growing challenges and imbalances, particularly with China and Asia, but, you know, Europe still remains America's largest trading partner. We exported $398

billion in goods and services to the EU in 2009 and imported more than $419 billion in goods and services, so while slight deficit, a relative balance.

In addition to these trade flows, in 2009 a net $114 billion flowed from U.S. residents to EU countries in direct investments, and on the other side of the ledger, over $82 billion flowed from EU residents into direct investments in the United States. Our economies, again, are inexorably linked.

On top of these flows, according to the Bank of International Settlements—we will go ahead and put up the first of our two slides—while a lot of the attention in the news has directly focused on Greece, one of the things that is remarkable to me is we do not really have a full recognition of how great our American exposure is to the Greek challenges.

U.S. banks have more than $7 billion, which on a relative basis, compared, obviously, to the United Kingdom, Germany and France, is not that great a number. But if you look beyond that in other potential exposures—and these are just from depository institutions—you have more than $34 billion in potential exposure.

And, candidly, this does not fully reflect what is our exposure just to Greece. We do not have information in terms of our insurance exposure. Hopefully there is not out there the son, cousin, or nephew of AIG lurking in terms of insurance. We do not have an understanding of our money market fund exposures. We do not have an understanding of, you know, banking, lending to hedge funds that might be also further invested in Greece.

If we go to the next slide, even assuming on a relative basis this is manageable, if you then look at our exposures to other European countries where there have been very real issues about the potential for contagion, you see this exposure growing dramatically. It really does reinforce the point that what is happening real time in Europe has a direct affect on American jobs, American growth, and, again, I believe that we are all in this together.

I would point out as well, one of the things that is of grave concern to me—and I know on this Committee and in the Senate there remains a great deal of controversy about some of the things that we did in the so-called Dodd-Frank bill. But with one of my other colleagues, Senator Corker, we put together Title I and Title II of that legislation, which created the Financial Stability Oversight Council and the Office of Financial Research with the goal of at least making sure that the regulators could get out of their stovepipes and see what our exposure in these kinds of circumstances is. And, unfortunately, I do not believe we have that information. At least I do not believe the Senate does, and, frankly, I am not sure that the Administration on both FSOC and the OFR has moved as quickly as we would have liked to make sure that at least we have got that information as we try to plan and coordinate action in terms of taking on this crisis.

So I will now turn to my friend and the Ranking Member, Senator Johanns, for any opening comments he might have, and then since we have got a small hearing, I will call on Senator Bennet. Then it will be my great pleasure to introduce the witnesses, and I am anxious to hear your testimony. Senator Johanns.

STATEMENT OF SENATOR MIKE JOHANNS

Senator JOHANNS. Thank you, Mr. Chairman.

Mr. Chairman, let me just say thank you for bringing us together today to discuss the economic situation in Greece, and I guess for that matter the rest of the European Union. I have to say your timing is remarkable.

Senator WARNER. I wish not.

Senator JOHANNS. I can share that sentiment. But I look at what is happening today in the markets, what happened last night, and the timing of this hearing could not be better in terms of just timeliness in terms of us trying to get an understanding of what the panel of witnesses thinks about all this.

I do not think there is any question whatsoever that our country is facing a fiscal challenge that the current generation probably could have never imagined, and we have to start making decisions to correct our fiscal ship.

As a Nation, we are borrowing about 42 cents of every dollar. I know of no economist anywhere in the world, whether they are considered a liberal or a conservative, who would put forward the argument to anyone that that is a sustainable course. It just simply is not.

Austerity measures in Greece have not calmed the panic, and the contagion around Europe continues to impact other countries. Certainly more fiscally responsible countries are beginning to wonder where this is going to lead and how far do they get entangled in this, although obviously they already are.

Widespread uncertainty over what is happening in Greece and countries around it is directly affecting the United States, and it is not just a big bank and a downgrade that they may be enduring. It is the teachers' retirement, it is the 401(k), it is all of those things that are real in the lives of our citizens.

This uncertainty only adds to the uncertainty of our domestic policies, many of which, I believe, are only stifling economic growth in the United States. Until nations such as Greece and the United States, for that matter, can provide confidence in our ability to control runaway debt and to deal with our fiscal houses, I believe we are going to continue to struggle.

This hearing, I hope, will enlighten us on maybe some mistakes that have been made and enlighten us on the interrelationship between our country and what is happening in the European Union. My hope is that we will have an opportunity to not only hear from you but to ask questions and try to get to the bottom of what is happening and get a better understanding today.

Thank you, Mr. Chairman.

Senator WARNER. Thank you, Senator Johanns.

Senator Bennet.

STATEMENT OF SENATOR MICHAEL F. BENNET

Senator BENNET. Thank you, Mr. Chairman, and I will be very brief because I want to hear the witnesses' testimony. But I also want to thank you for holding this hearing. It is very timely, and it is very important. This may surprise our witnesses, but there are people in this town that will say that things have to get worse before we can construct the politics that will actually solve the prob-

lem that we are facing. They will say, you know, not until it gets worse can we have a conversation with our constituents about what is needed to fix this problem. And I think that is a very tragic way of looking at it.

My hope is that this hearing, among other work that is being done on the Hill, will show how perilous the position we are in is today, how perilous the global economy is today, and the reason we care about that is, I think, for two reasons:

One, the folks in our States that are suffering through the residue of the worst recession since the Great Depression. You know, we find ourselves at a place where our productivity is very high, actually; our GDP has grown somewhat. But we have got 14 million people that are unemployed that we have not been able to figure out how to put back to work. We were at the end of—not the end, but at the end of about 15 years of median family income falling in this country. And those things are only going to get worse if we do not deal with these challenges that we face.

The other issue that we have is the fiscal condition that the country is in, which is threatening to constrain the choices that our kids and grandkids will make. But it also is having a profound effect on our economic activity in this country, I think. People are unwilling to invest when they have no idea what interest rate environment they are going to be in. And, you know, when you have got $1.5 trillion of deficit and $15 trillion of debt, and it is unclear to everybody that watches what is going on in Washington, the conversation that we are having here, whether we have the political capacity to actually get ahead of this, there is a lot of reason for concern.

So the first thing I would say is that it is not a sufficient answer to the people we represent that things have to get worse before we fix this problem. And, second, if we really are accepting as a Congress a standard of outcomes of success that is just keeping the lights flickering with temporary transportation bills and temporary FEMA bills and temporary continuing resolutions and all this kind of stuff, without doing the hard work that is necessary to deal with a crisis it is inevitably going to become, we are all going to rue the day that we did not have a more meaningful conversation about it.

So, Mr. Chairman, thanks for having the hearing, and I look forward to hearing the testimony.

Senator WARNER. Thank you, Senator Bennet. I again want to thank both my colleagues. They have been part of the group that has been trying to reach that common ground.

We have got a very distinguished panel. Let me very briefly introduce each of the panel members, and then we will take each of your opening statements. And we have got your statements. We have reviewed them. If you want to amend off of those, particularly in light of some of the immediate circumstances, please feel free to.

Nicolas Véron is a Senior Fellow at Bruegel, a Brussels-based economic policy think tank, and has served as a Visiting Fellow at the Peterson Institute for International Economics since October 2009. A French citizen, he has held various positions in the public and private sectors, including as corporate adviser to France's Labor Minister, as chief financial officer of the publicly listed Internet company MultiMania/Lycos France, and as an independent fi-

nancial services consultant. Since 2008 he has been a member of the CFA Institute's Corporate Disclosure Policy Council. He also recently co-authored "Smoke and Mirrors, Inc.: Accounting for Capitalism." Mr. Véron, thank you for being here.

Joachim Fels co-heads Morgan Stanley's global economics team and is the firm's Chief Global Fixed-Income Economist. Based in London, Joachim edits the Global Monetary Analyst, a weekly Morgan Stanley research publication. Mr. Fels joined Morgan Stanley in 1996 to cover the German economy; later he co-headed the currency economics team and the European economics team, where he won several number one ratings in the institutional investor poll over a number of years. Mr. Fels was also the firm's ECB watcher from the institution's birth in 1995 until 2005. He is a member of the Germany Banking Association's Economic and Monetary Committee and Volkswagen Foundation's Asset Allocation Advisory Board from 1999 to 2008. He has advised the German Finance Minister on international economic policy and financial market issues, and since it seems so much of what is going on in the EU now is dependent upon what Germany decides, we are particularly looking forward to your comments, sir.

Dr. Domenico Lombardi is a Senior Fellow for Global Economy and Development at the Brookings Institution. As an expert on G–20 and G–8 summits, international monetary relations, global currencies, his current projects focus on the recent and ongoing international financial crisis, the ongoing European crisis, and reform of the IMF and World Bank. He is also president of the Oxford Institute for Economic Policy. He is a member of a whole series of committees and associations, and we are grateful to have Dr. Lombardi here.

Dr. J.D. Foster, this is the second time we have had a chance to hear Dr. Foster—I at least—this week. He is the Norman B. Ture Senior Fellow in Economics and Fiscal Policy at the Heritage Foundation. His primary focus is studying long-term changes in tax policy to ensure a strong economy. He also examines changes in Medicare, Medicaid, and Social Security so they are both affordable and more efficient. Dr. Foster came to Heritage in 2007 after serving many years at the White House, the executive branch, Capitol Hill, and private policy institutions. His last job before joining Heritage was the White House Office of Management and Budget where he was Associate Director for Economic Policy.

Again, we have got four very distinguished panelists. We are anxious for your analysis of not only origins but kind of next steps, particularly in Europe. And, again, since many of you know who work in this town or here in America we still have this American bias, so if you could also help make clear how much real time going on in Europe both directly and indirectly affects some of the challenges we have in this country, that will be helpful as well.

Mr. Véron.

STATEMENT OF NICOLAS VÉRON, VISITING FELLOW, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS, AND SENIOR FELLOW, BRUEGEL

Mr. VÉRON. Thank you very much, Chairman Warner, thank you, Ranking Member Johanns, thank you, Senator Bennet, for giv-

ing me the opportunity to testify today. It is a great honor. It is also the first time, as far as I am aware of, that Bruegel, which is a young organization, has one of its fellows giving testimony on this Hill. So it is a moment of pride also for this organization and for the Peterson Institute. My views are very informed by conversations with my colleagues, which is why I mention many of them in my written testimony. My main focus in research is on financial regulation, and this also informs the emphasis of my remarks.

I also call for forgiveness for my imperfect English. I will probably make mistakes in expressing myself, so I call for your understanding.

Senator WARNER. You heard how badly I did some of my introductory comments in English, so you are doing quite well, sir.

Mr. VÉRON. The roots of the crisis, I believe, are very much to do with the European banking system and European banking system fragilities. Subprime, Lehman Brothers collapse, shock was exogenous to Europe. It came from the United States, but it revealed very significant weaknesses in the European banking system. One big difference between Europe and the United States is that the United States by comparison addressed its banking crisis more decisively and more quickly than the European Union, which did not have an equivalent to the sort of aggressive stress testing and recapitalizations that was endeavored in 2008 and 2009. Why? Because of a number of factors of political economy. But the fact is that the European Union has been in almost continuous stage of systemic banking fragility—you may call it systemic banking crisis—basically since 2007–08, so there has been a continuity on this.

And now we have—and this is my second point—a sovereign crisis which is really a combination between sovereign fiscal crisis and banking crisis. So the title of this session is well taken. It is really a financial and debt crisis, the two feeding each other. Of course, it started in Greece with the statistics manipulation of the Greek Government. The contagion went to other countries. In some countries, the banking system has had a negative impact on the fiscal dynamics, like Spain and Ireland. In other countries it has been the other way around, fiscal dynamics having a negative impact on the banking system, like Greece and Italy. But we have had very significant contagion.

Now, this could perhaps have been better resolved if we did not have also weaknesses in the EU institutional framework, and this is my third point. This is becoming basically a European institutional crisis because the inability of our institutions—and I say our institutions not our leaders, because I think institutions are more to blame than individual leaders. So their inability to provide the right solutions in a timely fashion has been a very significant factor in the crisis, especially at this point. I think when you discuss with investors these days, they really express very vividly the feelings that the political systems or policymaking system are not delivering, and this is their major focus on concern, even as much or in some cases even more than the bad debt dynamics or the bad economic situation.

My fourth point is that the resolution of this crisis, because of all the time lost and because of all these components, will need basically four planks. We need to put in place a credible system of

fiscal federalism in Europe, and there are many ways to do that, but it is something new compared to the current situation where monetary policy is being done in a federal framework but not fiscal policy.

Then I think we also need banking federalism, which is perhaps less discussed but, in my view, as important. We need a truly European banking system. At this point we have an unstable hybrid between national banking systems and European banking integration. It is not sustainable. And to enable this, we need a significant overhaul of EU institutions to make them more accountable, more accountable to EU citizens, and giving them a better executive decisionmaking capability. So this implies treaty changes. It is very complicated. In the meantime, we need gap financing for those countries which need it, probably some debt restructuring—I am sure we will come back to this—and also some bank restructuring which goes with the sovereign restructuring under the current institutional framework.

My fifth and final point is about the outlook. There is no sufficient political willingness at this point to provide what I have identified as conditions for crisis resolution. So, unfortunately, in the case of Europe, I am afraid it will get worse before it gets better. And this will have an impact in the United States, the same way the U.S. crisis had an impact on the EU in 2008.

I think there are encouraging recent signs of the debate moving forward in Germany and other countries, but we are not yet there.

Will this lead to a break-up of the euro area? I do not believe so. I do not even believe that Greece will leave the euro zone because I think this is a case of united we stand together or we fall, and that the alternative of break-up or some countries leaving the euro zone will be really very negative in their consequences, so leaders will not go for it.

The EU framework may be strengthened in the end by the results of the crisis, but in the meantime, the road will be very bumpy, and I think Europeans will pay a high price for it.

Thank you very much.

Senator WARNER. Thank you, sir.

Mr. Fels.

STATEMENT OF JOACHIM FELS, GLOBAL HEAD OF ECONOMICS, MORGAN STANLEY

Mr. FELS. Thank you, Mr. Chairman. Thank you, Senators. It is a pleasure and an honor to be here today.

I will focus on three issues: first, the origins of the crisis; second, the options to resolve it; and, third, the implications, the macro implications for the United States and for the global economy.

Now, starting with the origins of the crisis, I think there are three key factors at the root of the current crisis:

First—and it was already mentioned by Mr. Véron—the very peculiar institutional framework of the euro area because we have a single monetary policy conducted by a central bank with a very narrow inflation focus; then we have a decentralized fiscal policy, and we have a decentralized banking supervision in the 17 members states. So a very unique set-up.

Second, we have an oversized and undercapitalized and fragmented banking sector in the euro area, so that is very different from the U.S. situation.

And, third, we have diverging trends in growth and price competitiveness between the member states, and this has led to very large current account imbalances within the euro area, and it has led to a buildup of debt in the deficit countries.

Now, I think that the most important of these three factors is the institutional set-up, and one distinctive feature of this framework is that monetary policy is centralized, but individual member states have retained their fiscal sovereignty.

Now, we put rules in place to avoid irresponsible fiscal behavior—that was the so-called Stability and Growth Pact—but as we found out, it did not work and many member states have been running excessive fiscal deficits because we did not have well-designed rules.

Moreover, the European Treaty contains a "no bailout" clause. I think that is well know. It states that no member country can be forced to stand in for the debts of other member countries. And at the same time, the treaty lacks a mechanism for orderly sovereign debt restructuring, and it does not provide for a mechanism to exit the euro zone. So, in summary, the euro area's fiscal framework has neither been able to prevent irresponsible fiscal behavior, nor does it provide a mechanism for an orderly resolution once a fiscal position has become unsustainable.

Now, to make matters worse, we have a European Central Bank that is constitutionally banned from financing governments directly. You may say that is a good thing. However, as a consequence, European governments no longer have a lender of last resort that they can resort to in times of crisis. And without access to the printing press in extreme circumstances, there is a risk—and this is what we have learned over the past year—of self-fulfilling runs on otherwise solvent governments.

Now, I think this lack of access to a lender of last resort helps to explain why investors treat countries in the euro area as credits. So these government bonds are seen as credits. That is different from countries which have similarly high debt levels, like Japan or the United States or the United Kingdom, but in these countries where governments have access to the central bank as a last resort, investors see them as true sovereigns.

So these are the factors at the origin of the crisis. There have been a number of exacerbating factors, namely, a series of policy mistakes that have been made ever since the Greek crisis broke out, but I would refer to my written statement on the details here.

Now, briefly on the second point, what is required to resolve the crisis, I think to get a lasting solution we need three things:

First, very bold reforms of the fiscal framework. This involves two elements: first, a fiscal transfer mechanism or an insurance scheme on the European level—so that is the fiscal federalism that was already referred to—and this would provide a backstop for governments unable to fund in the market; and, second, as a compensation, we need a partial transfer of member states' fiscal sovereignty to the European level in order to avoid irresponsible fiscal behavior at the national level.

The second thing we need is a central bank able and willing to serve as a lender of last resort, as I just explained. To some extent, the ECB has assumed this role during the crisis. They have started to buy government bonds. They have bought Greek bonds, Portuguese bonds, Irish bonds. They have started to buy Spanish and Italian bonds. However, the amounts they have purchased have been relatively small, and the ECB is constitutionally barred from buying bonds directly at auction.

Then the third thing we need is a large-scale bank recapitalization, and I think this would break the negative feedback loop between the sovereign crisis and the banking crisis that we have already seen. U.S. banks are much better capitalized than European banks, and I think this is what needs to happen.

The problem here is that all these reforms require changes in the European Treaty which would have to be ratified in all national parliaments, and it would require popular votes. And to be honest, I think this is a process that could take years. I am not talking months. I am talking years here. So, therefore, I think it is fair to assume that the crisis will continue in the foreseeable future, and it will probably deepen further.

My final point, the last point, what are the implications for the United States and the global economy? Mr. Chairman, you have already referred to them. The first thing that we need to look at here is that the euro economy will probably stagnate in a broad sense over the next couple of years. We think that southern member states like Italy and Spain will experience a renewed recession next year, and this means that European import demand looks set to slow, and as a consequence, U.S. exports to Europe will also slow further.

Second, the European crisis deepening means that the euro will weaken further. We are seeing this as we speak in the markets, so this means a stronger dollar, and, again, this will hurt U.S. exports.

Then the third and last consequence is the financial market linkages. U.S. banks are stronger in terms of capital, liquidity, and asset quality than their European peers, but the European crisis has already contributed to higher funding rates also for U.S. banks and to a higher cost of capital in the United States and elsewhere.

So I conclude by saying that just as Europe and the rest of the world were severely impacted by the subprime crisis several years ago, I think it is very fair to assume that the United States is now very severely impacted by the European crisis, which is very unlikely to end soon.

Thank you.

Senator WARNER. Mr. Fels, thank you for that very uplifting——

Mr. FELS. I did my best.

Senator WARNER. I am anxious to get to the questions, but a very good presentation.

Dr. Lombardi.

STATEMENT OF DOMENICO LOMBARDI, PRESIDENT, THE OXFORD INSTITUTE FOR ECONOMIC POLICY AND SENIOR FELLOW, THE BROOKINGS INSTITUTION

Mr. LOMBARDI. Chairman Warner, Ranking Member Johanns, Senator Bennet, thank you for this opportunity to share my views with you today.

The crisis of the euro area has entered a new stage. What was initially a fiscal crisis of relatively smaller peripheral economies has now turned into something that is very close to a systemic crisis of the euro area itself with large sovereigns like Italy, Spain, even France coming increasingly under strains, and not only the sovereigns but also their respective financial sectors, as we have seen through a number of downgrades of several Italian banking and financial institutions and also French financial institutions days ago.

