S. HRG. 112–350

THE G–20 AND GLOBAL ECONOMIC AND FINANCIAL RISKS

HEARING

BEFORE THE

SUBCOMMITTEE ON
SECURITY AND INTERNATIONAL TRADE AND FINANCE

OF THE

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

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

ON

EXAMINING THE DIMENSIONS OF THE EUROPEAN ECONOMIC CRISIS INCLUDING OPTIONS FOR RESOLVING IT AND IMPLICATIONS FOR THE U.S. AND GLOBAL ECONOMY

OCTOBER 20, 2011

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

Available at: http://www.fdsys.gov/

U.S. GOVERNMENT PRINTING OFFICE

73–895 PDF WASHINGTON : 2012

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

TIM JOHNSON, South Dakota, *Chairman*

JACK REED, Rhode Island	RICHARD C. SHELBY, Alabama
CHARLES E. SCHUMER, New York	MIKE CRAPO, Idaho
ROBERT MENENDEZ, New Jersey	BOB CORKER, Tennessee
DANIEL K. AKAKA, Hawaii	JIM DEMINT, South Carolina
SHERROD BROWN, Ohio	DAVID VITTER, Louisiana
JON TESTER, Montana	MIKE JOHANNS, Nebraska
HERB KOHL, Wisconsin	PATRICK J. TOOMEY, Pennsylvania
MARK R. WARNER, Virginia	MARK KIRK, Illinois
JEFF MERKLEY, Oregon	JERRY MORAN, Kansas
MICHAEL F. BENNET, Colorado	ROGER F. WICKER, Mississippi
KAY HAGAN, North Carolina	

DWIGHT FETTIG, *Staff Director*
WILLIAM D. DUHNKE, *Republican Staff Director*

DAWN RATLIFF, *Chief Clerk*
RIKER VERMILYE, *Hearing Clerk*
SHELVIN SIMMONS, *IT Director*
JIM CROWELL, *Editor*

SUBCOMMITTEE ON SECURITY AND INTERNATIONAL TRADE AND FINANCE

MARK R. WARNER, Virginia, *Chairman*
MIKE JOHANNS, Nebraska, *Ranking Republican Member*

SHERROD BROWN, Ohio	MARK KIRK, Illinois
MICHAEL F. BENNET, Colorado	
TIM JOHNSON, South Dakota	

NATHAN C. STEINWALD, *Subcommittee Staff Director*
SARAH NOVASCONE, *Republican Subcommittee Staff Director*

C O N T E N T S

THURSDAY, OCTOBER 20, 2011

WITNESSES

THE G–20 AND GLOBAL ECONOMIC AND FINANCIAL RISKS

THURSDAY, OCTOBER 20, 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 3:04 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. I would like to call to order this hearing of the Banking Subcommittee on Security and International Trade and Finance. This hearing's subject, which is more timely than I think when we initially planned it, is the G–20 and global economic and financial risks.

We are fortunate to have on our first panel the Honorable Lael Brainard, Under Secretary for International Affairs at Treasury, with us today, and since we moved this hearing back from 2 o'clock to 3 o'clock because we had votes, I will be very brief in my opening comments and try to make sure we take advantage of the witnesses' time for questions.

Obviously, the timing of today I think is particularly important in the fact that the G–20 Finance Ministers just met this past weekend where they issued a new communique, and we have got the European Union summit this weekend, which all the eyes of the world will be on. Following these two summits, the G–20 will hold a full summit in Cannes, France, November 3rd and 4th.

The single most obvious challenge facing the G–20, at least at this moment, is the European Union economic and financial crisis. It is not the sole responsibility of the G–20 to fix Europe's problems, and obviously this is not the only item on the G–20 agenda in early November. But if the G–20 is to prove itself useful—useful in the long run—and demonstrate its ability to react and at times get in front of the next economic or financial crisis, then these next few weeks are going to be extraordinarily important.

The world economy now faces a variety of crises. We still have in America an economy that, while technically in recovery, a huge number of Americans have not felt that yet. A further shock to the system coming about from a non-structured default by Greece or any other country or even contagion spreading across Europe that could freeze financial markets will have a dramatic effect on our economy and an effect that, if not appropriately monitored and dealt with, could even rival the challenges of 2008. And the challenge right now is we do not have all of the same tools available to us that we had in 2008, both in terms of monetary policy and fiscal stimulus, as well as a growing concern and some level of skepticism amongst the American public that some of the actions in 2008 disproportionately helped financial institutions over many of our fellow citizens.