While European governments, of course, are obviously primarily responsible for the unfolding of the current events—and Nicolas Véron was reminding us that the Greek Government was fudging statistics, and this prompted what we are now going through—the incomplete architecture of the euro area also created unprecedented scope for contagion by exposing each member of the union—albeit to varying degrees—to the vulnerabilities of the other members. And coupled with the inexistence of a lender of last resort, this means, as Mr. Fels has reminded us, market expectations can rapidly become self-fulfilling in the context of the euro area.

In terms of the policy options—of course, I would refer you to my written statement for a fuller elaboration. In terms of the policy options, I think the euro area governments ought to implement a multi-pronged approach consisting of immediate, short-term, and medium-term options. And on the immediate measures, certainly the EFSF—that is, the European rescue funds—we should not that the euro area leaders already agreed to a number of amendments to strengthen the European rescue fund on July 21st, and yet those amendments have still not been ratified by the member countries. I believe the German parliament is expected to review the amendments sometime in October, as other euro area parliaments will.

It is important to further strengthen the EFSF, however, perhaps by providing a line of credit to the European Central Bank and, therefore, turn the EFSF into an effective crisis manager and relieve the ECB from duties that are technically outside of its own mandate, like, you know, in some ways the role of a lender of last resort that the ECB to some extent has been performing in the current crisis, or certainly that of a crisis manager.

It is important to ring-fence the Greek crisis because right now there is no program of assistance that can work in Greece as long as its debt-to-GDP ratio is projected to reach 140 percent. And Senator Johanns was reminding us that whether you are a liberal or a conservative economist, having a high burden given by the debt of country and economy is—it makes it really impossible for the economy to grow, and this is certainly much more true in the case of Greece.

Of course, the fiscal surrounding needs to pooled. There will be also a need for medium-term measures like coordinating macroeconomic and structural policies. Of course, if Germany has a cur-

rent account surplus, it cannot expect to continue to have that surplus if the other euro area countries where it was exporting its own goods and services are in retrenchment.

In terms of, you know, the levers that the United States can leverage on, I think given where we are, this is perhaps by far more relevant. I think there are five levers that the United States can use. No one of them is—of course, the responsibility still lies with the European governments in the first place.

First, there is, of course, the worldwide bilateral relationships between the United States and the single European countries. The Administration has been engaging bilaterally with the various European countries. Perhaps it is not a coincidence that German Chancellor Merkel declared her public support to the first rescue package in Greece on the very same day she had a conference call with the U.S. President.

There is the G–20, and there is a framework that was proposed by the United States in 2009, the Framework for Strong, Sustainable, and Balanced Growth. It is very important that we do not lose momentum on that, that there are still—there should still be progress in terms of rebalancing of global demand in China to try to positively contribute to flagging European and possibly U.S. demand. So it is very important this euro area crisis does not sort of make these talks lose momentum.

There is the G–7, and there has been actually a revival in the G–7 countries to what many had expected, because I believe continental European countries are more attuned in discussing about their issues with G–7 countries. And the United States, of course, is a leading member in this forum.

There is certainly the International Monetary Fund. Of course, the United States is represented by one of the executive directors. The first deputy managing director has also been an American citizen since the position was established.

Here I would like to draw your attention to the confidence-building effect that enhancing the IMF war chest would have in terms of stabilizing expectations. And the Board of Governors had already approved a doubling of the quotas, and, again, national legislatures would need to approve—to ratify that agreement. So far only a few countries have done so.

The IMF can rely on the NAB, which is a contingent credit line that it can activate should there be any need. Again, it is not about enhancing the IMF financial capability to imply that the IMF will be spending more money, but just to emphasize the confidence-building effect that enhancing the IMF war chest could have.

And then, of course, there is the U.S. Federal Reserve that has been very cooperative with the European Central Bank. There has been a number of bilateral currency swaps through which the ECB, thanks to the Fed, has been able to ease pressure on the European banks so far.

Mr. Chairman, I am sorry for taking too much time, and I will stop here and await questions from the Committee. Thank you.

Senator WARNER. Thank you, Dr. Lombardi. I would say on the EFSF, to my understanding the French Foreign Minister today has made some proposal, and we are anxious to hear from you all on that.

Dr. Foster.

STATEMENT OF J.D. FOSTER, PH.D., NORMAN B. TURE SENIOR FELLOW IN THE ECONOMICS OF FISCAL POLICY, THE HERITAGE FOUNDATION

Mr. FOSTER. Chairman Warner, Ranking Member Johanns, Senator Bennet, thank you for the opportunity to testify today. I am J.D. Foster, a senior fellow at the Heritage Foundation. The views I express in this testimony are my own and not the official position of the Heritage Foundation.

The European economic crisis is no accident. It is entirely self-inflicted, resulting from two fundamental economic policy mistakes begun long ago and since magnified and papered over repeatedly.

The first mistake was adopting a single currency without the economic policy infrastructure necessary to sustain it. As a matter of economics, the euro could have succeeded as envisioned, but Europe largely ignored the prerequisites of harmonizing labor, commercial, environment, labor, and fiscal policy.

The second great mistake was adopting a generous social welfare state without attending to the pro-growth policies necessary to sustain such a state in light of an increasingly competitive global economy.

But that is past. What is next?

Europe's immediate problem is a budding liquidity crisis. European financial institutions are struggling to access short-term dollar credit markets, and depositors are getting very nervous. Confidence, the lifeblood of financial markets, is failing fast.

The reason? The banks hold vast quantities of dodgy government debt. Many have serious solvency problems. Joaquin Alumnia, the European Union's competition commissioner, noted recently that, "Sadly, as the sovereign debt crisis worsens, more banks may need to be recapitalized."

Mr. Alumnia has a knack for understatement. An IMF study out yesterday puts the shortfall at about 300 billion euros.

The solvency problem, in turn, traces to the sovereign debt problem—unsustainable debt and deficits—unsustainable because of their magnitudes and because these countries also suffer from an ongoing growth problem. The problem is not enough growth. Now they are contracting, in some cases rapidly. So while their debt is high and rising, the economy on which the debt rests is flat or contracting.

Worse yet, the cost structures in many of these countries render them highly uncompetitive, even within Europe. This means they cannot run the trade surpluses necessary to generate the earnings with which to pay their foreign creditors.

Liquidity problem to solvency problem to sovereign debt problem to growth problem to competitive problem.

The painful immediate policy conundrum is that addressing excessive sovereign debt and deficits through tax hikes, for example, weakens their economies further, thus making current debt levels even less sustainable. Meanwhile, issuing even more debt to buy time for fiscal consolidation to take hold worsens the bank solvency problem by depressing the value of the dodgy debt held by the banks. And it gets worse. Drawing attention to the need for more

bank capital, the financial market solvency problem, brings the liquidity crisis to a fevered pitch. This is a Gordian knot of enormous complexity, and I think we have to have a little grudging admiration for the European leadership for at least managing to get this far.

The fundamental transmission mechanisms of the European economic crisis for the United States economy are as straightforward in outline as they are murky in detail. There are two such mechanisms, one through financial markets and the second through trade flows.

Five years ago, the European financial crisis might have appeared to us as a European affair that would stop at water's edge. Five years ago, the Europeans thought the same about the then-rumored U.S. subprime mortgage fiasco. The fact is, Mr. Chairman, as you noted, the issue is financial global interconnectedness. No one, including the participants and regulators, really understands all the connections or all the weaknesses. A financial crisis in Europe will spread to the United States Will the shock to the United States be great or small? No one knows. And it is this uncertainty more than anything else that is rattling markets today.

European leaders will not be able to kick the can down the road indefinitely. At some point this house of cards will come tumbling down, taking much of the European financial system with it. That is the bad news.

The good news is, I believe, this part of Europe's problems will be halted in its tracks fairly quickly by recapitalizing the banks and other financial institutions. Done quickly and decisively, this is a light switch for the liquidity and solvency problems. The questions for the Europeans will be whose capital and how much. For the United States, too, the immediate threat will then pass. Europe will then be left with a dysfunctional monetary union, uncompetitive economies in many cases, and excessive debt burdens in others, and a deep recession. Even after the financial crisis passes, Europe will still face grave difficulties. Most immediately, Europe, a major U.S. trading partner, will be in a deep slump, which can only mean U.S. exports to Europe will suffer badly, and the effects will not be fleeting—again, Mr. Chairman, a point you emphasized yourself.

Our focus today should be in preparing for the immediate threat of financial contagion. Above all, the key to preparing for the financial threat is capital. Capital reserves act like levees in the face of a flood, protecting financial institutions from the onrushing river of failing confidence. Presumably, America's financial regulators and supervisors, and this Committee, are keeping a close eye on bank capital reserves and adequacy.

The American economist Joseph Schumpeter once observed, "The problem that is usually being visualized is how capitalism administers existing structures, whereas the relevant problem is how it creates and destroys them." The next few years are very likely, and painfully, to bear this out.

Thank you, Mr. Chairman.

Senator WARNER. Thank you, Dr. Foster.

I think I made one comment in private to the panel before we got started. You know, I hope the kind of American political ral-

lying cry does not become, "Well, at least we are not as bad as the euro zone," which should not be—oh, boy. Normally, Mr. Véron, what we do is we take 5 minutes each and we rotate around, but I am going to try to be brief so that we can try to get a more active discussion since we have got a smaller group here. And we will all have a chance to ask a series of questions.

I guess politicians, rightfully, always are accused of short-termism, and that is true. It is interesting that you have got, I think, a variety of economic philosophies along the panel, but we all see the institutional challenges that were set up in the euro zone. And while we need to come back to the time that it will take to make those changes, as Senator Bennet has pointed out, we have got to work on some of these things in our own country as well.

I guess what I am looking at is, recognizing the first round of kind of short-termism, do you believe the ECB or the European regulators even have the appropriate level of data to know how deep not only their banking crisis is but other financial instruments, for example, exposure to Greece? So, you know, if you think about ring-fencing, do they even know the size of the problem? One of the challenges I think we have still got in this country, number one.

Number two, what will be some of the markers that we should look at? I know the Germans are now grappling with the decision on what will be the trigger mechanism to make the next round of emergency relief—I think it is mid-October, I believe, in terms of the next payment, and will the Greeks meet those preconditions? And are the Finns, by saying they want collateral—if they suddenly take a Greek island or two as collateral, will everybody else kind of get in line as well on that?

Then, three, I would just like a quick comment on some of these immediate actions today in terms of what I think Dr. Lombardi was referring to, trying to kind of lever up this emergency fund that the French Foreign Minister mentioned. So, you know, do they have the data? What are the metrics in terms of what we should be watching for as the triggering events? And, you know, will there be anything we will see even in advance of the middle of October of actions being taken? In whatever order.

Mr. VÉRON. Maybe I will start very briefly on the question——

Senator WARNER. If I could just again, because I want to make sure all my colleagues get time, if you could answer relatively briefly to all these. I have got a lot more questions, but I want to make sure they get a chance.

Mr. VÉRON. Very briefly on the data, of course, there is never enough data, and there has been some improvement with the latest round of stress tests where the disclosure part of the stress testing was a much better quality than the previous round, so the latest round was July 2011, the previous in 2009 and 2010. The stress testing itself was not very harsh, but disclosure was valuable.

I think, however, the contagion we are witnessing is not reducible to something we can analyze, that we can model with, you know, equations. If you look at the contagion patterns to Italy in July, to French banks in August, which are the two latest dramatic developments of the euro zone crisis, I do not think they can be

well captured by an analysis of the direct exposures, of the direct financial interdependence. Even so, it is important to know them, the sort of numbers you showed on the two slides. There are many other things at play, including the political factors. In a way it is what makes the situation so difficult right now.

Take a country like Italy. You look at it objectively, frankly, it has a primary surplus. It has a fiscal situation which is characterized by high debt but also quite sound in terms of fiscal management. But because of all the uncertainty in surrounding factors, nobody can be sure that this is enough.

Senator WARNER. Thank you.

Mr. FELS. All right, Mr. Chairman. Well, on your first question, I think that, you know, does the ECB—do the regulators know enough? I think the good news is that Europe is still a largely bank-financed system, so about 80 percent of all the loans to the private sector come from the banks rather than from the capital market or the shadow banking system. So in that sense—and the regulators and the ECB know a lot about what is going on in the banks due to the stress tests. So I think they have a very good grasp of how deep the problem in the banking sector is. And, again, this is what really matters for the euro area economy.

The bad news is, Where does the capital come from to recapitalize the banks? I think we all agree with need bank recapitalization. The problem is in many of these countries, where the capital would have to come from the sovereign, from the national government, these governments do not have access to the capital markets anymore, so they do not have the money. And so far it is very difficult to explain to the taxpayers in the stronger countries, Germany and others, that they should put capital into the peripheral banks. There is strong resistance in those countries to recapitalize their own banks because, obviously, people are angry with the banks, given that we had a major and still have a major crisis. It is even more difficult for them to explain that they should put capital into peripheral banks.

Then your question on Greece, will they get the next tranche, and, you know, will the EFSF changes, the rescue fund changes go through parliaments? My answer to both questions is yes. Greece has come up with additional measures. I think it is very unlikely that Greece will be allowed to fail in the near term. Nobody has an interest in that. So it looks as if Greece will get its next tranche in October.

On the EFSF changes that have to go through national parliaments, I am also quite confident that these changes will go through by the beginning or the middle of October, and then I think the real problems only start then, because then when the EFSF will be able to put money—or to lend to governments so they can recapitalize their banks. When the EFSF will be allowed to buy government bonds in the secondary market, there may be a bigger incentive among some politicians to let Greece go bankrupt because the view would be that we will be able to ring-fence this.

I do not believe that the ring-fencing will be possible. I think the EFSF is not big enough to do that, and I think it would be a major mistake if we would allow Greece to go bankrupt over the next couple of years. But the thinking may be very different in some polit-

ical circles, so this is a key risk to watch, once the enhanced EFSF has come into action in mid-October or early November.

Senator WARNER. Thank you.

Mr. Lombardi?

Mr. LOMBARDI. Thank you, Mr. Chairman.

In terms of the data, I would say that in continental Europe there is a good wealth of data. The Bank of Italy has a credit registry, so we know perfectly well, almost perfectly, how the banks have allocated their portfolios. I think the same is true in France with the Banc de France, and these systems are very much relying on banks rather than intermediaries outside of the banking system. So data-wise, I think the ECB more or less, you know, is in good shape.

Turning to your other points, Mr. Chairman, the EFSF has a potential capability of 440 billion euros because roughly 175 of them have already been committed in some way or another. The residual will not be able to even fund a program for Italy should, you know, Italy for some reason be unable to borrow from the financial markets. And for that matter, 1 year of the Italian funding needs currently standing at roughly 235 billion a year would also deplete the IMF capabilities.

So this is why it is important that the EFSF is able to exceed an ECB credit line, so just—line of credit, sorry, so just, you know, enhancing the EFSF but without enabling the EFSF with the needed financial capability would essentially be almost unhelpful.

The EFSF could be used as a device to recapitalize the European banking system so to make banks to be in a better position once a substantial part of the Greek debt will have to be written off in terms of—in order for the Greek economy, you know, to rebound, of course, in exchange of strict conditions and in exchange of some commitments from the Greek authorities. But certainly the EFSF could be used well beyond its current capabilities if, you know, the euro area parliaments were to act in that direction.

Senator WARNER. Dr. Foster?

Mr. FOSTER. Yes, Senator. In terms of the exposures, I am reasonably confident the ECB and the IMF have very good data as to the exposures of the banks to the direct threats. But, as you alluded to in your remarks, sir, it is the indirect exposures that are the risk. You may think you are holding a perfectly good asset, but it turns out the company you own through asset is itself in trouble because it holds too much bad debt. We have read a lot over the years about how much of this risk has been hedged through use of credit default swaps. CDS does not eliminate risk. They shift it. To whom? We do not know. That is the issue.

The issue is also only contextualized by the numbers. The real driving force is confidence. That is the lifeblood of financial markets, people trusting each other and what is going to happen.

Remember back in 2008 in the peak of our crisis, fully solvent large banks stopped talking to one another. Markets broke down because of a lack of confidence in basic business arrangements. It is a psychological matter, and it could be triggered by anything—a bad soccer match. It could be triggered by an event where some politician makes an unfortunate statement. But whatever it is, it is a question of psychology. Greece primarily, but other nations in

the periphery as well, are hanging by a thread, and that thread is being eroded as the confidence erodes. When it goes it is hard to say.

One last note about Greece. I think there is no question that if Greece were to default or spin out of the euro, the consequences for Greece would be terrible. The consequences for Europe would be terrible. It does not change the fact, in my opinion, that this is inevitable. It is only a question of time. And the reason for that is very simple. It is not a question of fiscal matters. It is not really a question of finance. It is a question of the fact that Greece's cost structure, wages and prices, are grossly out of line with their productivity. They cannot possibly produce the trade surpluses with their current cost structure necessary to pay off their foreign creditors. That is not a question of financing.

There is one way it could occur, and that is if the German people were willing indefinitely and with unknown amounts to bankroll the Greeks. I do not see that happening.

Senator WARNER. With that, I am going to turn to Senator Johanns, recognizing that Dr. Foster said, you know, this issue about confidence. And I was a bit taken aback when he said that occasionally a politician might make an ill-suited comment.

Senator JOHANNS. Be careful.

Mr. FOSTER. Not the Members of this Committee, sir.

Senator JOHANNS. I remember during the height of the financial crisis of a few years ago in the United States, I was visiting with a president of one of the major banks, and the bank is still operating today. I was probing as to the condition of the bank, you know, the capital and a whole host of things, you know, what is the loan portfolio like, *et cetera.* And kind of at the end of it, I said, "So how do you feel about your current situation? How do you feel about the security of the bank?" And he said, "You know, Senator, when a run starts, it is very hard to stop." And it was to me a very telling comment that you could have a secure financial institution that seemed to be doing all the right things, and I believe today they were. But what he was saying is when things start going downhill, they really can go downhill very quickly.

I saw that because I would like to offer a perspective, and then I would like your reaction to it. Certainly we go to Greece and we see the challenges there, and, Dr. Foster, I found your comments to be very interesting. Something bad is going to happen. We just do not know how bad and to what extent. But we know something bad is going to happen. But to have Greece out there that, I agree, how you get this country competitive is a significant issue. But it does not stop with Greece. It is Spain and Portugal and potentially Italy and potentially France. And once the run starts, where do you stop it?

Now, my experience with the European Union is that it is even hard to define the structure. Those who work there and are experienced in it could probably give us 2 hours of what the structure is. But what is it? It is a governing body that, by and large, operates on consensus, and when they want to change the treaty, they have this very cumbersome process.

So you lay out the pathway, and then you say, "But they have got to change the treaty, and here is what they have to do." And

I am thinking, holy smokes, that is like amending the Constitution of the United States. This does not happen anytime soon. That is why we do not do it very much.

And so I look at all of these things that are happening, and then I add in this factor—and, again, this comes from our own experience in the United States. There is a point at which you are asking your strong countries to bail out weak countries who maybe have better social benefits, better whatever, and those strong countries with their citizens are saying, "Excuse me? Why? Why would I, who worked so hard, be forced to do that?"

And then the final thing I wanted to mention—and then I will ask for your reaction to what I have said—is it just occurs to me that if part of the key here is to recapitalize the banks, where do you find the capital, number one? And, number two, how do you muster up the willingness of the citizens to tolerate that? Much like we ran into here in the United States, there is a point at which the population, our constituents just say no, enough is enough, no matter what the consequences are.

Adding those factors in, where am I missing the point here? What about my analysis of this is not accurate or misses the mark here? Dr. Foster, I will start with you.

Mr. FOSTER. Thank you, sir. I do not think your analysis misses the mark hardly at all. The question ultimately will be, as I noted, the recapitalization of the banks. When that occurs—likely not 1 minute before it has to. When that will be we do not know. Where the capital will come from is the big question, but the European tradition and, in fact, our own in the recent crisis, says it is going to come from the governments. Simply put, the governments are going to own the banks. Germany can do that. France can do that. They have access to capital markets. I suspect Italy will be able to.