So we are very, very pleased to have Under Secretary Lael Brainard here, somebody whom I have had the opportunity to know and work with over the years. She has got an enormous challenge, and obviously I will submit my full statement for the record.

Senator WARNER. I would like to now turn it over to my good friend and colleague, the Ranking Member, Senator Johanns.

STATEMENT OF SENATOR MIKE JOHANNS

Senator JOHANNS. Let me just start out and say to my colleague, Senator Warner, thanks for your willingness to do this. This could not be more timely and could not be more important.

Secretary Brainard, I think you said it well and very directly. I was reading through your testimony, and right here you say, "Europe's financial crisis poses the most serious risk today to the global recovery." And that is what this hearing is about. We want to hear about that and what you see on the horizon.

If I might just offer a couple of thoughts about what I would see because I would like your reaction to that at some point. You know, on the one hand, I think there is consensus about the need for action, obviously. You have countries like Greece and Portugal that are really struggling and trying to figure out how they better position themselves.

On the other hand, you have political realities, too. How far can other leaders move to deal with the crisis that they are facing? And every day is a day of concern. Every week is a week of concern. And as we continue to move down this pathway, if there is not some hint of resolution or some pathway, then it appears to me that whatever sense of security the financial markets have in the potential for resolution, the underpinning for that really gets hit, and they begin to be more and more concerned, and it gets tougher and tougher to fashion the solution.

So, again, today this could not be more timely. We apologize for putting everybody off, but that is the way of the Senate. My life is more dictated today by what Mitch McConnell and Harry Reid are doing than what my wife is doing, and that is a terrible thing to admit in an open hearing, but it is true. Some of this is just unavoidable, so we appreciate your patience.

With that, I am very anxious to hear from you, Secretary, your thoughts on this, and this is informal enough where I think we can actually engage in a dialogue about what we see and what we need to thinking about in the weeks and months ahead. Thank you.

Senator WARNER. Thank you, Senator Johanns. And both of us being relatively new here, it is particularly painful for us as former Governors when we used to make the agenda to have these kind of constraints.

[Laughter.]

Senator WARNER. Again, with no further ado, Secretary Brainard.

STATEMENT OF LAEL BRAINARD, UNDER SECRETARY FOR INTERNATIONAL AFFAIRS, DEPARTMENT OF THE TREASURY

Ms. BRAINARD. Well, thank you, Chairman Warner and Ranking Member Johanns. As you said, this hearing is very timely.

Today Americans are focused on securing good jobs, providing for their families, building opportunities for their children. That is why it is so important for us to strengthen America's recovery, which still remains too vulnerable to disruption beyond our shores.

Europe's financial crisis poses the most serious risk today to the global recovery. While the direct exposure of our financial system to the most vulnerable countries in Europe is moderate, we have very substantial trade and investment ties with Europe, and European stability matters greatly for consumer and investor confidence.

Last week at the G–20 meetings in Paris, and on an ongoing basis, the Europeans are discussing their efforts to deliver a comprehensive plan to address their crisis by the Cannes Summit in early November. This plan must have four parts.

First, Europe needs a powerful firewall to ensure that governments can borrow at sustainable interest rates while they bring debts and strengthen growth.

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

Third, Europe is working to craft a sustainable path forward for in Greece as it implements very tough fiscal and structural reforms.

And, finally, European leaders need to tackle the governance challenge to get at the root causes of the crisis and ensure that every member state is pursuing economic and financial policies that support growth and stability.

For our part here in the United States, pro-growth policies in the near term and meaningful deficit reduction in the medium term provide the best insurance policy to protect the U.S. recovery from further risks from beyond our shores.

To promote near-term growth and job creation, the President has put forward a series of proposals that would put veterans, teachers, and construction workers back on the job and put more money in the pockets of every American worker.

President Obama has also proposed importantly a framework to put our medium-term public finances on a stronger and more sustainable footing, placing the Nation's debt-to-GDP ratio on a declining path by the middle of the decade.

With overall demand in the advanced economies likely to remain weak, it is essential for emerging economic powers in the G–20, such as China, to move more rapidly to a pro-growth strategy that is led by their domestic consumption by allowing their exchange rates to adjust. At the G–20 meeting the surplus emerging market economies, including China, committed to do just that—accelerate the rebalancing of demand toward more domestic consumption and to move toward more market-determined exchange rates.

We have made this our top priority with China, and we have seen progress with appreciation of over 10 percent real terms bilaterally since June 2010 and with exports to China growing twice as fast as to other markets. But the exchange rate remains substantially undervalued, and we need to see it appreciate faster.

There are two other priorities that I will just touch on briefly in the G–20 and in the Financial Stability Board.

First, we have been working very hard to level up the playing field across major and emerging financial centers. In the wake of the most globally synchronized financial crisis the world has seen, we are working to implementation the most globally convergent financial protections the world has attempted. And we are trying to do so in lockstep as we implement the reforms here under Dodd-Frank.

The G–20 endorsed new global capital standards in November of 2010. It will endorse a new international standard for resolution regimes at this summit so that large cross-border firms can be resolved without the risk of severe disruption or taxpayer exposure to losses. And it is very important that we move forward in sync with our G–20 partners on the reforms to derivatives markets that were enacted under the Dodd-Frank Act and that are extremely important for ensuring that there is much greater transparency about where the risks in the system lie and efforts to mitigate them.

Finally, sustained and strong American leadership through the international financial institutions is vital to achieving our goals in the G–20 and at home. We were instrumental in 2009 in strengthening the IMF, which helped to strengthen the global economy, and our continued leadership is vital in the IMF to provide us with outsized influence as the IMF responds to challenges, such as the European crisis, which matter greatly to American jobs and growth.

We look forward to continuing to working closely with you on these important challenges, and with that let me conclude.

Senator WARNER. Thank you, Secretary Brainard.

Senator Johanns and I work very well together, and since it is just the two of us, rather than putting time on the board, I have got a couple questions, and if you want to break in at any point, we will go back and forth in a more informal fashion.

The first question is—and here we are a year-plus after Dodd-Frank, 3 years after the 2008 crisis. One of the things we saw in 2008—I am not sure we would have predicted that not only Lehman but then potentially the counterparty exposure with AIG, because we did not have accurate real-time ability to figure out counterparty exposure and overall exposure. This is not directly your area, but with the FSOC in place at this point—the Financial Stability Oversight Council—we have seen a lot of published reports about U.S. bank exposure to Greece. What level of confidence do you have, at the regulator level, at the FSOC level, that we have enough knowledge to know not only depository exposure but we have talked a little briefly about money market exposure, counterparty exposure? Obviously direct and indirect exposure is only one thing. If we have a freezing of the credit markets, the percentage of our financial exposure to Europe or to Greece in particular all goes out the window. But do we have enough current real-time knowledge in terms of our financial institutions' exposure both to Greece and some of the other countries that are at least talked about being in the path of contagion?

Ms. BRAINARD. Well, I think as you indicated, some of the reforms under Dodd-Frank and some of the confirming reforms in the international system under the FSB will help over time, although these are in the process of being implemented as we speak. The FSOC has spent time on the risks from Europe, and it does provide a forum, as was intended, for sharing of information among the supervisors and the regulators so that they have common assessments of risk.

As you said, the direct exposures particularly to the most vulnerable periphery countries are relatively modest at this juncture. There is also——

Senator WARNER. Direct exposures, not just depository institutions but——

Ms. BRAINARD. Direct exposure from depository institutions to——

Senator WARNER. Insurance companies, money market. We do not have as much knowledge of hedge funds. What about these other——

Ms. BRAINARD. So in terms of the information we have on some of the other entities in the system, there is much greater information, much more detailed information available now on money market funds, and that information is publicly available, and that was a critical development from the crisis. Insurance is still a work in progress, but I think we are going to see that moving along at a rapid pace as well. And, of course, the reforms that are just in the early stages on derivatives will provide extremely important transparency into what was previously a very opaque set of markets between central clearing, between the information being reported on a real-time basis to trade, depositories, those reforms as they move forward will make a material difference in terms of our regulators' and supervisors' visibility into the system.

Senator WARNER. Well, again, I just hope we recognize that we are doing as much as possible we can at this moment in time in terms of the counterparty exposure of some of our institutions.

Let me ask one other question, and, Senator Johanns, please jump in.

We had Chairman Bernanke in around lunch to do a small briefing around some of these issues as well. One of the things that I think obviously Europe is wrestling with, we have focused on Greece, and we are looking at what the Europeans directly have done in terms of the European Stabilization Fund and potential ways to lever that up. But my understanding—and Chairman Bernanke made the point that in the next—if we were to see contagion while Greece—a central default on a run on Greece would be challenging, if this were to spread to Italy, which has got to roll over a trillion euros in debt over the next year, and Spain, 500 billion euros in debt over the next year to roll over, when you look at the size of the European Stabilization Fund, you know, even if you then layer on top of that the IMF dollars, our reserves, those reserves are not enough to take on the kind of challenges and the firewall you mentioned in point number one, the Europeans need to do in terms of this firewall, but do they have enough capital at this point under the current framework to provide that firewall?