What Greece is going to do, and some of the peripheral countries, is another matter. But one way or another, that is how you address the financial system. You had insolvent banks. Now you have solvent banks. They are owned by the government. Why would Europeans tolerate this? Well, the Europeans, frankly, are more tolerate of governments owning financial institutions than we are. When we do it, the expectation is that the banks will pay back the money and so will get rid of the public ownership. AIG is trying very hard to become a private institution again. The banks that received TARP funds tried very hard to give the money back, and that was our policy as well as a Nation.

The Europeans—I am not sure how anxious they are going to be to resell those financial institutions. But that is where the capital is going to come from; ultimately it is going to be from the governments.

Why would the strong continue to bail out the weak? They would do so as long as they think they are sustaining a sustainable system. There is something to the European vision that is widely shared across the continent. It may not be always comprehensible to Americans, but we have to acknowledge its existence, and they will defend it, to a point. I think it is pretty clear that point has been reached in Germany, in Finland, and some of the other countries. And so I do not expect this to continue. They are going to have to find a resolution pretty quick.

Senator JOHANNS. Mr. Lombardi?

Mr. LOMBARDI. Thank you, Senator Johanns, for your question. I would say I think in the current context of the euro area crisis, there has not been an even perception of the benefits of the single currency. So in a way it is the politicians' jobs, I would say, to highlight to their own national electorates what the benefits of the current European projects have been and are and can be in the future. I mean, it is a very hard job to do, but it really hinges on the European senior political leadership.

I think if Chancellor Kohl had called a referendum on the euro or on the European single market, I doubt that the national electorates of the various euro area countries would have ever voted yes. And yet, you know, over several decades of sustained economic, financial, and political integration, I think that there have been substantial benefits overall that this crisis should not obscurate.

Clearly there is more than a perception, the reality that the peripheral economies, including even Spain, you know, other economies like Ireland, have benefited from low interest rate policies that they were able to access thanks to the single European currency. But I think also Germany—and I am referring to Germany because it is always the strong country that is very competitive, of course, with a very sound fiscal stance. So this is why I am referring to Germany. Even Germany has benefited from the single currency. Germany has been able to run current account surpluses in proportion of GDP even higher than those of China but, however, without the compensating mechanism given by the appreciation of the currency, because being part of a monetary union, of course, the euro did not rise as it should have if Germany had its own currency. So, in a way, Germany has benefited from a sort of hidden subside through the single currency as much as, you know, other countries have also benefited from some other forms, perhaps not so hidden, of subsidies.

In a way this is the benefit of creating a single market, so there are benefits for all in different forms. Some are more evident, other times less evidence. But there are for all.

In terms of the other levers that politicians could leverage in Europe, I have here the projections that the IMF has released a day ago, and, again, Germany last year grew at 3.6 percent, which is a rate of growth that, I would say, used to be pretty normal in the United States, maybe even low-ish, but it was really extremely high compared to European standards. This year Germany will grow at 2.7 percent. Next year and the next again, it is going to grow at 1.3 percent.

So, of course, Germany is being affected by the crisis. German consumers will have, of course, less resources to spend compared to what they would have had otherwise. But in the end, again, everything, you know, hinges on the political leadership sort of explaining very difficult things to their own national electorates.

Just one more quick point on Greece, if I may. I understand the reasoning made by Dr. Foster, and, you know, as an economist, there is certainly substance to it, I have to acknowledge. But at this moment I think entertaining the idea that Greece could be exiting the euro area would just be destabilizing because it is going to be impossible really to draw the line. You know, after Greece,

is there going to be any other country that will leave the euro area? And where are you going to put Italy or Spain?

So I think the emphasis should be in stabilizing the Greek situation by perhaps leveraging on the EFSF to strengthen the balance sheet of the banks, and then perhaps in the medium term certainly there should be at least an institutional framework allowing the orderly exit of some countries who voluntarily want to leave the euro area. But right now I think it would just be destabilizing and would just trigger contagion and further destabilize the prospect for exiting from this crisis.

Thank you.

Senator WARNER. I am going to go to Senator Bennet, and maybe he can start with Mr. Fels or Mr. Véron.

Senator BENNET. Sure. Thank you, Mr. Chairman.

I have two questions I will get out here. Mr. Fels, when you had your list of the things that would be required for—in order to accomplish them would require treaty changes, was the bank recapitalization on that list? Or it would require treaty changes to do the——

Mr. FELS. No. Bank recapitalization does not require treaty changes.

Senator BENNET. OK, so it was my——

Mr. FELS. The other changes do, but bank recapitalization should be relatively easy to do.

Senator BENNET. OK. And the other smaller question I had was on Italy, Mr. Véron or Mr. Fels. In trying to understand the domestic politics of the countries there, when you think about Italy and who holds the Italian debt, I gather 50 percent of it is held by Italians and the rest by others, but the first question is: Do you know, do we know? And the second is: If banks like the large German banks own a lot of that paper, how does that inform the decisions about recapitalizations and the politics of the work going forward?

Mr. FELS. Senator Bennet, if I may start on the Italian question, slightly more than half of the Italian debt is held abroad. We pretty much know where it is. It sits largely with banks in the rest of the euro area, but also in large portfolios here in the United States. and the rest of it is owned by Italian banks and Italian citizens. The Italians have a very high savings ratio, so Italy is country that has, you know—it is a poor state or a poor government, but rich citizens with a savings rate of around 20 percent of disposable income year after year. The comparable number here in the United States is now 5 percent, and that has gone up a lot over the last——

Senator BENNET. It was zero. It was zero.

Mr. FELS. It was zero before the crisis, correct. So I think we know where the debt sits, and the issue with Italy is that, as I am sure you are all aware, Italy is the third largest bond market in the world, and it is the largest bond market in terms of bonds outstanding in the euro area. It is larger than Germany. It is a smaller economy, but they have a higher debt ratio. So Italy is too big to fail. If Italy fails, then I think it is game over, and that would be a major financial crisis. I think Lehman would pale in comparison. Everybody knows that.

The other problem is Italy is not only too large to fail, it is also too big to rescue because there is nobody around in the euro area who could, you know, bring up the money to bail Italy out. This is why it is absolutely crucial to follow what is happening in Italy. To me, Greece has become a sideshow.

Senator BENNET. Exactly.

Mr. FELS. This is really about Italy.

The encouraging thing—now, I said a lot of things that, you know, may have depressed you, but the encouraging thing is we have seen considerable responses in Italy. This Italian Government has responded. They have come up with additional fiscal savings. They have agreed to put a balanced budget amendment into their constitution. Now, that has not happened yet, and they are still debating how. But this is something that has happened. And I am actually quite confident that Italy can get through this for a simple reason: they have done it before. Italy managed in the 1990s, before the euro started, to push through very significant pension reforms that put the country's debt on a sustainable level, and this will play out over the next 10 to 20 years. And so Italy has a high inherited debt-to-GDP, but its long-term trajectory is much better than that of most other countries of—and that is a big "if"—they can continue to fund at reasonable interest rates. That is the big question, and this is why this contagion has to be stopped, and this is why the ECB buying is playing a very important role here.

Mr. VÉRON. I think what Mr. Fels just said is very important. European countries have shown a significant ability to reform, including to accept painful reforms, with different levels in different countries, but if you look at certainly the most graphical examples—Latvia, Ireland, they have taken exactly painful economic medicine and with a very stoic population not only the decision-makers.

I think Portugal and Spain also have very much owned up to their crisis. They have gone way past the stage where they blame it on foreigners or outsiders. They really, you know, understand that they have to take the bitter medicine, and they are taking it.

I agree with a lot of things that Dr. Foster said, but I do not think there is anything mechanistic or deterministic in these dynamics. If you look back a decade, many people were saying Turkey and Brazil are basket cases, there is no way they can get out of their predicament, and they did. So I am not saying that—I mean, of course, the question is: Can Greece avoid debt restructuring? I am not sure I can answer yes to this. But to the more general question of ability to reform and take painful measures, I think it is higher than how it is sometimes depicted both in Europe and outside Europe.

Regarding Greece, they announced yesterday some very, very significant measures of adjustment, which will be painful, which will be depressing on growth, but I think were necessary.

I would also say on this account that the electoral dynamics are not as dire as perhaps sometimes they are described. There has been a lot of press coverage, rightly so, of populist parties gaining ground in Europe, but they remain very much in the minority. If you look at the German opposition, they are more pushy on EU integration and solidarity with the Greeks than the ruling coalition.

So it is not the case—even when the coalition has a problem in parliament, it is not the case that that means there is just a minority willing to go further with EU joint action in Germany.

Of course, this is one political cycle. The next political cycle might be different, and I think we have to be very cautious on medium-term political assessment, but I think it is important to mention these facts.

As regards recapitalization, I think we all see the paradox—it is a Catch-22, right? The big risk right now for the banks is the solvency risk for euro zone countries. So the bank capital assessment is dependent on the solvency assessment of these countries. So the two are completely linked, and there are banks which say, well, Italy is solvent so why should I mark-to-market Italian debt? There is no point of doing that. And it is a very difficult cycle to break.

I will only say that, yes, there will be probably some need for public capital eventually for the recapitalization of the European banking sector, but I think there are two crucial questions which will vastly affect the shape of the outcome. One is, are cross-border acquisitions possible in Europe in the banking system? There is a lot of economic nationalism, especially in the banking system in many European countries, including, I must say, my own. If politicians in those countries realize that they have to deliver on the vision of an integrated banking market and that, say, the acquirer of an ailing French bank may be a Spanish bank or a German bank or a U.K. bank or a U.S. bank, then we have a very different picture than the picture we have if there is the constraints that any merger and acquisition have to be inside individual countries. And also in terms of the public capital, we said, national governments, now that the EFSF has been explicitly also raised to intervene in the banking sector, at this point indirectly through loans to individual member states for them to restructure their banks, I think at some point we will start discussing the injection of EU money as opposed to national government money, and this will also bring to it a different picture, of course, with a lot of difficult political issues involved.

My last point on this is on Greece. There are scenarios in which a disorderly Greek debt restructuring would force an exit from the euro zone, and this cannot be ruled out because some of these scenarios are very serious.

Now, I think the trick with Greece will have to be how to restructure the sovereign debt without Greece exiting the euro zone, in spite of the temptation, of course, as an economic boost of devaluation in the short term and so on. But I think my hunch and my expectation is that the contagion from a euro exit would be so impossible to manage that leaders in the end will do their best and may succeed in having a Greek debt restructuring, if this is really necessary—which it may be—while keeping Greece inside the euro zone. This requires very hands-on extraterritorial, I mean supranational instruments on the Greek banking system. It is an absolutely necessary condition. But it may happen.

Senator BENNET. Thank you, and I appreciate the answer. I am going to ask a question with the Chairman's indulgence, and then we will answer it.

One of the things that I am worried about in our country is that we have seen periods of growth in the 1980s and the 1990s where there was a relationship between the growing GDP and growing wages and growing jobs. And we saw a decoupling of that during the decade before this recession happened, and we are seeing in this recession here a deepening of that disconnect between growth and job creation and income.

I wonder, in thinking about the political cycles that Mr. Véron was talking about, whether you could give us a picture of what that looks like in Europe. There was a lot of discussion here about the program that Germany had in place to keep people employed during this downturn about a year or two ago. Is there any insight you can give us on what that looks like? Is the cycle we are seeing here repeating itself there? Mr. Lombardi, do you have——

Mr. LOMBARDI. Thank you. Yes, this is indeed a very crucial issue because right now the Europeans, of course, the peripheral economies under stress, but also all the other economies have embarked on fiscal retrenchment programs just fearing what may be happening to them if they would not do so.

Clearly, this implies, you know, lagging demand with effects on jobs, and in a way the euro area has always focused on, you know, fiscal stability. But there has never been enough emphasis on structural policies, on, you know, enabling the euro area economies to grow more. And now we are in a way—you know, they are paying the price.

Just to give you a more concrete example, there is now in Italy a lot of emphasis on achieving this balanced budget objective. Of course, this is certainly something that the Italian authorities would need to embark on. But yet if the public debt sustainability is the main issue, that does not come from a balanced budget because the Italian public finances have been run in a pretty conservative way over the latest decade. The crucial issue is the very low rate of growth. Clearly, if the economy grows at a very low rate and you have a high and increasing public debt stock, there is no way the economy in the very long run can be solvent.

And at the European euro area level, there have been a lot of discussions on keeping the fiscal deficits shrinking, but there has never really been enough emphasis on these other crucial aspects, also important for the fiscal sustainability in the long run. And, clearly, this has alienated a lot of consensus, and I have to say that right now there has been no lesson learned in a way because what euro area governments have committed to, in a way well before that we would achieve this kind of escalation of the prices, was fiscal retrenchment across the board. So even countries in a better position, they have focused on fiscal retrenchment, and, again, there has not really been enough emphasis on creating jobs, and this is why the euro area economy as a whole is performing very poorly in terms of its own potential rate of growth.

Senator BENNET. Thank you. Thank you very much for your excellent testimony.

Thank you, Mr. Chairman.

Senator WARNER. Thank you all. Let me just as a brief question, and then if any of my colleagues would like to ask another brief question. I think Senator Johanns made an interesting comment

earlier when even those of us who take an interest in trying to understand, you know, all the EU mechanisms, it sometimes seems probably as challenging as understanding the American congressional processes.

We do have another chance in the United States now before the end of the year through this so-called Super Committee to set a process in place. And I agree with Dr. Foster so much about the issue of confidence. We do not know what will spark something that could lead to this contagion.

What should we be—between just now and the end of the year—we have not even got to long-term structural, but what are the events or things that as American policymakers we should be watching for to see if progress is being made? Obviously, the next tranche of the Greek relief, but are there other events or markers that we should either say, Aha, we are moving in the right direction, oh, my gosh, or should further evidence be on the 486-point drop we just had today of, oh, my gosh, this may be getting worse?

Mr. VÉRON. I think there is a temptation to put Germany in an even more central position than it is, but actually it is central right now. It is a pivotal country. So I would suggest watching very closely the German internal debate, including perhaps spending a bit on translation, to understand what are the currents and undercurrents in the German debate. I think it is moving perhaps too slowly, but it is moving in directions which are encouraging, with a lot of uncertainties, and ultimately the German debate will have a huge impact on what gets done or does not get done.

Senator WARNER. And when will that conclude?

Mr. VÉRON. There is a bunch of parliamentary votes that are planned. There is obviously at each time that the German constitutional court has to give a ruling, it is important. But I would also watch indicators like, you know, what do senior figures in the German business community say, how do, of course, parties, change their stance or not change their stance. So it is a lot of moving elements, and I acknowledge that it is very complex to watch from outside. But I think it is crucial.

Senator WARNER. Just very briefly, any other markers we should look—because I want to make Senator Johanns gets another round, and we are going to have to conclude around 4.

Mr. FELS. Just one thing. The crucial vote in Germany on the EFSF, the changes, is on the 29th of September, and I agree we need to watch that very closely. And then after that, after the EFSF is—the reforms are in place, I would really watch the bank, how we are progressing on bank recapitalization because I think that is at the core.

If the new EFSF will be used to recapitalize some of those banks in the weak countries through their governments, I think that would be a very, very positive sign.

Senator WARNER. And you think that process can start before the end of the year?

Mr. FELS. It can start before the end of the year. I think the regulators will be pushing it as soon as the reformed EFSF is in place, which should be around mid-October.

Mr. LOMBARDI. Mr. Chairman, I would say in the immediate I will be looking at, of course, Germany, would also be looking at

Italy for the simple reason that the government has issued to us budget supplementary plans in less than 2 months. But now they are working on a third supplementary plan just because the previous one, which was approved by the parliament days ago, and then, you know, the following day Italy was downgraded by Standard & Poor's, of course, relying on growth projections that were in a way exceedingly overoptimistic. Now these growth projections have almost been cut in half, and, of course, the plan that the government was confident would allow it to achieve a balanced budget in 2013 does not any longer have a basis.

So there is already a shortfall which has already been assessed by the IMF, and the authorities are working on a third supplementary plan.

However, this also highlighted the lack of a comprehensive strategy, at the European level but also in Italy, because you cannot clearly tackle the crisis from month to month issuing a budget supplementary plan each month.

In the more medium term, again, by the end of the year, which was your timeframe, I would also look in Germany at the German parliamentary discussion on the European Stability Mechanism that is the mechanism which will succeed to the EFSF for the simple reason that there was a few days ago a decision by the German constitutional court that would prevent Germany from joining any permanent rescue mechanism. And the EFSF is a temporary mechanism and will be replaced by this ESM, European Stability Mechanism, which is permanent in nature. And, therefore, as currently we think, the German participation to this new mechanism—the German constitutional court has decreed that would be unconstitutional.

Senator WARNER. Dr. Foster, and then Senator Johanns will get the last questions.

Mr. FOSTER. Yes, sir. Very quickly, following up on this last point, the issue really is Germany. The real issue is the constitutional court decision. What they decided almost looked like it was written by Angela Merkel herself, because what it said was that the budget committee of the Bundestag must be consulted if there is any more German funds to be used. Well, basically what that is saying is this is a way for Germany to say no without the problem landing in Angela Merkel's lap. They now have the ability to say no, and she will not be blamed.

Senator JOHANNS. This is going to be a bit of a general question, so I will just warn you of that as I think about all these moving parts and pieces and what has to happen and trying in my mind to prioritize what is absolutely critical from something that maybe is not.

Can you describe for me what I would say would be a tipping point? Is there an event out there that you are anticipating must, must happen to set up the line of defense, and if it does not happen, all of a sudden it is the catalyst that things really start unraveling and will be very hard to corral, if you know what I am saying? Maybe I will start at this end.

Mr. VÉRON. Well, I would say two things. One is something that would look like what Secretary Geithner suggested apparently in his discussions with the European Finance Ministers last weekend,

which has been mentioned in this panel, *i.e.,* access to ECB liquidity for the EFSF. I think this could be really something that would stabilize the market situation enormously.

And on the banking side, a clear signal by euro zone governments that they are ready for a truly European banking system, for decoupling their national banking system from the national sovereign. And this takes various dimensions. Some of them are mentioned in my written statement, but I think it is basically a political statement that the era of national banking systems within the euro zone is over.

Mr. FELS. My answer is very similar. The EFSF changes have to come through over the next 4 weeks. The EFSF has to be leveraged up, so to increase its size by access to ECB funding.

And my last point is bank recapitalization has to happen. I think that is crucial, and it can happen once the EFSF is reformed and is larger. And as I said earlier, the bank recapitalization, that is what I am watching.

Mr. LOMBARDI. I would say that over the next few weeks we will be watching a possible escalation of the crisis in the Italian bond markets, and this will come with an increasing weakening of the several large financial institutions, European financial institutions. And that could provide a tipping point for really a quantum leap in the political debate that we have been watching in Europe.

I think we have not reached that tipping point, and I think once a systemic economy of the euro area comes under hit, this will generate—this hopefully will generate a new perspective in the political debate at the euro area level, and this trigger, this tipping point, I think will come from intensification and escalation of the crisis in Italy.

Mr. FOSTER. Senator, I think all of what my co-panelists said I would agree with. I would only add that if Greece were somehow denied its next tranche of help, that would certainly be a major event. I do not expect that to happen. Europe will find a way to rewrite its rules to make sure Greece gets the money.

While I cannot tell you the date, I can give you a bit of the timing—24 to 48 hours after we have an unpleasant, unexpected event from some direction we were not anticipating, something nobody was looking for that will so unsettle the markets, that will trigger the contagion. I cannot tell you what it would be. It could be a financial institution suddenly finding that one of their traders committed $2 billion of bad trades—UBS, for example. It may not be Greece. A Spanish provincial government that suddenly decides, oh, we have been running much larger deficits than we were telling the central government, as we saw a few days ago.