Ms. BRAINARD. Well, I think it is very important, as you say, to emphasize that in order for Europe's financial stability to return, what they categorically need to do is take the risk of cascading defaults and bank runs off the table. And in order to do that, they need a firewall of sufficient force and size to overwhelm the markets. I think that is something that we saw in our own financial crisis was critically important in helping to restore orderly functioning to our financial markets, and it is something that European leaders are talking about as they are moving forward on this comprehensive plan.

They have quite substantial resources in the European Financial Stability Fund, but they will need to——

Senator WARNER. They have about 440 euros?

Ms. BRAINARD. They have 440 billion euros under the structure that was just approved by the national parliaments in the euro area. And that funding is going to be critically important for doing those things that we talked about earlier, which is to ensure that large sovereigns with sound policies such as Spain and Italy can fund at affordable rates so that they can implement those critical reforms that will allow them to grow and to bring their debt down. They also need to have adequate bank capital backstops so as they move forward with their plans to set strong capital buffers in the banking system, that where needed they have public capital backstops.

In order to do that, the EFSF will need to be leveraged up. There are a variety ways of doing that. It is achievable. These goals are achievable with the capital that they have, but that, of course, is one of the key issues that will be part of their comprehensive plan.

Senator WARNER. Again, I want to turn to Senator Johanns, but you did say you think within that European Stabilization Fund it is adequate when we are looking at a trillion dollar rollover in Italy and a half trillion dollar rollover just in Spain alone, not counting some of the other nations?

Ms. BRAINARD. The funding that is available in the European Financial Stability Fund can be leveraged up to adequately address the needs that we were talking about to ensure that Italy and Spain and other large performing sovereigns have adequate funding to backstop the banking system and, of course, to continue to fund the program countries as they perform. But, again, it is vitally important that they leverage up the EFSF.

Senator WARNER. They have not decided how to leverage it up yet.

Ms. BRAINARD. And what is on the table right now is precisely what is the form of that leverage. And that leverage needs to be credible in the markets, and it needs to give them that overwhelming force that takes the threat of defaults and bank runs off the table.

Senator JOHANNS. There is so much to talk about and ask about, but let me, if I might, start with some of the thoughts expressed on Dodd-Frank and I think the dilemma that we are heading toward. We have put in place with Dodd-Frank an enormously complex piece of legislation. I did not support it. Now the rules are coming out, and it is just a massive amount of injection of new systems, new rules, new requirements for the financial system.

At a Banking hearing some months ago, a concern was expressed actually by Senator Johnson, and others actually, and the whole issue was how is this going to be harmonized internationally. And Deputy Secretary Wolin said, and I am quoting, "We are working closely with our G–20 partners to make sure that we get a regime that works worldwide so we do not have new opportunities for arbitrage." I think, translated, what we are all concerned about is you end up with this U.S. system and then our capital flees because why deal with this if you can find less resistance in Singapore or a G–20 country?

Soon after that, I am reading an article, and I probably will butcher his last name, and Michel Barnier of the European Union said this: "We don't support the same approach." He said, "That is not what we are going to do," and really kind of put down what we had done in the United States.

So what assurance can you give me that the G–20 with all of these other problems that they have—and they are economy-threatening problems for that part of the world—that in the midst of that they are sitting there trying to figure out how to put the Volcker Rule in place and how to put this rule in place, *et cetera,* and following the leadership of the United States?

Ms. BRAINARD. Well, Senator, let me just say, first of all, I could not share more fully your concern and your determination to make sure that as we move to put in place new mechanisms to ensure the vibrancy and the resilience of our system, that we move in lockstep to ensure that other financial centers around the world, both established financial centers and those that are coming online, move in sync with us so that we do not inadvertently undermine the safety and soundness of our system by providing regulatory arbitrage opportunities or, equally importantly, create a competitive disadvantage for our financial institutions.

I believe we have done more on that than has ever been true in the past, and we are having quite a lot of forward momentum among the other members of the Financial Stability Board and in the G–20.

Michel Barnier, the Commissioner who has responsibility for these issues in the Commission, meets very regularly with Secretary Geithner, and they both have repeatedly stated their commitment to ensure that as we move to put in place new capital liquidity leverage standards, the Europeans do the same; that as we move to put in place requirements for standardization and central clearing, trade repositories on derivatives, they move to do the same.

I think we have had successes in terms of getting general adoption of the principles across all the G–20 and FSB membership. I work very hard with my counterparts to make sure that not only are they adopting these principles but they are implementing them, and our staffs sit with the staffs of international financial authorities and go through in fairly great detail, as do the staffs of the SEC and the CFTC, and we are trying to be as granular as we possibly can to make sure that as our implementation proceeds, theirs does as well.

Obviously, we each have different national legal regulatory environments, and so there are going to necessarily be moments where, for instance, on Dodd-Frank we move forward with our legal framework more quickly than the Europeans did, but we have similar implementation deadlines, and we are all working extremely hard because they are—similarly, they are as committed as we are, and I think they see the same risks to their system, which are more evident today perhaps than ever before of not moving forward on those key requisites for a sound financial system.

Senator JOHANNS. Like I said, we could spent hours on this, debating this, but here is my impression. My impression in having worked with the European Union for many, many years, part as Governor, more intensely as Secretary of Agriculture, is that this is a very unusual governance system, something we are not used to. You have got this umbrella organization out there, and it is not really a central government, but it kind of tries to act like a central government. You have got all of these other countries that are member countries of the European Union. They are forever proclaiming their sovereignty because it is important that they proclaim their sovereignty to their citizens in their country. And, you know, when you talk about principles being adopted, it is not very reassuring to me, to be honest with you. All that tells me is that we are having a lot of meetings. I think you are working hard. But I will bet when we look back 12 months from now and 24 months from now and 36 months from now, we are going to see little activity by the member countries to embrace anything near what we did with Dodd-Frank, putting our financial structure at a serious disadvantage.

Now, I hope you can call me in 12 months and 24 and 36 months and say, "Boy, Mike, you were really wrong about that, and I am here to call you and tell you you are." But I do not think I will be wrong about it, unfortunately.

But if I might move on to, I think, what probably is occupying our attention right now, and that is the financial crisis that we are all worried about. Here is another impression, and I would like your reaction to this. We have a handful of countries that really are struggling. Greece would lead that. You could probably talk about Portugal, Ireland. I hope their Ambassadors do not call me and yell at me, but I think, quite honestly, they are really trying to figure out how to deal with what is a crisis. There were huge protests in Greece yesterday, for example. They are really resisting the efforts.

You have got a second group of countries—Spain, Italy—that somebody said to me, and it probably describes it well, too big to fail, too big to bail out, large economies. If somehow the problems with the other countries cannot be walled off, they kind of get tangled up in it, and their cost of borrowing goes up, *et cetera.*

You have got serious undercapitalization of the banks. You have got stress tests that nobody has regarded very seriously. I think they made an attempt, but, quite honestly, our financial community is not relying on their stress tests. And then in the midst of all of this, you have got a European system, and you have got people, citizens like mine—it would be like—you know, for Germany to embrace the idea of bailing out Greece, it would be like Nebraska with a balanced budget amendment and an obligation that we cannot borrow any more than $100,000 so we have no debt bailing out another State that spent wildly and borrowed money. Well, you can only come to understand how the Germans are looking at this and going, "Are you kidding me?"

And then you begin to realize how do you move those dynamics with this system to the kind of resolution that is necessary, because we are not talking about a few dollars. And if the market does not have confidence that this is a big enough firewall—and I think guaranteeing 10 or 20 or 30 percent of the debt is not going to be sufficient—and you cannot calm the markets down, then I think this thing really has some serious, serious potential.

Now, boy, I have put a lot out there, but I would love to have your reaction. Where am I wrong in this? What have I misread about this?

Ms. BRAINARD. Well, I think the risks that you point to are real. I would say, though, on the other side that Europe has the resources, it has the capacity, and we have heard from European leaders that they have the will. The things that need to be put in place I think are fairly clear, and, of course, as you said, I think there is mixed public support. But if you look at the vote, for instance, in Germany of the EFSF, overwhelming majority in favor of supporting the July 21st reforms, which expanded the EFSF and enabled it to do the critically important functions of providing precautionary financing and backstopping the banks.

So you are exactly right that Europe will need to muster the political will, but everything we have heard is that European leaders are determined to do so. And they have the capacity, they have the ability to leverage up the EFSF to a magnitude that really is commensurate with the size of the challenges. They have the ability to take the risk of contagion to Italy and Spain off the table entirely, and we will see over the next days and weeks how they are going to confront those challenges.