Any one of these kind of events—a shock from an unexpected direction—24 to 48 hours later the balloon is up.

Senator JOHANNS. Let me just say that was very, very helpful testimony, and I really appreciate you taking time this afternoon to work with us and give us your best thoughts on this.

Senator WARNER. Let me just add as well, this has been sobering, but I think you have given us some of the markers. I would love to—I am going to look through your testimony. Maybe we can continue this conversation as we think as well about—we have focused on the immediate, the intermediate, and longer-term struc-

tural changes and how—not to be answered because we have to break now—but how we in the United States can be helpful to our European friends and allies in that process, but, boy, oh, boy, anyone that denies the interconnectedness that we are all in this together, I think that would—I would hope they would listen to this presentation today. It has been excellent testimony, and again, I thank my colleagues for joining me in this.

Thank you, gentlemen, and with that the hearing is adjourned.

[Whereupon, at 4:04 p.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

PREPARED STATEMENT OF NICOLAS VÉRON

VISITING FELLOW, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS, AND SENIOR FELLOW, BRUEGEL

SEPTEMBER 22, 2011

Thank you Chairman Warner, Ranking Member Johanns, and distinguished Members of the Subcommittee for the invitation to appear at today's hearing. The European crisis is entering a critical phase as policy initiatives undertaken so far have not prevented systemic contagion. I will concentrate my remarks on the role of Europe's banking system in the crisis, the steps needed at the European level for the crisis to be resolved, and the short-term outlook.

I currently work both at Bruegel and the Peterson Institute, on a half-time basis in each organization, and divide my working time between Europe and the United States. Bruegel is a nonpartisan policy research institution that started operations in Brussels in 2005 and aims to contribute to the quality of economic policymaking in Europe through open, fact-based and policy-relevant research, analysis and discussion. The Peter G. Peterson Institute for International Economics is a private, nonprofit, nonpartisan research institution devoted to the study of international economic policy. The views expressed here are my own and not those of the Peterson Institute or Bruegel. I have no financial or commercial interest that would create a bias or conflict in expressing these views.

The key points of my statement are the following:

- First, Europe's banking system has been in a continuous stage of systemic fragility since 2007–08, in contrast with the United States where banking crisis resolution was swifter and was essentially completed in 2009. The inability of European policymakers to resolve their banking crisis so far can be explained by deeply embedded features of their respective countries' financial systems and political economy structures.
- Second, the current phase, which is often described as a sovereign debt crisis, is really a sequence of interactions between sovereign problems and banking problems. Had Western Europe's banks been in a better shape a year and a half ago, the policy approach to the Greek debt crisis would have been entirely different, possibly allowing for a much earlier sovereign debt restructuring. So the situation is best described as twin sovereign and banking crises that mutually feed each other. The result of this interaction is a gradual contagion to more countries and more asset classes.
- Third, the crisis has exposed a major deficit of executive decisionmaking capability in the EU and Eurozone institutional framework, which helps to explain the insufficient policy response. It can thus be said that the banking and sovereign crises are compounded by a crisis of the EU institutions themselves. Specialized European bodies, primarily the European Central Bank (ECB), have partly bridged this gap with policy initiatives that go beyond a narrow reading of their mandate, but they could do so only to a limited extent that has not been sufficient to stop the contagion.
- Fourth, a successful crisis resolution will need to include at least four components at the European level, in addition to steps to be taken by individual countries: (a) fiscal federalism, *i.e.,* mechanisms that ensure that fiscal policies in the Eurozone are partly centralized with shared backing across countries so as to meet the requirements of monetary union; (b) banking federalism, *i.e.,* a framework for banking policy at the European level that credibly supports the vision of a single European market for financial services; (c) an overhaul of EU/Eurozone institutions that would enable fiscal and banking federalism to be sustainable, by allowing centralized executive decisionmaking to the extent necessary and by guaranteeing democratic accountability; and (d) short-term arrangements that chart a path toward the completion of the previous three points, which is bound to take some time. These should involve expanded instruments to intervene in the banking sector and to provide interim funding to struggling Eurozone governments, taking into account the possibility of insolvent member states having to undergo debt restructuring.
- Fifth, these requirements for crisis resolution cannot be met unless political conditions change sharply in their favor. This leaves the United States exposed to a risk of financial contagion, which it can partly mitigate with adequate contingency planning and proportionate precautionary measures. The United States can and should also continue to play a constructive role by providing advice to its European partners, and thus helping them rise to the momentous

challenges they face. However, only the Europeans themselves can solve their current predicament.

I would not want these remarks to sound unduly pessimistic. In the U.S. public debate, one frequently hears the Eurozone described as an inherently unsustainable experiment, and European nations as incapable of reform. Such dark depictions of the European situation are unhelpful and misleading. European monetary union is certainly an experiment, but it is not doomed to fail: Eurozone countries have shown and are showing an extraordinary degree of political commitment to perpetuate their currency union. They have already taken very significant institutional steps toward more centralized economic and financial management since the beginning of the crisis, and are gradually accepting the need for further steps, even though the process is not as swift as external observers might wish it to be. Most Eurozone periphery countries have taken very serious and painful initiatives to reform and place themselves back on a sustainable economic track. And elections in many European countries since the start of the crisis have shown that the vast majority of citizens resist the temptation of populism and are willing to embrace the needed adjustment policies.

I personally believe that the integrity of the Eurozone will be defended in this crisis and that the EU will eventually emerge from it with a stronger, more resilient economic and financial policy framework. But I also expect the road to be very bumpy, and that the Europeans will pay a high economic price for the inadequacies of their collective decisionmaking processes.

The rest of this statement expands on these points and provides additional background.

Europe's banking crisis

Europe has been in a continuous state of systemic banking fragility since August 2007. This puts it in contrast with the United States where the phase of systemic banking crisis ended in 2009, even though the broader economic crisis has proved difficult to address and casts a shadow on America's long-term fiscal outlook. One indication of Europe's prolonged state of fragility is that the ECB's extraordinary liquidity support to Eurozone banks (in the ECB's parlance, fixed-rate full allotment in refinancing operations), introduced in October 2008, remains in place to this day. By contrast, the closest comparable program on the U.S. side, the Federal Reserve's Term Auction Facility, was gradually phased out and expired in March 2010. Similarly, in October 2008 the European Commission's Directorate-General for Competition Policy (DG COMP) made its enforcement practices on the control of State Aid to the banking sector more flexible on the basis of Article 87.3b of the European Community Treaty, which allows for aid "to remedy a serious disturbance in the economy of a member state." This adaptation of competition policy to crisis times has been continuously in place since then, and European Commissioner for Competition Policy Joaquin Almunia recently announced that it would remain so until early 2012 at least.

In comparison with the United States, the European banking sector has until now gone only through modest restructuring as a consequence of the crisis, particularly in the Eurozone. Among major European financial institutions, only Halifax Bank of Scotland (HBOS) in the United Kingdom (U.K.) and Fortis in the Benelux countries were dismantled or forcibly merged into competitors at the height of the crisis, in comparison to Countrywide Financial, Bear Stearns, Lehman Brothers, American International Group, Washington Mutual, Wachovia and Merrill Lynch which were merged or restructured in the United States. Moreover, the U.S. bank receivership process administered by the Federal Deposit Insurance Corporation meant that a significant number of small- and medium-sized banks (and some large ones, such as Washington Mutual) were allowed to fail. In Europe, where most countries did not have an orderly resolution process for depository institutions in 2008–09, senior creditors were made whole in almost all cases of individual bank problems, and so were junior creditors in the vast majority of cases.

In the spring of 2009, the U.S. Supervisory Capital Assessment Program (commonly known as "stress tests") identified 10 of the country's 19 largest financial institutions as undercapitalized, and the subsequent wave of capital strengthening helped investors regain trust in the institutions at the core of the U.S. financial system, even as smaller banks continued to fail in large numbers in 2009 and 2010. In the EU, no similar process of triage and recapitalization was conducted in time to restore confidence. A first round of European "stress tests" in September 2009 had negligible market impact as only aggregate numbers, not bank-by-bank results, were published. A second round of stress tests led to the publication of bank-by-bank results for 91 financial institutions across the EU in July 2010, but the disclosures lacked specificity and comparability, and some institutions that had passed

the tests, such as Allied Irish Banks, were exposed as severely undercapitalized shortly afterwards. A third round of stress tests led to better disclosures in July 2011, but identified only limited recapitalization needs.

The European reluctance to accept bank failures and banking sector restructuring can be traced to various factors. To start with, banks are comparatively much larger in Europe than they are in America, compared with the size of national economies and even after the consolidation that the crisis has induced on the U.S. side. According to the Bank for International Settlements, in 2009, the aggregated assets of the top three banks represented 406 percent of GDP in the Netherlands, 336 percent in the U.K., 334 percent in Sweden, 250 percent in France, 189 percent in Spain, 121 percent in Italy, and 118 percent in Germany, compared with 92 percent in Japan and "only" 43 percent in the United States. This is due to a combination of two main factors. First, banks generally play a larger role of financial intermediation in Europe than in the United States, where nonbank financial intermediaries and capital markets provide a larger share of total capital and credit. And second, many European banks have aggressively expanded internationally, thus increasing the scope of activities that, to the extent that these banks aren't allowed to fail, are implicitly supported by taxpayers in the home country. On average, the largest European banks have 57 percent of their activity outside of their home country (in the rest of Europe and in the rest of the world in about equal proportions), while the average ratio is only 22 percent among a comparable sample of the largest U.S. banks.

Moreover, there is a high degree of interdependence between banking systems and policymaking systems in most Western European countries. This interdependence also exists in the United States, as my Peterson Institute colleague Simon Johnson has repeatedly argued, and its specific forms vary widely from one country to another. In Germany, many locally elected officials sit on the boards of local public banks, an activity from which they typically derive a not insignificant part of their personal income; publicly owned banks at regional *(Land)* and sub-regional levels are often used as tools for local economic development policy. In Spain, a similar situation used to exist with the local savings banks *(Cajas),* even though this is now changing as many *Cajas* are being merged and restructured under compulsion from the central government. In Italy, non-profit foundations with strong links with local political establishments are key shareholders in most prominent financial institutions. In France, the regional component is perhaps less strong but at the national level, financial policymakers and bank executives tend to come from the same small pool of senior civil servants, and it is common practice for the former to switch to a high-level bank position at mid-career. In all these countries and elsewhere in Europe, this interdependence is a significant factor in the national political economy.

Moreover, the protection granted by national governments to their "home" banks does not have to be a function of cozy links between public and private-sector elites, as there is also a strong component of economic nationalism at play. In most Eurozone countries, banks are frequently seen as national or local "champions" whose prosperity is presumed to be broadly aligned with the national interest—even where this presumption does not rest on specific, compelling evidence. Resistance to cross-border bank takeovers remains deeply entrenched particularly in France, Italy and Spain but also in parts of Northern Europe—even though the ongoing restructuring of the Spanish banking sector might eventually result in a change in attitudes there. The same factors help explain why national policymaking communities are often in collective denial of the moral hazard created by the too-big-to-fail problem, as well as in denial of the conflicts of interest that are potentially embedded in the universal bank model which combines retail banking, investment banking, plus in many cases asset management, insurance activities, and proprietary investment within diversified financial conglomerates. In many Continental European countries, supervisory authorities harbor a culture that favors keeping sensitive information tight between themselves and the supervised entities, and are thus inclined to resist calls for public disclosures about financial risks and exposures, as was illustrated by controversies around the successive rounds of European stress tests.

Banking crisis and sovereign crisis

The financial crisis spilled over into a sovereign crisis in the Eurozone in early 2010. A year before, in the first months of 2009, the tense situation of several Central and Eastern European countries had raised widespread market concerns, but was subsequently stabilized thanks to energetic efforts of economic reform and budget tightening, most remarkably in the Baltic countries, and to successful international coordination in the form of the so-called Vienna Initiative to maintain liquidity to local banking systems. The Eurozone sovereign crisis started when the

Government of Greece, freshly elected in October 2009, revealed that its predecessor had misled its Eurozone neighbors and the public about the true state of the country's public finances. The ensuing deterioration of Greece's access to capital markets led it to seek help from fellow Eurozone countries and the International Monetary Fund (IMF), resulting in the May 2010 announcement of a first conditional assistance package of EUR110bn, quickly followed by the decision to set up a European Financial Stabilisation Facility (EFSF) with EUR440bn financial firepower to intervene in similar situations. Simultaneously, the ECB initiated a "Securities Markets Programme" under which it buys sovereign debt of troubled countries in secondary markets. Subsequently, the EFSF and IMF jointly agreed to provide conditional assistance packages to Ireland (November 2010) and Portugal (April 2011), and in July 2011, further assistance to Greece was decided by the Eurozone heads of state and government.

The interdependence between sovereign credit and banking systems has been a running theme of this sequence of events. Eurozone sovereign debt assets are held in large amounts by Eurozone banks, with a significant bias for the bonds of the country in which the bank is headquartered but also significant cross-border exposures to other Eurozone countries' sovereign debt. This is partly due to policy choices before the crisis which in retrospect appear questionable, particularly the risk-weighting at zero of Eurozone sovereign bonds in regulatory capital calculations, the longstanding acceptance of such bonds with no haircut by the ECB as collateral in its liquidity policies, and possible instances of moral suasion by home-country public authorities that resulted in large holdings of the home country's sovereign debt. In early 2010, the concern about the possible financial stability consequences for banks in France, Germany and other countries of having to book losses in the event of a Greek debt restructuring was a significant motivation for the decision to provide financial assistance to Athens. Even though it is impossible to know counterfactuals, had the Western European banking sector been less fragile at that time, it is very possible that a different course would have been taken involving Greek debt restructuring as early as 2010, and everything afterwards would have developed very differently. Put bluntly, the moral hazard created by the Greek package is largely a consequence of the failure or unwillingness of European policymakers to resolve the European banking crisis in 2009.

Similarly, the perceived fragility of Continental European banks is the main reason why the Irish Government was not allowed to impose losses on holders of senior bonds issued by the country's banks, including the collapsed Anglo Irish Bank, in the discussion of the November 2010 assistance package provided by the IMF and the EFSF, with a strong involvement of the ECB in the negotiation of that package. This condition correspondingly increased the burden of fiscal adjustment for Ireland and remains to this day a matter of controversy in the Irish political environment. Conversely, deterioration of sovereign debt prospects in Greece, Portugal, and Italy has had a knock-on negative effect on their domestic banking systems, given local banks' high levels of home-country sovereign debt exposure, as well as on French banks which hold large portfolios of sovereign debt from the Eurozone's periphery countries.

In the latest step to date, a relatively mild debt restructuring scheme euphemistically known as "private sector involvement" (PSI) was made a condition for the new assistance package to Greece whose outline was announced on July 21st, 2011, largely because of domestic political factors in countries including Germany and the Netherlands. However, the continued banking fragility led leaders to go for a "voluntary" form of PSI that would only entail moderate impairment of the affected assets. This arguably results in the worst of both worlds for Greece and the Eurozone: a further deterioration of Greece creditworthiness (PSI being considered "selective default" by the main credit rating agencies) and contagion to other Eurozone countries, in spite of solemn declarations that the Greek case is unique and would not be used as a template for other country situations; and simultaneously, a reduction of the Greek debt burden that is too limited to significantly improve its debt dynamics.

The interconnectedness between the banking and the sovereign crises helps to explain the lack of consensus about the current capital strength of Europe's banks. The official position of EU authorities and all Eurozone governments remains that, with the possible exception of Greece, Eurozone countries are not going to default on their sovereign obligations. Under this assumption, the current depressed market prices of periphery countries' debt need not be reflected on the balance sheets of banks with large held-to-maturity portfolios of such debt, and the European banking sector would appear adequately capitalized as a whole. If, however, market signals are taken at face value, or simply if a prudential approach is applied that compels banks with high exposures to periphery sovereigns to hold sizable additional capital

buffers, the average level of capital strength appears seriously insufficient. Thus, the solvency assessment of Europe's banks crucially depends on the view one has of the seriousness of the sovereign crisis. The rapidity of contagion, which extended to Italy in July and to French banks in August, suggests a conservative attitude is warranted, as the IMF is also arguing in its latest Global Financial Stability Report.

A crisis of EU institutions

This sequence of events highlights that European policymakers missed an important opportunity when they neglected to address their banking sector's fragility decisively when market conditions were relatively favorable in 2009, especially after the success of the U.S. Supervisory Capital Assessment Program. This failure is not for lack of good advice: the IMF, among others, had emphasized this challenge in its policy recommendations to European leaders. Had this advice been taken, and had Greek debt been adequately restructured in the first half of 2010, we would probably not have a major systemic crisis in Europe.

In decisions taken after May 2010, and until now, European leaders have often appeared to be behind the curve, and to react to the crisis's previous stage rather than to the current one. The European Commission, with the significant exception of DG COMP (the European Commission's Directorate-General for Competition Policy), has not been able to make executive decisions that it could impose on individual market participants. Its Directorate-General for the Internal Market and Services (DG MARKT) has focused on drafting new financial legislation but has devoted limited resources to its core mission of enforcing the integrity of the single market for financial services. Its Directorate-General for Economic and Financial Affairs (DG ECFIN) has provided valuable economic analysis, but so far has not presented a blueprint for crisis management instruments that would bring the situation under control. The Commission's President, José Manuel Barroso, has been very successful and proactive on one important occasion, when he commissioned a report from a blue-ribbon group led by former French central banker Jacques de Larosiére, which resulted in a major overhaul of the EU's supervisory architecture (see below). But in terms of crisis management, the Commission has generally not been able to get ahead of events, partly because of its limited de facto decisionmaking autonomy *vis-à-vis* member states (apart from DG COMP, which enjoys special status). This has left much of the action in the hands of the Council, *i.e.,* the group formed by relevant representatives of the individual member states' governments, who, being accountable as they are to their respective national constituencies, have found it difficult to overcome their differences.

This is better analyzed as a failure of institutions than of individual leaders. A different set of political leaders might have done better, but the core problem has been the insufficient political mandate of the Commission (and of the permanent president of the Council since the entry into force of the Lisbon Treaty in January 2010, Herman Van Rompuy), combined with the misalignment between the incentives of individual countries' leaders and the collective European interest. This combination works more or less satisfactorily in ordinary times, but its shortcomings become much more apparent in a crisis environment as it does not allow for effective executive decisionmaking at the EU level. The "French-German couple" is occasionally presented as a pragmatic option to bridge the executive leadership gap, but its accountability and legitimacy have been insufficient to provide the required impetus.

In the course of the crisis, individual EU bodies have occasionally found it possible to bridge part of the executive leadership gap. This has been most obviously the case of the ECB, particularly since May 2010 with the Securities Markets Programme of buying sovereign bonds from selected Eurozone countries on the secondary markets. However, the extent to which the ECB can go further on this path is not unconstrained, because it is seen by a number of constituents (notably in Germany) as a dangerous intrusion into fiscal policy that is bound to compromise the ECB's independence and its integrity in delivering on its core mission of ensuring price stability. Similarly though less prominently, since 2008 DG COMP has leveraged its authority to examine state aid by individual member states to individual financial institutions to press for more aggressive recapitalization of the weaker links in Europe's banking system, but its mandate has not allowed it to embark on a system-wide approach.

As mentioned above, a high-level group led by Jacques de Larosière was formed in late 2008 at the initiative of the European Commission's President, and in February 2009 this group recommended the creation of three European Supervisory Authorities to help oversee Europe's financial sector from a pan-European perspective—respectively, the European Banking Authority (EBA) based in London, the European Securities and Markets Authority (ESMA) based in Paris, and the European

Insurance and Occupational Pensions Authority (EIOPA) based in Frankfurt. These supervisory authorities were complemented by the creation of a European Systemic Risk Board (ESRB) to coordinate macroprudential policy. The corresponding EU legislation was (by EU standards) swiftly approved and the new institutions officially started operations on January 1, 2011. Even though it is still early to form a judgment, the EBA has had a material impact in making the disclosures accompanying the July 2011 stress tests markedly more reliable than had been the case in the previous round a year earlier. Thus, it can be hoped that these new agencies can bridge part of the leadership gap in the future as they gather institutional strength. However, as with the ECB and DG COMP, their mandate is limited and cannot be overextended to matters that entail major dimensions of political legitimacy and accountability.