As you indicate, though, over a slightly longer period of time—and they are talking very clearly about this—they will need to move forward on putting in place mechanisms that give them the fiscal capacity that really matches their monetary union, and that is the piece that will take a little longer. But they are going to need to have much more fiscal unity and much more centralized fiscal governance over time. And I think that is something that member states are clear-eyed about in the face of this crisis.

Senator JOHANNS. If I might, just one more. Does that require a treaty change, the last step that you have just described? It does, does it not?

Ms. BRAINARD. It depends very much, Senator, on how they decide to move forward on creating a more unified fiscal structure. Some of the ideas that are being discussed would require treaty changes. Others might not. They have already put forward some very important governance reforms in terms of surveillance and penalties for not meeting fiscal targets, for instance. So some of these issues have already—we have already got a sense of where they are moving. On the broader sense of where their fiscal governance is likely to be in several years' time, I think they are still working on that, but they are committed to it from everything we hear.

Senator JOHANNS. I only raise that because changing their treaty is akin to amending our Constitution. I mean, this is no easy task. A complicated problem, I guess, is what this all comes down to, a very complicated problem.

Senator WARNER. I would, first of all, agree with Senator Johanns about the complexity of this. I would think, though—I think what we have got a little bit, to carry on your analogy, is a balanced budget state, as well, with a AAA bond rating——

Senator JOHANNS. Yes.

Senator WARNER. I get what you are saying, but it is kind of like——

Senator JOHANNS. Good governance——

Senator WARNER.——*de facto* that if the Nebraskan government was well run but Nebraskan banks completely financed California's budget, you have got a little bit of that problem that I think we are looking at in Germany in that, one way or the other, Germans are going to have some level of responsibility, whether directly through their people or indirectly through their banks' exposure.

I think one of the things—we had a spirited debate about Dodd-Frank. I think it is imperfect, but the reaction I heard more from our European colleagues was, thank goodness that at least America went first, and again, echoing what Senator Johanns said, because we have advanced capital standards, move further, and we have had more transparent stress tests, for example. And the fact that we are intertwined, whether we like it or not, if we did not try to have these coordinated standards, slipping to lowest common denominator is not going to help anyone.

I believe that, and I share Senator Johanns's concern about how we do this in an organized basis. I want to go off subject a little bit. I actually think you may see, as we have seen in the United Kingdom, they may even be taking an even more structured approach than what we took. And when you hear some of the leaders in France and Germany in terms of transaction tax or other things that would go way beyond even Dodd-Frank in terms of financial constraints, and while we may disagree about merits or lack of merits around Dodd-Frank, I think we would both agree that we need to have not this arbitrage and consistently moving forward.

At the end of the day, I think we and the EU will mesh, probably the Japanese and others. But as we get to this G–20 framework, how do we make sure that, even if all the West moves forward in a coordinated fashion, that there is not that kind of outlier in this enormously interconnected system that does, in effect, become the equivalent of a tax haven but with a low standard financial center that does not agree to these international standards? What are we doing to grapple with that?

Ms. BRAINARD. Well, Senator Warner, as you said, I think we derived tremendous advantage from moving first and pulling the world to our high standards. And what we have seen in the G–20 and the FSB is that we have succeeded in having all the members of the G–20 and the FSB sign up for tougher standards on capital liquidity and leverage at banks, sign up for resolution, higher prudential standards, greater intensities of supervision around systemically important financial institutions, and sign up for a host of very profound changes that will make our derivatives markets less opaque, more transparent, less risky.

In terms of getting emerging financial centers to come on board, that is why we thought it was so important to be working through the Financial Stability Board and the G–20 where the major financial centers and the emerging financial centers sit together, and so we have a variety of standard setting bodies now, the Basel Committee, the FSB, where we have emerging markets, emerging financial centers represented and taking on the same obligations, the same principles, the same commitments, the same Basel III standard uniform across all members of the FSB. We are intensely engaged with Singapore on our derivatives reforms and we have received repeated assurances from the Singapore monetary authorities and financial supervisory authorities that they will move in lockstep as Europe and the United States come together on their derivatives regimes.

So I think that the concerns that you raise are very real. We are working very hard on them. We have to stay extremely engaged at a level of detail on implementation, which we will continue to do. But I think we have a real chance of having a system that has far fewer major areas that present regulatory arbitrage risks and disadvantage our financial institutions.

Senator WARNER. We will obviously want to monitor that, and we need to have—we need to establish what those metrics ought to be. I know you have got to leave in a couple minutes. I want to ask one more question and make sure my colleague gets another crack at you.

I think we just saw today—you may not have even seen the news—that while there was some anticipation that the EU might resolve some of these issues this weekend, they are already talking about now a second summit, meaning they may not get there. A lot of pressure on the meeting in Cannes. How do we make sure that this crisis does not just—or what—is there anything we can do other than continue to urge you to move forward and the Administration and others to move forward to make sure this does not just drag itself out? At some point, we in this country, right or wrong, stanched some of that with dramatic actions in late 2008.

What is your—I recognize you do not want to make news on this, but what is your best guesstimate that we will see definitive action within this next 30-day period with this summit, Cannes coming, and probably a second summit within the next 30 days, or is this going to be an overhang that is going to take months and months to work through?

Ms. BRAINARD. Let me just say that the European leaders, I think, are very intensively engaged on this. I think it is a good sign that they are meeting intensively on this. President Obama has been on the phone with European leaders and has spent a lot of time asking them about the comprehensive plan as they are developing it. He is very, very committed to ensuring that the U.S. economic recovery is as robust as it can be and as insulated as it can be from shocks emanating from abroad, recognizing that Europe has—headwinds from Europe have slowed our recovery somewhat.

I think that the set of issues on the table are the right set of issues. European leaders are focused on the firewall, the bank recapitalization plan, ensuring Greece is sustainable, and then that longer-term set of governance reforms. And again, I think that they have that capacity. They have stated repeatedly that they have the will, they have the resources, and I think they know from discussions that we have had among finance ministers and central bank Governors at the G–20 last weekend that this is an issue that the world cares a great deal about, that the emerging markets that are part of the G–20 also see European financial stability as central to their own economic growth, that this is the most important priority for the G–20 meeting, and we see every indication that the Europeans are working very hard to come with their plan and to have a plan that succeeds on the four dimensions that they are talking about.

Senator WARNER. Well, I understand your answer and I appreciate your comments and I appreciate your appearing before me. I hope, recognizing that we are inexorably tied, that there will not be continuing ratcheting back of expectations, which seems to be the news of today if the European Union has already decided a second summit and is opposed to putting out those at least first two steps of the plan in terms of the firewall and the bank capitalization in a definitive way this week. We do hope that the G–20 will continue to show that these kind of large international organizations can be successful, but dragging this out is not clearly in Europe's interest nor clearly in the United States' interest.

Senator Johanns did not have any other questions. Again, we appreciate your time, Secretary Brainard, and now we will move on to the second panel.

Ms. BRAINARD. I appreciate the opportunity.

Senator WARNER. Thank you.

If we could go ahead and move to the second panel, and as they get settled, I may go ahead and start to make some introductions, recognizing that we will probably have another round of votes at some point.

Senator JOHANNS. Yes.

Senator WARNER. In our second panel, we are going to continue this question of G–20, the European crisis, and currency issues, in terms of making the point that all our economies are enormously intertwined. So we have three very, very distinguished panelists.

Dr. Uri Dadush serves as the Senior Associate and Director for the International Economics Program at the Carnegie Endowment for International Peace. His work focuses on trends in the global economy and the implications of the increased weight of developing countries for the pattern of financial flows, trade, and migration, and associated economic policy and governance questions. A French citizen, Dr. Dadush has previously served as the World Bank's Director of International Trade and before that as Director of Economic Policy. He directed the Bank's World Economy Group, leading the preparation of the Bank's reports on the international economy over 11 years. Before that, he was President and CEO of the Economic Group's Economist Intelligence Unit and Business International. Thank you, sir, for joining us.

Dr. John Makin is a Resident Scholar at the American Enterprise Institute. Dr. Makin is a former consultant to the U.S. Treasury Department, the Congressional Budget Office, and the IMF. He specializes in international finance and financial markets, including stocks, bonds, and currencies. Dr. Makin also researches the U.S. economy, including monetary policy and tax and budget issues, as well as the Japanese economy and the European economy, so we will be anxious to hear your comments on some of the EU actions. He is a principal at Caxton Associates and is the author of numerous books and articles on the financial, monetary, and fiscal policy. Dr. Makin writes AEI's Monthly Economic Outlook.

And, our good friend, Dr. Fred Bergsten, has been Director and a widely quoted think-tank economist at the Peterson Institute for International Economics since 1981. He has been ranked as somebody who can move the markets by Fidelity Investment's Worth. Dr. Bergsten was the Assistant Secretary for International Affairs at the U.S. Treasury under the Carter administration. He also functioned as Under Secretary for Monetary Affairs, representing the United States on the G5 Deputies and in preparing a G7 summit string in 1980 to 1981. During 1969 to 1971, Dr. Bergsten coordinated U.S. foreign economic policy in the White House as an Assistant for International Economic Affairs to Dr. Kissinger at the National Security Council. Dr. Bergsten is also a well-published scholar and has served in several distinguished institutions on foreign policy, economics, and competitiveness matters throughout his career.