The European Parliament has been gaining competencies in successive revisions of the European treaties, and is now an important player in shaping legislation. However, its oversight powers on the EU institutions, especially the Council, remain restricted in comparison to most national parliaments. Moreover, the European Parliament, unlike lower houses in democratic regimes, is not elected on the basis of electoral constituencies of about-equal demographic weight, as smaller EU member states elect more Members of the European Parliament (MEPs) than larger ones in proportion to their population. These shortcomings have led Germany's Federal Constitutional Court, in a landmark ruling in June 2009, to find the EU institutions not democratic enough to be granted powers in key areas of sovereignty, including fiscal policy.

In the words of the Court, "With the present status of integration, the European Union does, even upon the entry into force of the Treaty of Lisbon, not yet attain a shape that corresponds to the level of legitimisation of a democracy constituted as a state. (. . .) Neither as regards its composition nor its position in the European competence structure is the European Parliament sufficiently prepared to take representative and assignable majority decisions as uniform decisions on political direction. Measured against requirements placed on democracy in states, its election does not take due account of equality, and it is not competent to take authoritative decisions on political direction in the context of the supranational balancing of interest between the states. It therefore cannot support a parliamentary government and organise itself with regard to party politics in the system of government and opposition in such a way that a decision on political direction taken by the European electorate could have a politically decisive effect." This "structural democratic deficit" (also in the words of the Court) is a fundamental impediment to building up an effective executive capability at the EU level.

Conditions for crisis resolution

The design flaws of the Eurozone, including the lack of a federal fiscal and banking policy framework and the democratic deficit of EU institutions, had been well identified by analysts at the time the Maastricht Treaty was signed in 1991. However, this did not prevent the euro from being introduced in 1999 and from having what can fairly be described as a highly successful first decade, ostensibly disproving its doubters' warnings. Similarly, the same shortcomings need not be fatal now if individual member states succeed in bringing their sovereign finances, their banking systems and their economies back on a sustainable track. However, the unfavorable global economic environment and loss of investor confidence during the sequence of events so far make it unlikely that the crisis can be overcome without meaningful progress in addressing fundamental weaknesses in the European institutional framework.

Structural reforms that favor entrepreneurship and enhance the economy's growth potential, fiscal adjustment, and bank restructuring are required at the level of individual member states. They are an indispensable dimension of any successful crisis resolution. They vary from one country to another and their elaboration would require detail beyond the scope of this testimony. At the European level, the necessary steps can be (rather simplistically) summarized into four components: (a) a consistent federal Eurozone framework for fiscal policy (fiscal federalism); (b) a consistent federal Eurozone/EU framework for banking policy (banking federalism); (c) a general overhaul of the EU's political institutions that would upgrade their executive decisionmaking capability; and (d) adequate short-term crisis management arrangements to bridge the time gap between the present turmoil and an ultimate crisis resolution that would include the previous three components.

The first component, fiscal federalism, already exists in Europe in indirect forms, including the borrowing capacity of the European Commission and the European Investment Bank (which are however tightly limited) and the collateral policy of the ECB, which allows it to take risks with an ultimate guarantee from member states.

A further tentative step was taken in the direction of building a Eurozone fiscal federation with the creation of the EFSF, even though its design is strictly intergovernmental, and the decision to provide loans to struggling Eurozone countries at below-market rates. However, none of this prevents the possibility of fiscal or economic mismanagement or financial shocks in individual member states putting the stability of the entire monetary union at risk, as is now the case.

A vivid debate in Europe centers on the possible practical form of such fiscal federalism. One much-discussed proposal, by my Bruegel colleagues Jacques Delpla and Jakob von Weizsäcker, would have Eurozone members pool debt issuance up to 60 percent of their respective GDP in the form of Eurozone-wide "blue bonds," and meet any additional funding needs through higher-yielding "red bonds" that would instill market discipline at the level of individual countries. Another option, typically referred to as "Eurobonds," would be to federalize all sovereign borrowing in the Eurozone under a joint and several guarantee from all Eurozone countries. A more limited approach, first suggested by Daniel Gros at the Centre for European Policy Studies and Thomas Mayer at Deutsche Bank, would be to allow the EFSF to leverage its current resources and vastly expand its lending capacity by allowing it to borrow from the ECB. All these proposals imply new mechanisms to discipline the economic policy behavior of individual member states and mitigate the moral hazard inherent in any pooled borrowing scheme.

In a landmark speech in Aachen on June 2, 2011, ECB President Jean-Claude Trichet has outlined what he sees as the necessary next steps: in a first step "in the medium term," giving the European Council, on the basis of a proposal by the European Commission and in liaison with the ECB, the right to veto national economic policy decisions that may be harmful to Eurozone stability; and in a second step, "in the historical long term," establishing a European "ministry of finance" that would exert ongoing surveillance of both fiscal policies and competitiveness policies, that could take over direct responsibility for economic policy in failing countries, and that would also exert responsibilities in financial sector policy and external representation. Even though he did not specify how this intrusive authority could be legitimized from a political standpoint, this vision emphasizes the need for executive decisionmaking capacity at the core of the future fiscal federal framework, as not all future policy challenges can be captured in a set of ex ante rules and automatic sanctions, no matter how well designed.

The second component of eventual crisis resolution, banking federalism, also exists in embryonic form in the EU, with a largely though not completely harmonized banking regulatory framework in the form of EU financial legislation, and the recently created EBA which was endowed with limited supervisory and crisis management competencies. Even so, however, most supervisory and resolution authority still rests with member states, and so does a still significant amount of rulemaking that affects financial institutions, on conduct of business and consumer protection but also on prudential aspects as is illustrated by the current debate about the recommendations of the Independent Commission on Banking (or Vickers Commission) in the U.K.. Member states provide the guarantee for deposits, even though the modalities are harmonized under EU legislation, and only the member states have the fiscal capacity to intervene with equity or capital-like instruments in a crisis situation (even though liquidity policy in the Eurozone is mainly conducted by the ECB, and the ECB also has a say over additional liquidity assistance that may be provided by the Eurozone's national central banks beyond its own operations).

A European banking policy framework would imply the consistent formulation and implementation of regulatory, supervisory, resolution, deposit guarantee, and competition policies with regard to the banking industry throughout the EU. Compared with the present situation, this would entail at least four steps:

- The EBA should be granted supervisory authority over all credit institutions in the Union, which it would exercise either directly (specifically, over the central operations of banks with a pan-European scope) or indirectly (by delegating it back to national agencies, over banks that are only active in one country, or over local operations of pan-European banks);
- The EBA's own governance should be overhauled so as to ensure its decision-making is better aligned with the European public interest (the current decision framework involves single-majority voting by representatives of the 27 EU member states, which can lead to massively skewed outcomes because of the disproportionate influence of smaller countries);
- The EFSF should provide an explicit guarantee of national deposit guarantee schemes in all countries in the Eurozone, in order to prevent bank runs in the event of national sovereign-debt difficulties;

- Existing processes that allow member states to block cross-border acquisitions of "their" banks should be dismantled or brought under the control of European authorities.

The combination of these measures would have the effect of "decoupling" the banks from their national governments, putting an end to the single major impediment to the formation of a genuine European banking system, as opposed to a collection of national ones, as an indispensable complement to monetary unification. These proposals are broadly similar to the ones outlined by the IMF's then Managing Director Dominique Strauss-Kahn in a speech in Brussels on March 19, 2010.

The third component of crisis resolution is the upgrading of EU institutions, to enable them to support the federal frameworks for fiscal policy and banking policy in a politically sustainable manner. Essentially, this means bridging the current democratic deficit to a sufficient extent that executive decisions can be legitimately taken in these policy areas at the European level and not only at the national one. This cannot be achieved without significant changes in the EU treaties. One aspect has to be the correction of the design flaws identified by Germany's Federal Constitutional Court in its above-quoted 2009 ruling, namely the redefinition of the European Parliament's electoral constituencies in order to ensure equal representation of EU citizens, and enhanced oversight powers for the European Parliament over the executive and budget functions of EU institutions. Whether these measures would be sufficient to close the democratic gap is debatable, and would obviously warrant further public deliberation.

One additional layer of complexity is the tension between the Eurozone perimeter and that of the EU as a whole. At this point, the Eurozone comprises 17 of the EU's 27 member states, the outliers being the U.K., Sweden, Denmark, and seven Central and Eastern European countries (Bulgaria, Czech Republic, Hungary, Latvia, Lithuania, Poland, and Romania). Some of these countries may move toward joining the Eurozone assuming that the current phase of turmoil is overcome, but this does not seem to be a likely prospect for the U.K., and perhaps others. How the EU institutional framework can cohabit with what U.K. Chancellor of the Exchequer George Osborne has memorably termed "the remorseless logic of monetary union that leads from a single currency to greater fiscal integration" among Eurozone countries remains an open question. This is particularly true in the area of banking policy, which is currently set at the EU rather than Eurozone level, a fact that is reflected in the location of the European Banking Authority in London. This tension may become increasingly prominent in the years ahead.

Finally, the fourth necessary component of crisis resolution is to manage the transition from now to the completion of a federal fiscal and banking policy framework under reformed EU institutions, which, even under extreme assumptions, is bound to take an extended period of time, measured in years rather than months, to achieve. By definition, these transition arrangements represent a more short-term concern that needs to be addressed within the existing Treaty framework. Here too, in addition to action at the level of individual member states, the twin issues of banking crisis and sovereign crisis need to be addressed.

A central role could be played by an instrument to be created on an explicitly temporary basis, analogous to the Resolution Trust Corporation (RTC) that brought about the resolution of the U.S. savings and loan crisis in 1989–90. More than 2 years ago, in June 2009, Bruegel and the Peterson Institute published an analysis in which Adam Posen, now on the Monetary Policy Committee of the Bank of England, and I suggested a blueprint for such a European RTC, or as we termed it with reference to a German precedent a "European Banking Treuhand." The role of this *ad hoc* entity would be to catalyze and steer the necessary restructuring and cross-border consolidation of Europe's banking sector, by identifying which institutions are undercapitalized on a consistent basis across national borders, by taking over and restructuring those that cannot find enough capital from arm's-length sources, and by managing the corresponding assets and reselling them when market conditions allow. In the context of the sovereign crisis, this trust corporation could play an additional stabilizing role by ensuring the orderly functioning of the banking system in countries which undergo a sovereign debt restructuring. To fulfill its role, it would require enabling legislation passed in emergency by all relevant member states.

With a proper framework in place to manage banking emergencies on a consistent, system-wide basis, the Eurozone could envisage energetic debt restructuring in member states that cannot meet their obligations, which I believe to be the case for Greece alone at this point. This would send shock waves through the system but would also contribute to a reduction of uncertainty. It would need to be backed by enhanced liquidity assistance to other member states. The most likely option for this

in the short term is expanded intervention by the ECB, possibly through the agency of a leveraged EFSF that would be granted access to ECB liquidity. This appears to be what was recommended by U.S. Treasury Secretary Timothy Geithner in his conversations with his European colleagues last week. It is also the short-term solution that emerged from a collective simulation exercise jointly hosted by the Peterson Institute and Bruegel last week, on which my colleagues Guntram Wolff at Bruegel and Ted Truman at the Peterson Institute have reported on the two organization's respective Web sites. Our simulation suggests that this could be compatible with the ECB's mandate under the existing Treaty and that it could have a material impact in addressing market contagion.

Short-term outlook and policy options for the United States

Spelling out these conditions for crisis resolutions underlines the Herculean political challenges of their implementation. Treaty changes that involve multiple referendums and also likely amendments to national constitutions, including in Germany; the shift of core areas of sovereignty from the national to the EU level; the definition of a *modus vivendi* with non-Eurozone members within EU institutions whose functioning would become dominated by Eurozone-only processes; and, inevitably, the public acknowledgement of major policy failures in the treatment of the crisis so far.

At this point, it appears very difficult to identify a reliable path from here to there, and the short-term outlook is not the most encouraging. Things are likely to get worse in Europe before they can get better. In the current circumstances too many European citizens, and too many of their leaders, remain in denial of their collective predicament, which prevents necessary initiatives from being undertaken. This means that contagion may spread further in the very short term.

This, however, remains a crisis for the Europeans to resolve. Europe's international partners can help, but cannot take their place to fix the situation. The Eurozone as a whole is not in a state of financial distress. Its aggregate debt and deficit metrics compare favorably to the United States, U.K., or Japan.

The IMF has played a very constructive role since the beginning of the crisis. Beyond the financial assistance it has provided to Greece, Ireland and Portugal, it has brought invaluable experience and technical input to the discussion among Europeans. The U.S. Government, together with other non-European countries, has provided pointed advice at critical moments. But none of these external partners of Europe can unlock the key bottlenecks in the current phase, which are primarily political in nature.

Financial contagion to the United States from further deterioration in the Eurozone cannot be ruled out. In spite of the recent downgrading by Standard and Poor's, U.S. sovereign debt retains safe haven status and I do not expect this to change in the short term, including in the case that things would take a sharp negative turn in Europe. However, because of multiple financial interdependencies across the Atlantic, deterioration in Europe could have financial impact in the United States. These transatlantic contagion risks can be mitigated to an extent by appropriate contingency planning and enhanced dialog between financial supervisory authorities in the United States, on the one hand, and the U.S. arms of European financial firms, as well as U.S. financial firms with financial exposure to Europe, on the other hand. Under the current circumstances, the United States should not overreact and financially ring-fence itself from the rest of the world to an extent that would compromise global financial integration from which the United States is one of the key beneficiaries. Thus, precautionary measures are warranted but should remain proportionate. This seems to be the current mindset of U.S. financial authorities.

The Federal Reserve is also participating, together with others of the world's prominent central banks, in a network of currency swaps with the ECB that facilitates the access of Eurozone banks to liquidity in dollars and other non-euro currencies. The benefits of this initiative in terms of financial stability, at the global level and also from the strict domestic point of view of the United States, appear to vastly exceed the risks involved to the Federal Reserve.

The United States, the IMF and others global partners have an important role to play by providing advice and what John Maynard Keynes called ruthless truth-telling to their European partners. Many Europeans still find it difficult to acknowledge the extreme seriousness of the current conditions in the Eurozone. Expressing concern in constructive but frank terms can help, as Secretary Geithner apparently did last weekend in Poland. But, once again, only the Europeans themselves can meaningfully address their current, dangerous situation.

PREPARED STATEMENT OF JOACHIM FELS

GLOBAL HEAD OF ECONOMICS, MORGAN STANLEY

SEPTEMBER 22, 2011

Introduction and Summary

1. The origins of the euro area's twin sovereign debt and banking crisis include (i) a weak institutional framework with one money but many nations; (ii) an oversized and undercapitalized banking sector with high exposure to sovereign debt; and (iii) diverging growth and competitiveness trends between euro member countries, leading to large current account imbalances and a buildup of debt in the deficit countries. The crisis was exacerbated over the past eighteen months by a slow and inadequate response to the Greek and the banking sector problems, and more recently by the decision to involve the private sector in the latest Greek bail-out package. A lasting solution of the crisis requires bold reforms of the euro area's institutional framework, including (i) a big step toward closer fiscal union between member states with a (partial) loss of fiscal sovereignty to avoid moral hazard, (ii) large-scale recapitalization and restructuring of the banking sector, and (iii) a central bank able and willing to serve as a lender of last resort to member states in order to prevent self-fulfilling 'runs' on otherwise solvent sovereigns. Major political and legal obstacles to such reforms imply that a quick resolution of the crisis is unlikely. A deepening crisis potentially involving a default by one or several members states and, as a worst case, a break-up of the euro would have severe adverse consequences for the U.S. and global financial sector and economy.

The Origins of the Crisis

2. There are three key factors at the root of the current sovereign debt and banking sector crisis in the euro area. First, a unique institutional framework combining a single monetary policy conducted by a central bank constrained by a narrow inflation mandate with decentralized fiscal policy and decentralized banking supervision in the 17 member states. Second, an oversized, undercapitalized and fragmented banking sector highly dependent on wholesale funding. Third, divergent trends in growth and price competitiveness between member states' economies, which led to large current imbalances within the union and a buildup of debt in the deficit countries.
3. The most important of these three factors is the euro area's peculiar institutional framework. One distinctive feature of this framework is that while monetary policy is centralized, individual member states have retained their fiscal sovereignty. To prevent countries from running excessive fiscal deficits, the Stability and Growth Pact (SGP), an inter-governmental agreement that accompanied the move to a single currency, set limits for individual countries' debts and deficits and envisaged fiscal sanctions for fiscal sinners. However, the SGP lacked teeth because the imposition of sanctions always required a qualified majority vote by all finance ministers ('sinners watching over sinners'), and because the criteria were watered down further in 2003, when the two largest countries, Germany and France, missed the fiscal criteria and coalesced to change the goal posts. Moreover, the Treaty regulating monetary union contains a 'no bail-out' clause, stating that no member country can be forced to stand in for the debts of other members. At the same time, the Treaty lacks a mechanism for orderly sovereign debt restructurings and it does not provide for a mechanism to exit the euro area. In fact, while a country may chose to exit the euro, there is no provision for excluding a non-compliant member state. In summary, the euro area's institutional framework has neither been able to prevent irresponsible fiscal behaviour, nor does it provide a mechanism for an orderly resolution once a fiscal position has become unsustainable—either in the form of fiscal transfers or an orderly insolvency.
4. To make matters worse, another distinctive feature of the euro area's institutional framework is that the European Central Bank is constitutionally banned from financing governments directly, be it through direct loans or purchases of government bonds at auction. This provision was enshrined in the Treaty establishing monetary union to enhance the ECB's credibility as an inflation fighter—the Treaty states price stability as the ECB's primary mandate—and, in particular, to placate Germany's fears of financing governments through the printing press, which are rooted in the experience with hyperinflation in the Weimar Republic of the 1920s and the experience of financing two wars through the printing press. However, an important consequence of this provision is that governments no longer have a lender of last resort to turn to in

case creditors refuse to fund them at reasonable interest rates. Without access to the printing press in extreme circumstances, there is a risk of self-fulfilling 'runs' on otherwise solvent governments.

True, access to the printing press, if overused, can be inflationary. But investors typically fear default more than inflation, which is usually much slower to materialize and less disruptive for the financial system than a default. The lack of access to the central bank as a lender of last resort helps to explain why investors treat countries with high debt in the euro area as 'credits' and thus differently from countries with similarly high debt levels (Japan, U.K., U.S.) who, in principle, have access to their central bank and are thus 'true sovereigns'.

Exacerbating Factors

5. While the three key factors above—a weak institutional framework, an oversized and undercapitalized banking system, and growing imbalances within and between euro area member countries—have been at the root of the crisis, it was exacerbated by a slow and inadequate policy response ever since the Greek problems became apparent in late 2009. Delaying the initial aid package for Greece until May of last year helped spark contagion into Portugal and Ireland. Making the rescue fund (the European Financial Stability Facility EFSF) a temporary institution scheduled to expire in 2013 fueled fears that default would become likely after the fund's expiration. Including the principle of private sector participation in post-2013 bail-outs into the blueprint for the post-2013 permanent rescue fund (the European Stability Mechanism ESM) confirmed those fears. Failure to force banks to recapitalize faster and more aggressively undermined both investor confidence in the financial system and companies' and private households' access to bank credit. Moreover, by breaking an earlier promise and involving private investors in the latest Greek bail-out package decided on 21 July 2011 through a 'voluntary' debt exchange, euro area governments sparked the latest round of contagion into the Spanish and Italian bond markets as the promise that 'Greece is an exception' was not deemed credible. In all these cases, domestic political considerations in the face of widespread public opposition to further bail-outs especially in Germany, the Netherlands and Finland, prevented bolder and more timely steps. Rather than blaming governments in these countries for delayed or misguided decisions at the European level as many commentators do, we view this outcome as the logical consequence of what we identified as the most important underlying cause of the crisis—the euro area's inadequate institutional economic governance framework.

Options to Resolve the Crisis

6. A lasting solution of the crisis requires bold reforms of the euro area's institutional framework—fiscal and monetary—as well as banking sector recapitalization and restructuring. Fiscal reform should include two elements. First, a fiscal transfer mechanism or insurance scheme that provides a backstop for governments unable to fund in the market at reasonable interest rates. Second, a (partial) transfer of member states' fiscal sovereignty to a European authority to avoid irresponsible fiscal behaviour.
7. Second, to prevent self-fulfilling runs on otherwise solvent sovereigns, the euro area needs a central bank able and willing to serve as a lender of last resort to member states in exceptional circumstances. To some extent, the ECB has assumed this role in the current crisis by buying government bonds of Greece, Portugal, Ireland and, more recently, Spain and Italy in the secondary market. However, the amounts purchased have been relatively small and the ECB is constitutionally barred from buying bonds directly at auction.
8. Third, to break the negative feedback loop between the sovereign crisis and the banking sector crisis, banking regulators should push for a large-scale recapitalization program including both private sector and EFSF involvement.
9. There are major legal and political obstacles to bold and far-reaching reforms of the euro area's fiscal and monetary framework. These reforms would require a change in the Treaty of Europe, which would have to be ratified in all national parliaments and would, in several countries require popular votes. Past experience with Treaty changes suggests that this could take several years. Yet, without such reforms, the euro area's sovereign debt crisis is unlikely to be solved. As a consequence, it is safe to assume that the crisis will continue in the foreseeable future and probably deepen further.

Implications for the U.S. and Global Financial Sector and Economy

10. A deepening crisis potentially involving a default by one or several members states and, as a worst case, a break-up of the euro would have severe adverse consequences for the U.S. and global financial sector and economy. First, higher funding costs for the public and private sector, fiscal austerity measures and banking sector stress suggest that the euro area economy will broadly stagnate in the foreseeable future, with many Southern member countries including Italy and Spain experiencing a renewed recession. Thus, European import demand looks set to slow, which will dampen U.S. and other regions' export growth. Second, a deepening European crisis is likely to push the euro exchange rate lower versus the dollar and other currencies, which will also hurt U.S. and other exports to Europe. Third, while U.S. banks, in general, are viewed as stronger in terms of capital, liquidity and asset quality than their European peers, the European crisis has contributed, alongside global growth concerns, to higher funding stress and a higher cost of capital in the United States and elsewhere.

PREPARED STATEMENT OF DOMENICO LOMBARDI [1]

PRESIDENT, THE OXFORD INSTITUTE FOR ECONOMIC POLICY AND SENIOR FELLOW, THE BROOKINGS INSTITUTION

SEPTEMBER 22, 2011

Chairman Warner, Ranking Member Johanns, honorable Members of the Subcommittee, thank you for this opportunity to share my views with you on the euro-area crisis and its implications for the United States.

I have organized my remarks as follows: in the first section I elaborate on the origin of the crisis and provide a basic chronology of the main events until the downgrade by Standard & Poor's of Italy's sovereign bonds on Monday. In the following section, I focus on the policy response, highlighting the many gaps that still persist and proposing a multi-pronged strategy consisting of immediate as well as short- and medium-term measures. Finally, in the last section, I focus on the implications for the U.S. economy and elaborate on the diplomatic and institutional levers that the United States can mobilize to affect current developments in Europe.

Origins

What started in the fall of 2009 as a fiscal crisis in a smaller European economy—Greece, accounting for just 2 percent of the total area's GDP—has evolved into a systemic crisis of the euro-area itself. This crisis now threatens not just to melt down one of the world's major economies, but to destroy the social and political fabric that several generations of European political leaders have laid down with the unwavering friendship of the United States since the end of WW II.

In October 2009, when Greece's newly elected Socialist government revised the estimate for that year's budget deficit from 6.7 percent of GDP up to a whopping 12.7 percent of GDP, and then further revised to above 15 percent, credit-rating agencies began downgrading Greek bonds while investors faced increasing concerns about the country's high debt and about allegations that the Greek government had altered official statistics so as to enable spending beyond the country's means (Tables 1 and 2).

In May 2010, a loan agreement between the euro-area countries, the IMF, and the Greek government was announced in the amount of EUR110 billion, of which EUR80 billion would be financed by the euro-area countries and EUR30 billion by the IMF.

The inertia from the euro area in assembling a stabilization program for Greece until almost the middle of the following year focused market investors and analysts on the vulnerabilities of other countries sharing the single European currency. A few months later, Portugal and Ireland had to request a stabilization program from the IMF and the EU.

Following intense economic and financial pressures, triggered by a critically weakened banking sector in Ireland, public finances were weighed down by a deep fiscal deficit as a result of commitments to bank support. In late November 2010, an agreement was reached between the IMF, the EU, and the Irish authorities on a policy package of EUR85 billion for the period 2010–2013, of which EUR22.5 billion would be funded by the IMF.

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[1] I am grateful to, but do not wish to implicate, Karim Foda and Sarah Milsom for excellent research assistance.

Portugal was the third member of the euro area to seek assistance from the IMF and the EU. Its long-standing structural problems—including low productivity, lack of competitiveness, and high unemployment—had severely undermined its growth, which averaged only 1 percent during the previous 10 years. The lack of growth, combined with the impact of the global financial crisis, had resulted in a large fiscal deficit and high levels of debt (Tables 1 and 2). The joint EU–IMF financial package agreed for the period 2011–2014 was for EUR 78 billion, of which one third committed by the IMF.

Late this summer, market pressure on Italy escalated and the spreads of its government bonds *vis-á-vis* the German Bund widened to over 400 basis points—levels not seen since the introduction of the euro (Table 13). As a result, the Italian authorities put forward two supplementary budget plans in less than 2 months—the latter having been approved by the Parliament only days ago. Soon afterwards, just this Monday in fact, Standard & Poor's downgraded the country's sovereign rating, keeping it on a "negative outlook," which may prompt a further downgrade over the coming weeks.

Other large sovereigns have also been affected. French government bond spreads have risen *vis-á-vis* the Bund, albeit by far less than Italy's. Last week, two large French banks were also downgraded on account of their exposure to the distressed peripheral economies of the euro area.

While interest rates on German government bonds have been decreasing, it would be inaccurate to say that Germany has not been affected by the euro-area turmoil. Following a strong rebound of 3.6 percent last year in the aftermath of the international financial crisis, Germany's GDP growth will be subdued this year at an estimated 2.7 percent, and will further decline to 1.3 percent next year, according to the data released by the IMF on Tuesday (Table 8).

The stabilization programs pursued by the economies in distress and the fiscal retrenchment enacted by the rest of the euro area will, moreover, increasingly affect the ability of German manufacturers to export their products in the area. Compounded with increasing uncertainty, this is likely to result, at the very least, in a slowing down of the German GDP growth for the next few years—as a best-case scenario and barring significant repercussions in its financial sector.

While the national governments are obviously primarily responsible for the unfolding of the current events in Europe, the incomplete architecture of the euro area has created unprecedented scope for contagion by exposing each member of the monetary union—albeit to varying degrees—to the vulnerabilities of the other members.

Italy is a case in point. While the sluggish growth of its economy and the high-level (and increasing) public debt are not new phenomena, the crisis of the peripheral economies has provided the trigger for market investors to focus on the Italian economy's long-run ability to service an increasing stock of public debt.

Coupled with the inexistence of a lender of last resort, market expectations can rapidly become self-fulfilling in the euro area.

Options

The Policy Response So Far

As the Greek crisis reached its peak, the EU, concerned about contagion risks within euro zone countries, came forward in May 2010 with a broad package of measures worth EUR500 billion to preserve financial stability in the region. In addition, the IMF expressed its aim to support such financing arrangements with an additional EUR250 billion, bringing the total amount of the "safety net" to EUR750 billion.

The European Council also established a special-purpose vehicle, the European Financial Stability Facility (EFSF), which was incorporated weeks later in Luxembourg, with the objective to provide temporary financial assistance to euro-area partners. The EFSF became fully operational on August 4, 2010, and is designed to operate for 3 years.

It is authorized to issue bonds and/or other debt instruments on the market, with the support of the German Debt Management Office (DMO). Issues are to be backed by guarantees from euro-area countries, for a total amount not to exceed EUR440 billion. In September 2010, EFSF bonds were assigned the top credit rating (AAA) by rating agencies. EFSF debt instruments can be used as collateral in refinancing operations through the European Central Bank.

The EFSF is not a preferred creditor along the lines of the IMF. Its claims on a particular country have the same standing as any other sovereign claim. If too many creditors were granted preferred status, private investors would be reluctant to offer loans to the country concerned.

The EFSF has a very lean structure, with a staff of only about a dozen people, made possible because the German DMO and the European Investment Bank both

provide the EFSF support. The board of the EFSF is made up of high-level representatives-Deputy Ministers or Secretaries of State or director generals of national treasuries-from the 16 euro-area Member States. Observers from both the European Commission and the ECB also sit on the EFSF board, which is chaired by the EU's Economic and Financial Committee Chairman.

The euro zone summit held on July 21, 2011 widened the EFSF's scope of activity by allowing it to: i) act on the basis of a precautionary program; ii) finance recapitalization of financial institutions through loans to governments, including in non-program countries; and iii) intervene in the secondary markets on the basis of exceptional financial market circumstances and risks to financial stability, or on the basis of a mutual decision by the EFSF Member States, to avoid contagion.

Earlier on, at their summit on June 24, 2011, EU Heads of State and Government had also decided that the EFSF may intervene in exceptional circumstances in the debt primary market, in the context of a program with strict conditionality. These amendments are still not operational as they await approval by national legislatures. It is expected that they may enter into effect sometime in October, at the earliest. Meanwhile, a recent decision by the German Constitutional Court appears to preclude the possibility that Germany will join the new permanent crisis mechanism, the European Stability Mechanism, which EU Heads of State and Government decided to establish on June 24 as a successor to the temporary EFSF.

Moreover, earlier in the summer, euro-area leaders had agreed to a follow-up program for Greece on the order of EUR100 billion, which also awaits parliamentary approval. The German Parliament is expected the program sometime in October. Uncertainty exists as to whether, under what terms, and in what proportion the IMF might join such a program.

The European Central Bank Governing Council has taken extraordinary measures in filling a political and institutional vacuum. In the period from May 2010 to April 2011, the Eurosystem—the ECB and the euro-area's national central banks—conducted open market purchases of Greek, Irish, and Portuguese bonds for EUR78 billion through the Securities Market Program (SMP).

Following escalating market pressures on Italy and Spain over the summer, the Eurosystem reactivated the SMP by intervening for EUR80 billion as of September 16, 2011. Unofficial reports from trading desks suggest that approximately 65 percent has been spent to buy Italian government bonds, 30 percent to buy Spanish bonds, and the remaining 5 percent for Ireland and Portugal bonds. While the ECB has not disclosed for how long it intends to continue the SMP, it is reasonable to assume that it may plan to do so until the EFSF will be able to step in, following ratifications of recent amendments noted above.

The ECB has also intervened to ease pressures on European banks in the U.S. dollar funding market. At the end of June, the ECB extended the liquidity swap arrangement with the U.S. Federal Reserve to provide U.S. dollar liquidity to those banks unable to access the interbank dollar market. Research conducted by Barclays Capital (Euro Money Markets Weekly) reports that some European banks have recently been using ECB dollar facilities.

Assessing the Policy Response

Admittedly, the institutional framework established at the outset for the single European currency did not include a safety pillar such as an EFSF-type mechanism. This is mainly a reflection of the assumption, not fulfilled ex post, that subsequent to the introduction of the euro, the overall stability of the euro zone would be underpinned by a sustained convergence toward a unique policy process—one that would go well beyond monetary policy and would be geared toward macroeconomic stability. This expectation has not materialized, as economic policies have diverged.

More than a year after the establishment of the EFSF, there are still no emergency instruments for intervening in support of large sovereigns, like Italy, should market pressure significantly escalate in the coming weeks or months. Given that the EFSF has currently committed some EUR175 billion—based on estimates from Barclays Capital Research—of its EUR440 billion potential endowment, the remaining EUR265 billion would be insufficient to ring-fence Italy, should it be cutoff from markets.

In 2012 alone, the Italian Treasury will need to provision an amount of, at least, EUR235 billion, excluding T-bills (Buoni Ordinari del Tesoro). Assuming an approximately similar amount for 2013, this implies that a hypothetical joint 2-year EU–IMF program would deplete both the EFSF and the IMF. The resources of the latter were, as of September 15, SDR246 billion (or about EUR290 billion) in terms of its forward commitment capacity.

Oddly enough, if euro-area countries were to step up their guarantees in any substantial way to make the EFSF a viable financing instrument for large sovereigns,

the contingent fiscal liabilities that would arise for each euro-area member would increase proportionally by a few percentage points of GDP. For France, this could entail losing the AAA status.

In other words, in an attempt to stabilize Italy, France could make itself more vulnerable. As a result, Italy, and other large sovereigns, is currently exposed to self-fulfilling market runs against which there are no safety net, unless the ECB were to monetize public debt, which it is prevented from doing.

Against this background, an effective, credible, and comprehensive response would need to rely on three pillars of emergency, short- and medium-term measures.

i) First Pillar

In the immediate, the EFSF should be strengthened by implementing the decisions already agreed upon by euro-area leaders during the summer. Further reforms should also be introduced to step up the decisionmaking, operational, and financial capabilities of the EFSF so as to stabilize market expectations about the euro-area's immediate-response firepower.

The EFSF suffers, in fact, from a number of limitations. Its governance is symptomatic of a purely intergovernmental approach to the management of the euro-area crisis, with lending decisions requiring the unanimous approval of all the euro-area countries. Yet, one of the key reasons for the current crisis is precisely the fact that markets have very deep reservations about the credibility of a monetary union run on the basis of an intergovernmental approach rather than a federalist one.

As for its financial capability, the EFSF funds its lending programs by issuing bonds guaranteed by its euro-area shareholders. As a result, subscriptions to the EFSF's bond issuances cannot be taken for granted in the case of a systemic crisis, where contagion to otherwise healthy national financial markets is a serious possibility. Even when the EFSF can borrow from markets, its financial capability is severely constrained by the time lag needed to provision resources from the markets.

As has been suggested, the possibility of acceding to a credit line by the ECB would, instead, confer easy and timely access to funding, would enable the EFSF to amplify its financial capacity by leveraging on that funding, and would relieve the ECB of the role of crisis lender, which is outside its mandate. Admittedly, uncertainty would still persist against the lack of a lender of last resort, which would be needed to stabilize large sovereigns with substantial refinancing needs, should they be hit by a severe liquidity crisis.

Moreover, euro-area leaders and the Greek authorities would need to establish the sustainability of any new follow-up program. The Greek debt-to-GDP ratio is currently projected to reach over 140 percent; under these conditions, it is simply impossible for the Greek economy to return to a sound footing—all the more so given that monetary and exchange rate policies are outside the control of the authorities.

A more extensive engagement by the private sector (*i.e.,* "orderly default") is required to decrease the ratio to a lower, sustainable level. The enhanced EFSF could provide the resources to strengthen the European banks that will have to write off part of the Greek debt.

As long as the Greek crisis is not credibly reigned in, uncertainty will persist as to whether other euro-area economies may be stabilized, regardless of the required efforts that their national authorities have to implement.

ii) Second Pillar

In the short-term, the euro area would need to establish a framework for pooling the fiscal sovereignty of euro-area members. This would not need to result in a euro-area-wide finance ministry. Rather, a centralized entity such as the European Commission should be allowed to vet national fiscal policies or strategies on behalf of the euro area as a whole and on the basis of commonly agreed-upon and binding criteria.

In return, member countries could issue eurobonds, that is, government bonds backed by a common, euro-area-wide guarantee, up to a certain threshold, such as, for instance, 60 percent of GDP, as has been suggested. Admittedly, the issuance of eurobonds alone, without the safeguards afforded by the centralized vetting, would not stabilize all euro-area countries.

For instance, with a debt-to-GDP ratio of 120 percent or EUR1.9 trillion in absolute value, Italy would still need to issue the upper 60 percent tranche of its debt under the current framework of nationally guaranteed bonds. In other words, from Italy alone, there would be almost EUR1 trillion in bonds floating with no euro-area guarantee.

iii) Third Pillar

In the medium term, euro-area countries should establish a coordinating framework that would go beyond fiscal policies by encompassing macroeconomic and

structural policies. In fact, this is required to ensure that aggregate demand is sustained over time and that national economies do not pursue policies that are inconsistent at the euro-area level.

Along those lines, for instance, some euro-area economies like Germany cannot expect to run a persistent surplus in their current accounts while other economies of the area have to reduce their aggregate demand and, therefore, their imports from Germany as well. Accordingly, the latter could balance the reduced demand from the rest of the euro area by expanding its own domestic demand. This would have the advantage of supporting the rest of the euro-area economies that would otherwise be facing substantial retrenchment for years to come.

Up to now, there has been no mechanism to balance current accounts within the euro area. Germany has been able to accumulate consistent surpluses, even greater than those of China in proportion to GDP, without the restrictions of a compensatory mechanism provided by exchange-rate appreciation, such as that in play during the 1970s and 1990s with the German mark. Because of this asymmetry, Germany multiplied the benefits for its economy after the introduction of the single currency, with current account balances consistently in surplus and for the most part on the rise, reaching about 6 percent of GDP in 2010 (Table 9). During the 3-year period 2006–2008, the balance was even greater, representing a historical high for Germany, at least with respect to the last 40 years.

On the other hand, the current account balance with respect to GDP of the euro area in general has hovered, on average, around zero over the course of the past decade, without therefore generating any direct pressure for a compensatory adjustment in the exchange rate of the single currency. Never has this asymmetry been more evident than at the height of the international financial crisis, when the German economy benefited from a considerable increase in exports outside the euro area. Over the course of 2010, taking advantage of a relatively weaker euro—by 9 percent compared to the year before, in real terms—manufacturing orders from beyond the euro area for German firms reached their highest in a decade.

Implications for the United States

The U.S. exports goods to the euro area for approximately US$100 billion (Table 3) or a bit less than 10 percent of its total goods exports (Table 6). They are mostly skewed toward Germany, France, and, also, Italy. Flagging demand in Europe due to a gloomy outlook and increasing uncertainty is likely to result in fewer exports, thus increasing the fragility of the U.S. economic recovery.

From a financial standpoint, U.S. banks are exposed to the euro area for US$2.7 trillion, largely reflecting claims toward France (US$643 billion) and Germany (US$623 billion) (see Table 10). These claims account for 29 percent of the United States total exposure to foreign counterparts (Table 11). Exposure to France and Germany accounts for 14 percent altogether of total foreign exposure (Table 11).

U.S. banks are also exposed to the U.K. for some US$2 trillion or 23 percent of their total foreign exposure (Tables 10 and 11). Exposure to the peripheral economies under stress is modest—claims on Greece, Ireland, and Portugal account for 3 percent of total foreign exposure (Table 11).

Therefore, any significant impact to the U.S. banking system would accrue through the largest euro-area sovereigns, once or if the crisis becomes a fully blown systemic one. Accordingly, there is still an important window of opportunity that the United States may use in trying to stabilize the euro-area crisis.

While, of course, any resolution of the euro-area crisis ultimately hinges on the European countries themselves, the United States can rely on the following levers to affect the current developments.

i) Bilateral Relationships

Euro-area countries are traditional allies to the United States, with whom the United States has developed longstanding diplomatic and working relationships. The press has reported regular conference calls and meetings between senior officials of the current administration and their respective European counterparts.

The President has reportedly engaged European political leaders on a regular basis. Perhaps it is not a coincidence that German Chancellor Merkel publicly announced support for the first rescue program for Greece in the spring of last year, following a conference call with the U.S. president the very same day.

ii) The G–20

The G–20 played a pivotal role in the 2007–09 international financial crisis. The Bush administration convened the first Leaders' Summit in Washington in November 2008 ("Washington Summit"). Subsequently, President Obama and other world leaders from the G–20 decided to hold regular summits and "designated the G–20 to be the premier forum for.[their] international economic cooperation" (Pittsburgh

Summit, September 2009). Yet, the G–20 has kept a remarkably low profile in the wake of current developments in Europe, mainly as a reflection of the hesitation of its continental European members to involve the global G–20 forum on issues they consider "internal."

Regardless of whether the G–20 gets formally involved in the European crisis, it could still fulfill a very important coordinating role. In September 2009, the United States launched the Framework for a Strong, Sustainable, and Balanced Growth. The rebalancing of global demand through some large emerging economies' switching to a greater extent to domestic sources for their economic growth becomes a more urgent issue against flagging demand in Europe and the increasing fragility of the U.S. economic rebound.

Today and in the next few days, the G–20 will meet at the margins of the IMF and World Bank Annual Meetings. It is important that the G–20 makes tangible progress on global rebalancing by the time of the forthcoming summit in Cannes in early November. There is, however, a sense that expectations should be low as progress may not materialize.

iii) The G–7

The G–7 has been increasingly active in the context of the European crisis and has represented the international forum where Continental European countries have exchanged views with other nations on the developments unfolding in Europe. The longstanding, small network of G–7 officials provides a more intimate forum in contrast with the G–20, and the Europeans themselves regard this forum as better suited to have internationally broad discussions with traditional allies.

The United States has used this forum to persuade the Europeans and to prod them to a credible and urgent course of action.[2] Following the latest recent financial summit in France, the G–7 will meet again at the margins of this week's IMF and World Bank Annual Meetings.

iv) The IMF

The IMF represents an important source of leverage for the United States, given its status as the largest shareholder. The U.S. appoints an Executive Director in the Executive Board. Moreover, the post of First Deputy Managing Directorship has always been filled by an American citizen, since the position was established in the 1990s.

Given its role of overseer of the stability of the global financial and monetary system, the IMF has not just the right, but the duty, to intervene—on its own terms—in the current developments. Its role goes well beyond lending and falls under its original surveillance mandate.

The IMF has jointly funded, with the EU, all the programs in the distressed euro-area economies. Whether or not it will join future programs is a matter the Executive Board will have to decide on. Regardless of future lending commitments, however, the confidence-building effect from a step up in the Fund's financial capacity should be seriously considered.

Just as the G–20 leaders fortified the IMF's financial position with an extraordinary injection of capital following the London Summit in April 2009, the membership of the IMF should, at the very least, implement the reform package already agreed on by the IMF Board of Governors in December 2010 and previously endorsed by the G–20 leaders in Seoul the month before. Once approved, IMF resources will increase from SDR238.4 billion to approximately SDR476.8 billion (about US$750 billion). As part of the agreement, moreover, Western European countries will release two seats on the Executive Board in favor of emerging and developing countries.

The United States has not yet ratified this agreement.

The IMF also relies on contingent credit lines through the New Arrangements to Borrow. In the event the Fund needs to readily supplement its permanent resources, the NAB is a first-recourse facility. Once activated, it can provide supplementary resources of up to SDR367.5 billion (about US$580 billion) to the IMF. The NAB was activated last spring for a period of 6 months, in the amount of SDR 211 billion (about US$333 billion). The United States contributes with SDR69 billion (approximately US$100 billion).

Given the prospect of a meltdown of the euro-area, the NAB provides a fundamental backstop to the IMF's lending capacity, even more so as the final ratification of the doubling in IMF quotas will inevitably require several more months, at least.

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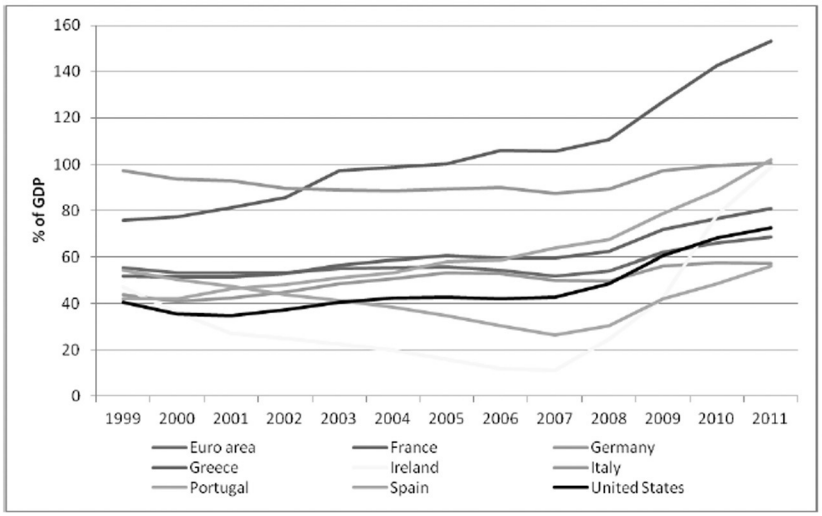
[2] See, for instance, the Dow Jones wire available at: *http://www.foxbusiness.com/industries/2011/07/19/in-flurry-calls-g7-governments-signal-eu-meeting-critical/*.

v) The U.S. Federal Reserve

The Fed has provided the ECB with dollar funding through currency swap operations since the outbreak of the international financial crisis, to enable the ECB to provide U.S. dollar funding to euro-area banks. In May 2010, the ECB reintroduced this form of transaction, as the Greek crisis led to tensions in the U.S. dollar liquidity market for European banks. In January 2011, the ECB then dropped the facility to reintroduce it again this summer. Accordingly, at the end of June 2011, the liquidity-swap arrangements between the ECB and the Fed were extended to August of next year.

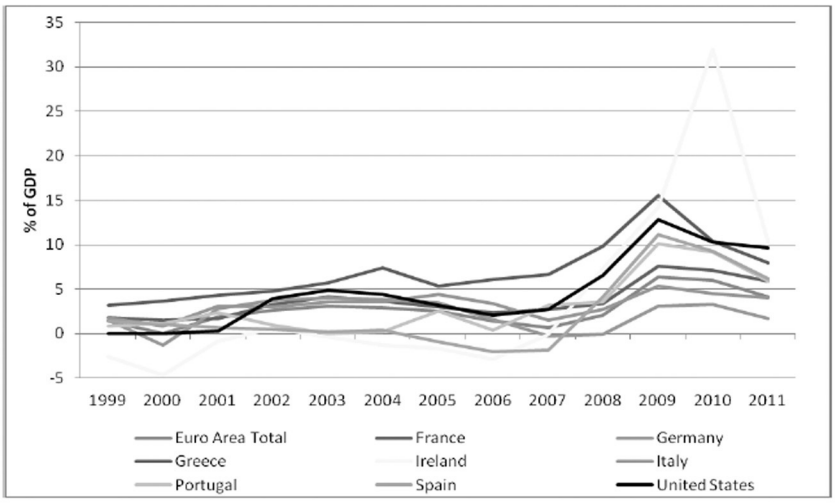
Notably, the Federal Reserve's cooperation lent to the ECB allows European financial institutions to meet their counterparty or loan obligations in U.S. dollars thus minimizing the risk of contagion in U.S. markets. The extension of these credit lines does not expose the Federal Reserve to foreign exchange or private bank risk. When the Federal Reserve provides dollars through the reciprocal currency swaps, they provide them to the ECB, not to the institutions obtaining funding through the liquidity operations tendered by the ECB. Nor does the Federal Reserve assume any exchange-rate risk, because the supplying of dollars in exchange for foreign currency, and the subsequent receipt of dollars in exchange for foreign currency at the swap's maturity date, take place at the same rate of foreign exchange.

Table 1. Government Net Debt
(Percent of GDP)



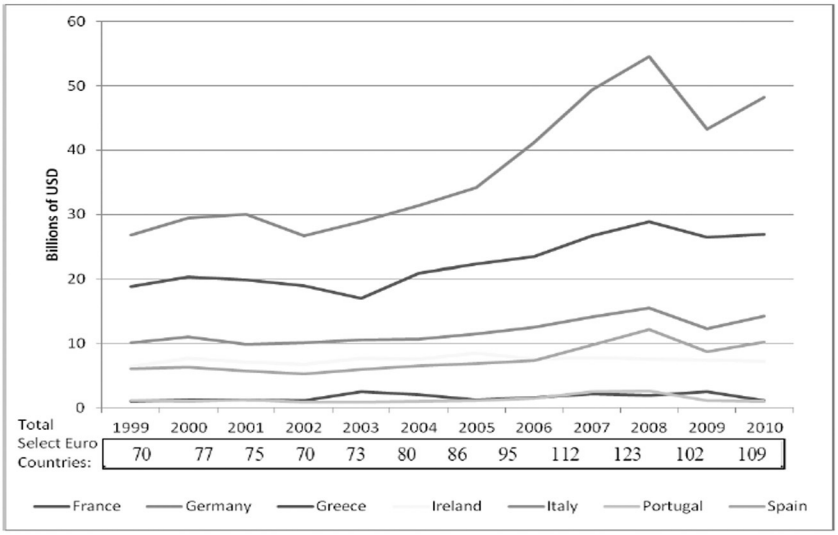
Source: IMF WEO database
Note: Euro Area Total excludes Estonia, 2011 data as of September

Table 2. General Government Budget Deficit (Percent of GDP)



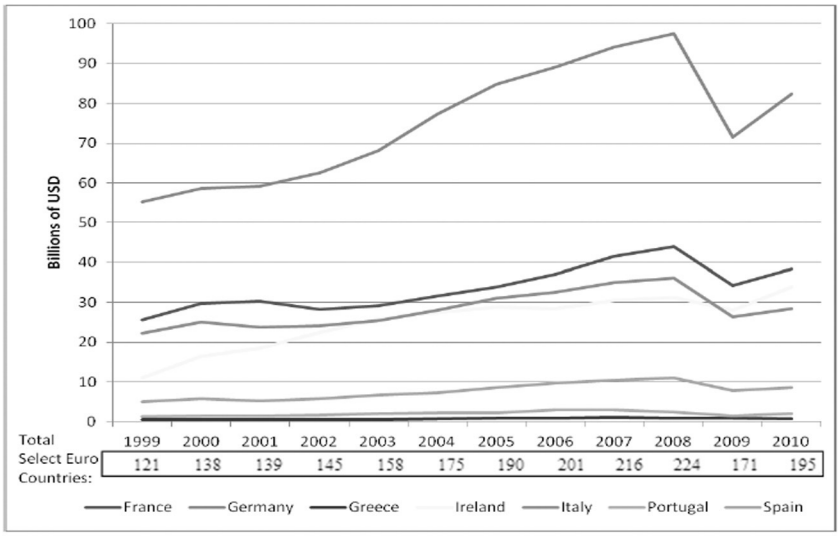
Source: IMF WEO database
Note: Euro Area Total excludes Estonia, 2011 data as of September

Table 3. U.S. Exports to Euro Area (Select Countries, Billions USD)



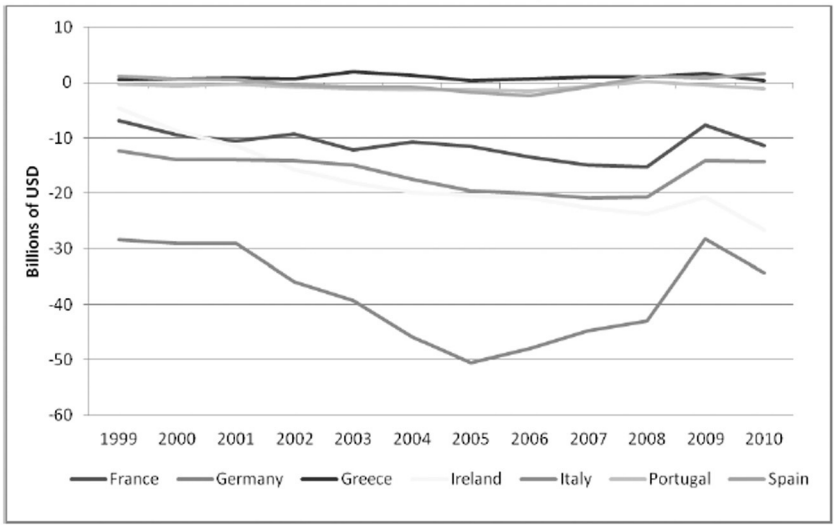
Source: http://www.census.gov/foreign-trade/balance/
Note: Trade in goods.

Table 4. U.S. Imports from Euro Area (Select Countries, Billions USD)



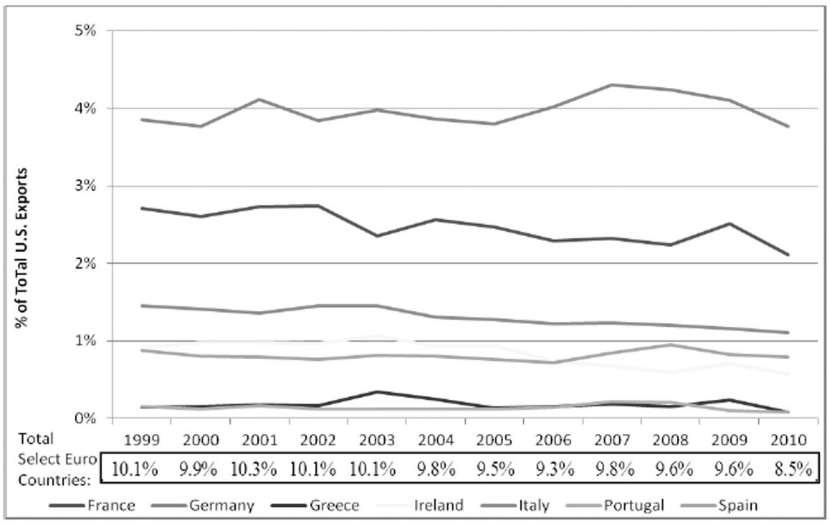
Source: http://www.census.gov/foreign-trade/balance/
Note: Trade in goods.

Table 5. U.S. Trade Balance (X-Im) (billions of USD)



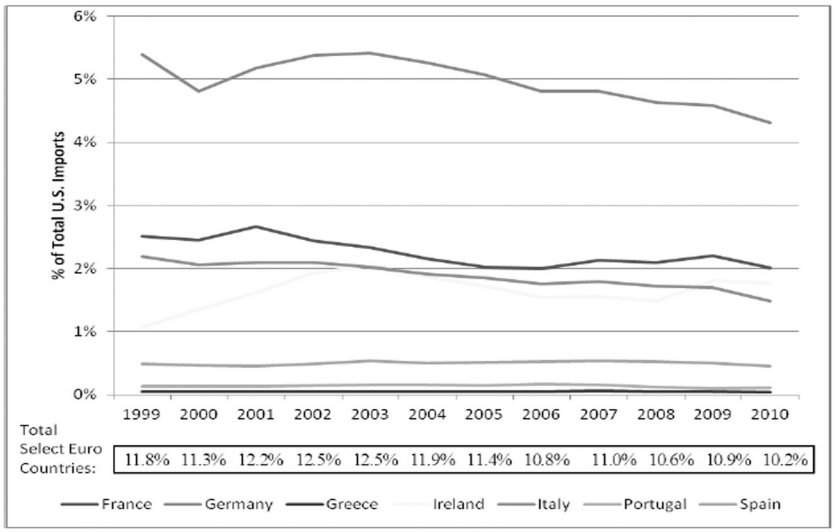
Source: http://www.census.gov/foreign-trade/balance/
Note: Trade in goods.

Table 6. U.S. Exports to Euro Area as % of Total U.S. Exports



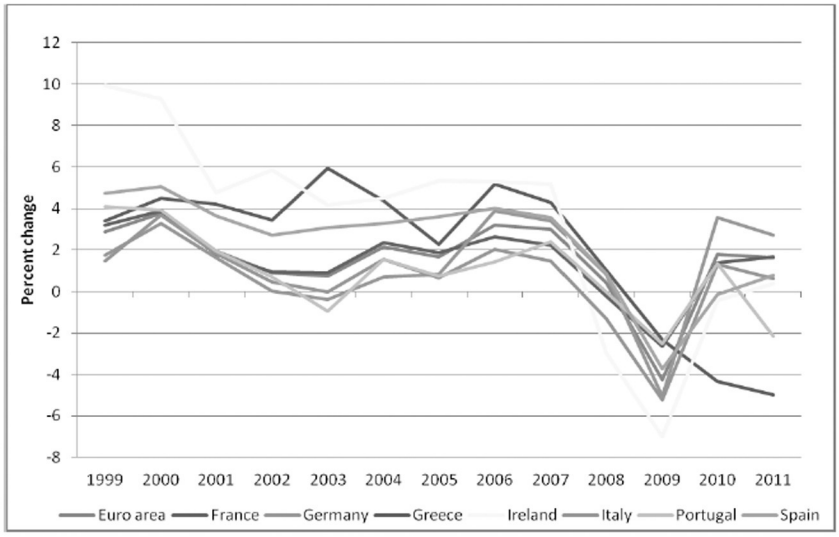
Source: http://www.census.gov/foreign-trade/balance/
Note: Trade in goods.

Table 7. U.S. Imports from Euro Area as % of Total U.S. Imports



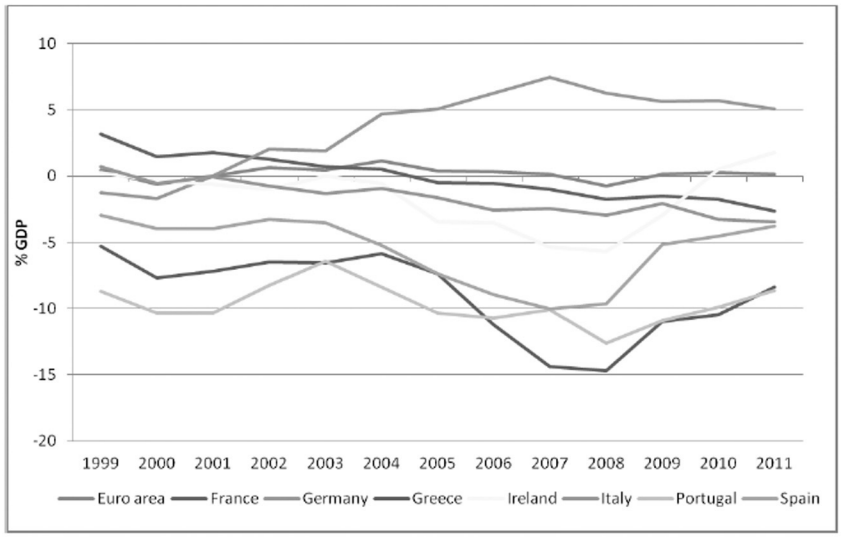
Source: http://www.census.gov/foreign-trade/balance/
Note: Trade in goods.

Table 8. Real GDP Growth
(Annual percent change, 1999 - 2011)



Source: IMF World Economic Outlook, September 2011.

Table 9. Current Account Balances
(Percent of GDP, 1999 - 2011)



Source: IMF World Economic Outlook, September 2011.

Table 10. U.S. Bank Exposure to Europe (billions of USD, as of Q1 2011)

		Foreign Claims			
	Total Exposure	Public Sector	Banks	Non-bank private sector	Other potential exposures[a]
Euro Area[b]	**2,664**	144	394	314	1,811
France	**643**	26	152	68	397
Germany	**623**	68	124	50	381
Greece	**47**	2	3	4	38
Ireland	**119**	2	15	43	60
Italy	**292**	14	16	14	248
Portugal	**55**	1	3	2	49
Spain	**212**	6	25	27	155
UK	**2,072**	58	206	451	1,357

[a] Guarantees extended, derivatives contracts, and credit commitments

[b] Does not include Cyprus, Malta, Slovak Republic and Slovenia

Source: Bank of International Settlements.

Table 11. U.S. Bank Exposure to Europe (percent of total US exposures by category, as of Q1 2011)

			Foreign Claims			
	Total Exposure[a]	Total Foreign Claims	Public Sector	Banks	Non-bank private sector	Other potential exposures[b]
Euro area[c]	**29%**	25%	23%	36%	19%	32%
France	**7%**	7%	4%	14%	4%	7%
Germany	**7%**	7%	11%	11%	3%	7%
Greece	**1%**	0%	0%	0%	0%	1%
Ireland	**1%**	2%	0%	1%	3%	1%
Italy	**3%**	1%	2%	1%	1%	4%
Portugal	**1%**	0%	0%	0%	0%	1%
Spain	**2%**	2%	1%	2%	2%	3%
UK	**23%**	21%	9%	19%	27%	24%

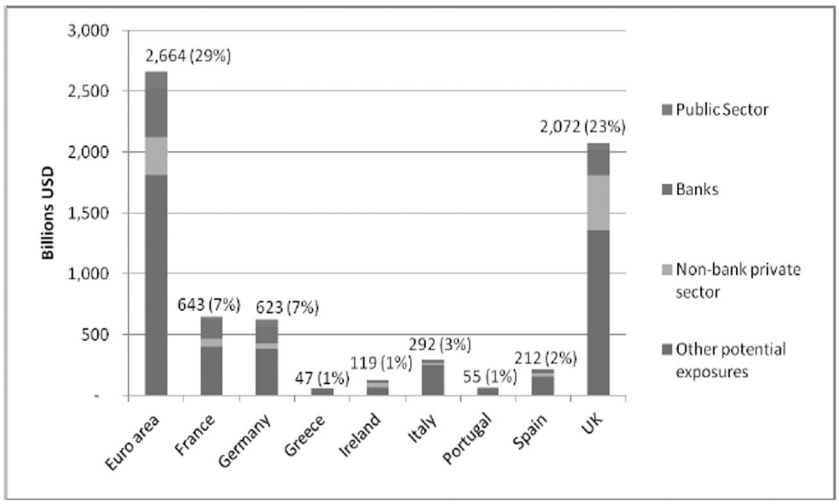
[a] Equals total foreign claims plus other potential exposures

[b] Guarantees extended, derivatives contracts, and credit commitments

[c] Does not include Cyprus, Malta, Slovak Republic and Slovenia

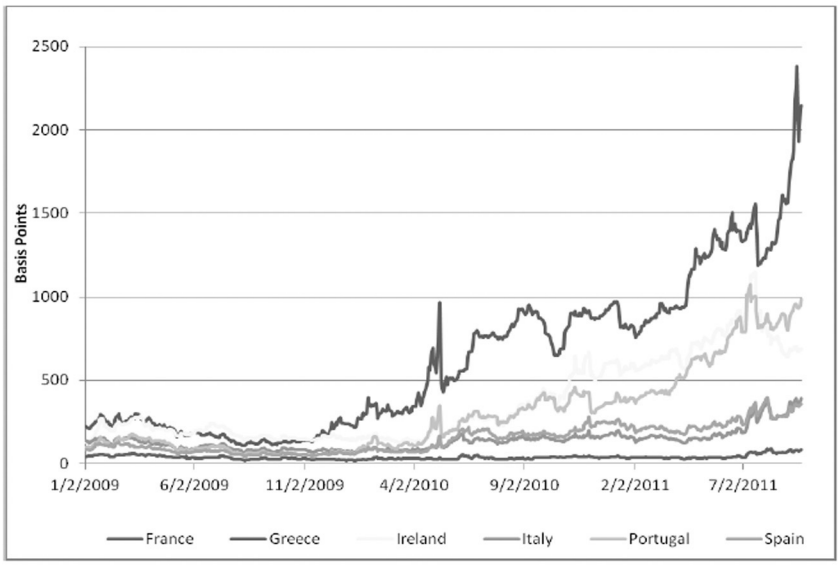
Source: Bank of International Settlements.

Table 12. U.S. Bank Exposure to Europe
(billions of USD and percent of total U.S. bank exposure, as of Q1 2011)



Note: Other potential exposures include guarantees extended, derivatives contracts and credit commitments; Euro area total does not include Cyprus, Malta, Slovak Republic and Slovenia.
Source: Bank of International Settlements.

Table 13. 10 Year Government Bond Spreads over German Bund
(Basis Points. January 2, 2009 – September 20, 2011)



Source: Bloomberg.

PREPARED STATEMENT OF J.D. FOSTER, PH.D.

NORMAN B. TURE SENIOR FELLOW IN THE ECONOMICS OF FISCAL POLICY
THE HERITAGE FOUNDATION

SEPTEMBER 22, 2011

Chairman Warner, Ranking Member Johanns, thank you for the opportunity to testify today. My name is J.D. Foster. I am the Norman B. Ture Senior Fellow at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

The European Economic Crisis is no accident. It is entirely the product of fundamental policy mistakes begun long ago and since magnified and papered over time and again. I believe there are two root mistakes that have produced this outcome.

The first is the relatively recent mistake of adopting a single currency without the economic policy infrastructure necessary to protect it. Without arguing the wisdom of the Euro one way or the other, the fact is that if it were purely a matter of economic policy the Euro could have succeeded as envisioned. But there were prerequisites relating to harmonization of labor policy, commercial policy, environmental policy, and so forth, and absent these it was imperative to harmonize fiscal policies. Europe made some progress in some areas and little in others. It was undeniably woefully inadequate.

The second great mistake was the adoption of a generous social welfare state without attending to the pro-growth policies necessary to sustain such a state in light on an increasingly competitive global economy. In the absence of increasing global competition a slow-growth big government economic model is viable; not, in my view, preferable by any means, but viable. In the face of fierce and rising competitive pressures from outside Europe, economic growth through rising productivity and improved economic competitiveness is not merely beneficial, it is essential to national survival.

The Europeans have long been aware of this tension, hence their efforts to cajole, coerce, or otherwise convince the rest of the world to adopt their economic model. An obvious example is their efforts to force Ireland to adopt a higher corporate income tax rate. Rather than adopt the policies necessary to speed their own economies to match those of the competition, Europe tried to slow the economies of the competition. It didn't work.

I very much regret what our friends across the pond must now endure, and what awaits them in the days, months, and years ahead. For them, there are no easy answers. For us, there is little we can do to help, but there are preparations we can make and lessons we can learn.

These causal questions are important and interesting, but the issue of the day is what is happening today, and what effect it will have on the United States. In the testimony that follows, I will attempt to describe briefly the basic dimensions of what continental Europe now faces, and then the transmission mechanisms by which the United States may be affected, and conclude with what the United States can do to prepare.

Europe's Many Layered Problems

Europe's immediate problem is a pending and building liquidity crisis. European banks and other financial institutions are experiencing increasing difficulty accessing short-term credit markets, and depositors are getting very nervous. According to reports, for example, Siemens recently withdrew 500 million Euros from a French bank. Greek banks have been on life support from the European Central Bank for months, and central banks have just recently pumped more billions of dollars into the continental-wide banking system. Confidence, the life blood of financial markets, is failing fast.

The reason, of course, is that these banks hold vast quantities of dubious assets—dodgy government debt. Some, perhaps many or even most, European banks have a solvency problem. As Josef Ackerman, Chief Executive Office of Deutsche Bank recently explained, "Numerous European banks would not survive having to revalue sovereign debt held on the banking book at market levels". This view was reinforced on September 20 by Joaquin Alumnia, the European Union's competition commissioner, who noted that "Sadly, as the sovereign debt crisis worsens, more banks may need to be recapitalized".

In this Alumnia was restating a view presented recently by Christine Lagarde, managing director of the International Monetary Fund (IMF) from which she subsequently beat a hasty retreat under withering fire from the EU establishment. Madam Lagarde had committed the unpardonable sin of speaking the obvious truth,

a truth that is likely to be laid bare by an IMF report expected to be out at the end of September reportedly showing banks need a "whopping 273.2 billion (euros)" in recapitalization. A big problem in this regard for credit markets is nobody really knows which bank would and which would not survive today.

The solvency problem, in turn, traces to the sovereign debt problem—some governments have issued debt and run budget deficits to unsustainable levels. And a big reason these debt levels are unsustainable is not merely their sheer magnitudes, but that these countries also suffer from an ongoing growth problem. The growth problem—even in good times they experienced little growth. Now they are contracting, in some cases rapidly. So while their debt is high and rising, the economy on which the debt rests is flat or contracting.

But growth rates tell only a part of the story. The larger story is that the cost structures in many of these countries render them highly uncompetitive economically, even within Europe and certainly outside of Europe. This means they cannot hope to run the trade surpluses necessary to generate the earnings with which to pay their foreign creditors.

The painful immediate conundrum Europe faces is that attempts to address the sovereign debt problem, through tax hikes for example, make the economic growth problem worse thus making current debt levels less sustainable. At the same time, issuing even more debt in an attempt to buy time to deal with the sovereign debt problem typically make the bank solvency problem worse by driving down the value of the outstanding dodgy debt.

And it gets worse. Attempts to address the financial market solvency problem by drawing attention to the need for more bank capital often bring the liquidity crisis to a fevered pitch. This is a Gordian know of enormous proportion and complexity, and one must express a grudging admiration for the European leaders in having managed so well for so long, all the while knowing they could not do so indefinitely.

Taking a step back for perspective, the long-run implications of being highly uncompetitive are catastrophic. Europe will, at some point and in some fashion, overcome the liquidity problem, and the solvency problem, and even the sovereign debt problem. These can be overcome in a variety of ways, all of which are painful to someone and all of which will cause hardship for years to come. But I am confident they can and will be overcome.

In contrast, the inability to compete globally presents problems of an entirely different nature. Greece is, unfortunately, an excellent example. Greece achieved an artificially high standard of living largely by borrowing from abroad. This also led to increases in wages and prices that far outstripped productivity growth, leaving Greek producers uncompetitive within and without Europe. However, in the good old days being able to borrow from abroad made up the difference in terms of income. Greek borrowing is today on a very short leash, the economy is contracting rapidly, and with their artificially elevated wage and price structures Greece cannot hope to generate the net exports and earnings needed to service its existing debt.

This leaves Greece with two very unpalatable options. One option is to let a deep, prolonged depression drive down wages and prices to the point where Greece's workers and companies can generate a trade surplus. Greece would quite possibly look enviously at Japan's lost decade.

The other option is to make the adjustment the old fashioned way—to devalue. And there's the rub—as a member of the monetary union, Greece lacks a currency to devalue; which is why the arguments about how difficult or painful it would be for Greece to break out of the Euro are irrelevant. There is no less painful alternative as long as Germany refuses to work so Greece can enjoy the fruits of German labor. As Financial Times columnist James Mackintosh wrote in Wednesday's paper, "Fixed exchange rates force economic adjustment via wages and prices; Greece needs dramatic wage deflation to regain competitiveness against Germany. The political impossibility of slashing pay packets enough is a reason it may have to leave the Euro, even though living standards will fall either way."

The Implications for the United States

With this as overview, the fundamental transmission mechanisms of the European Economic Crisis for the United States economy are as straightforward in outline as they are murky in detail. There are two such mechanisms, one through financial markets and a second through trade flows.

Five years ago, one might have viewed the European financial crisis, that is, the existential threat to European financial institutions and markets, as mostly a European affaire. To be sure, American financial institutions hold some of this dodgy European debt, as well. There have even been stories that super-safe money market funds have loaded up on scary levels of high-yielding Greek debt. But, on balance, one would have thought a financial contagion in Europe would be stopped at water's

edge. Five years ago, the Europeans thought the same thing about the then-rumored U.S. subprime mortgage fiasco about to unfold.

The issue is global financial interconnectedness. This is where matters get murky. No one, including the participants and including the financial regulators, really knows or understands all the connections, or all the weaknesses. We know in great detail, for example, how much foreign debt by country each of our banks own. But for years the Europeans have assured the world their true exposure to sovereign debt risk was limited because they had hedged their positions with credit default swaps (CDS). Note, however, that CDS do not eliminate risk but merely shift it. To whom? No one really knows.

Suppose, for example, you are the CEO of a well-run U.S. bank. You have carefully assessed your exposures to the European sovereign debt crisis and have built up a proper capital cushion. Your exposures to Europe all appear to be through credible institutions which themselves appear to have adequate capital. But what are their other assets? How much of these CDS do they own? How much capital do they have when they have to make good on their CDS exposure? They may not really know. You don't know. And so you as CEO don't really know how safe your bank really is.

European leaders will not be able to kick the can down the road indefinitely. Matters worsen almost daily. Italy's debt was recently downgraded. Economies are contracting. Greece is fighting for one more breathe in the form of the next tranche of oxygen from the IMF.

As these events unfold, the essential consequence for the United States economy is a large dose of bad uncertainty. Bad uncertainty is analogous to bad cholesterol. It builds up and creates economic blockages. In the economic sphere, this shows up as decisions delayed or downscaled, decisions that under normal times would produce the actions that produce growth. Europe is clearly adding to the headwinds facing the economy today.

At some point, this house of cards will come tumbling down, taking much of the European financial system with it. Fortunately, this part of Europe's problem can and I believe will be halted in its tracks fairly quickly by recapitalizing the banks. The questions for the Europeans will be—whose capital and how much? For the United States, too, the immediate threat will then pass.

As the financial crisis fades, as it will, Europe will be left with the remaining fundamental economic problems of a dysfunctional monetary union, uncompetitive economies in many cases, and recession. This, again, is where matters get murky. The monetary union may evolve in any one of a number of paths, none of which appear particularly germane to the U.S. situation; likewise the policies necessary to restore all the nations of Europe to a state of international competitiveness.

The depth and length of the recession in each country will vary, but none will be immune. Many of these countries suffered poorly performing economies before the crisis. For the United States the implications if not the magnitudes are clear—a major U.S. trading partner will be in a slump, and so U.S. exports to Europe will suffer.

If the U.S. economy were in good shape, a drop in exports would simply be another headwind to be overcome. In 1997, during the Asian economic crisis, the U.S. experienced an event similar in nature if not magnitude, but the U.S. economy was reasonably strong and accelerating and so the headwinds from the Asian crisis were essentially imperceptible in the aggregate.

Unfortunately, rather than strengthening, the U.S. economy today is flat on its back, and facing the very real possibility of yet another recession even without the headwinds of Europe. President Obama's economic policies have failed utterly and completely. Mounting a sustained, robust, job-creating U.S. recovery under the circumstances will prove very difficult.

What the United States Can Do to Prepare

There is very little the United States can do to help the Europeans through their troubles. There is, perhaps, some harm the U.S. Government can inflict, and Treasury Secretary Geithner appears to have done his best to inflict some in his recent lectures to the European leadership at their recent finance meetings in Poland. No doubt his counterparts are wondering to themselves the old refrain, "with friends like this, who needs enemies."

One rather nebulous issue for the United States arising from Europe's troubles is that once again the United States, despite all its troubles, is perceived as a safe haven for capital. Thus enormous capital inflows from abroad have propped up the dollar exchange rate to an extent, and driven down domestic interest rates. Given the current weakness in the U.S. economy and the Federal Reserve's current policy of maintaining very low interest rates and its expected attempts at driving down

long-term rates in particular, these interest rate pressures may actually be benefiting the U.S. economy today. On the other hand, there will be a flip side—at some point these capital inflows will become outflows, pushing up interest rates at an inopportune time.

As there are two definable threats to the United States economy, preparations should focus on dealing with those two threats. Above all, the key to preparing for the financial threat is capital. Capital reserves act like levees in the face of a flood, protecting financial institutions from the onrushing river of failing confidence. Presumably, America's financial regulators and supervisors are keeping a close eye on bank capital reserves. However, in light of what may be in the offing, it is reasonable to question the prudence of banks and other financial institutions paying out dividends at this time, dividends that if retained would add a few sandbags to the levees.

The second threat is from the expected drop in exports to Europe and the effects this will have on the U.S. economy. Little or nothing can be done about the drop in exports, but much could be done to strengthen the economy to absorb the blow better. All of these actions fall under the guiding principle of "do less harm".

To Grow, or Not to Grow, That is the Question

The fundamentals of our economy remain sound. The natural productive tendencies of America's workers, investors, and entrepreneurs remain undiminished. The economy is poised to grow.

Why, then, does it hold back?

There are, of course, the unusual headwinds, such as the follow-on effects of Japan's devastating earthquake and tsunami. But the economy faces and overcomes such headwinds even in the best of times. Headwinds there are, to be sure, but they do not explain the economy's lethargy.

The economy suffers from two categories of troubles. The first are structural troubles, which today primarily reflect a housing sector still in deep disequilibrium in many areas of the country.

There is very little substantively that government can do to return housing markets to normal, and heaven knows Congress and the President have tried just about everything. And that is part of the problem. Government's well-intentioned meddling has delayed and distorted the essential requirement for normalization—price discovery. On balance, these policies have set back the housing recovery by months, perhaps a year or more. There is an important lesson here.

The second category of trouble is what might be termed environmental—not the natural environment, but the economic environment. Most relevant for our discussion is alternatively a shortage of confidence or an excess of bad uncertainty. Those who could make the decisions and take the actions that would grow the economy lack the confidence to do so. Even today, the economy abounds in opportunities for growth. But turning potential into reality requires action, and action requires confidence—confidence in the future, confidence in the specific effects in government policy, and confidence that government can properly carry out its basic functions, like agreeing to a budget.

America suffers a confidence shortage, and Washington is overwhelmingly the cause.

Confidence, in turn, is lacking because of an excess of uncertainty: Uncertainty about the future, but also uncertainty about the effects of government policies—tax, regulatory, monetary, trade. Uncertainty is natural, of course. The future is always uncertain. But there is good uncertainty and bad uncertainty, much as there is good cholesterol and bad cholesterol. Good uncertainty, for example, presents opportunities for profit. Bad uncertainty arises largely when investors and entrepreneurs have very real questions about the consequences of government policy.

Tax policy provides a good example of bad uncertainty. The President's repeated insistence on raising taxes on high-income workers and investors slows the economy even without the policy being enacted. It does so by raising the uncertainty about the tax consequences of various actions. It does not stop all such actions, but it stops some, and therein lies the difference between growth and stagnation.

The President's insistence is a twofer in terms of bad uncertainty. The specific is that taxpayers don't know what their tax liability will be. The general is that suggesting raising taxes on anyone in the face of high and possibly rising unemployment suggests a gross lack of understanding about how an economy works. That's a source of bad uncertainty that afflicts the entire economy, not just those threatened with higher taxes.

In this environment, Congress need not enact bad policy to weaken the economy. Threats suffice to do real damage.

Unfortunately, President Obama's recent and urgent deficit-building jobs plan was so weak Senate Majority Leader Harry Reid (D–NV) refused even to attempt to bring it to the Senate floor. And his subsequent deficit reduction plan was so full of gimmicks and misrepresentations even his allies on the left had to stifle their reactions. Clearly, President Obama has chosen to campaign for re-election on a far left populist message that sacrifices economic strength and job growth for ideology, leaving the U.S. economy to fend for itself as events in Europe unfold.

The American economist Joseph Schumpeter once observed, "the problem that is usually being visualized is how capitalism administers existing structures, whereas the relevant problem is how it creates and destroys them." The next few years are very likely to bear this out.

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