I want to thank all of you for being here today. Again, the timeliness of this hearing could not be more important. And with that, we will get to Dr. Dadush and we will start with your testimony. Thank you.

STATEMENT OF URI DADUSH, PH.D., DIRECTOR, INTERNATIONAL ECONOMICS PROGRAM, CARNEGIE ENDOWMENT FOR INTERNATIONAL PEACE

Mr. DADUSH. Thank you very much, Mr. Chairman, Mr. Ranking Member, for inviting me here today.

On the Euro crisis, I think it is apparent from the discussion that just preceded that everyone understands that sets of sovereign defaults in Europe, possibly leading to a collapse of the Eurozone, would have major repercussions in the United States and could lead to a Lehman-like event, but in my view, one of longer duration.

What I think, however, is not sufficiently understood is that the Eurozone may not be able to handle this crisis on its own, and this is because of two dimensions. One is the politics and the other is, even more importantly, the economics.

The politics because Europe remains a half-built structure. The Commission is not the Federal Government and the European Central Bank is not the Federal Reserve Bank. So, therefore, the example of Nebraska bailing out another State, I think, is extremely appropriate in terms of understanding the dynamics of the current situation, but I would take it one step further, which is I do not think there is any question about Nebraska and other States considering themselves part of one country, America. We are far from that situation in Europe.

The second aspect is the economics. Whereas the Eurozone, as distinct from the European Union, is quite a bit smaller economy than the United States, the subprime crisis was between one and one-and-a-half trillion dollars, depending what you define as subprime. But the sovereign debt of the periphery countries is $4.5 trillion. Furthermore, banks are much more important in the European Union economies or the Eurozone economies than in the United States. They are just a much bigger part of the financing. And as you have already recognized, policy is largely out of bullets.

It is also important to realize that the European Financial Stability Fund is—there is an element of smoke and mirrors in it, because the guarantees come in part from countries that are themselves in trouble, and even the countries that were thought not to be in trouble, like France, now are confronting a billowing cost which has doubled the spread of France *vis-à-vis* Germany in the course of the last several months. It is in excess of 100 basis points. That is an indication that the market is now calling into question the capacity. And actually, referring to the guarantees themselves in the most recent Moody's decision to put France on credit watch, referring to the guarantees at the current levels, not at the levels that are contemplated for the next stage, as being one of the reasons that they are considering the downgrade of France.

So that is why in my written testimony I have proposed that there is an emergency, and as a precautionary measure, the IMF's resources should be expanded by a trillion dollars. I am audacious enough to say, with the United States making a contribution to that expense, audacious because I know that the previous expansion has not yet been agreed, but, you know, this is the situation that I see. I see it as an insurance against a very bad event. And I do not think—while I think the emerging markets want to contribute, I do not think the emerging markets will put all of that amount by themselves, and even if they wanted to, the United States would not necessarily want to see its interest diluted in the IMF to that extent.

Thank you.

Senator WARNER. Just one point. The current IMF balance sheet is about $300 billion, is it not?

Mr. DADUSH. I think the available forward capacity of the IMF, new commitments, according to Managing Director Lagarde, is $400 billion. I think the total balance sheet is somewhere in the region of $850 billion. So $400 billion is the forward capacity.

Senator WARNER. Thank you, sir.

Dr. Makin.

STATEMENT OF JOHN MAKIN, PH.D., RESIDENT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE

Mr. MAKIN. Thank you, Chairman Warner and Ranking Member Johanns, for the opportunity to testify. I am going to focus my comments, as well, on the European situation. It is, I think, appropriate to remember that the G–20 was first established in 1999 after the Asian debt crisis, which was tied to excessive rigidity of exchange rates in the region and attempts to avoid those adjustments. My contention today is that the European crisis will not be contained until some of the problems that are inherent in an unstable and nonviable currency regime are addressed.

And I think if I go a little bit in detail as to how we got here, how did we get to a situation where last April we were all thinking we were out of the woods, people were starting to invest again, the U.S. economy was looking good, to a situation where we are looking at a weekend where, once again, Europe is delaying needed adjustments, with good reason, because they face some very formidable problems.

Europe's current problems, I would term internal systemic driven. That is, they have a flawed currency system. How did they get here? When the European monetary system was set up, the assertion was made that you became a member, Greek debt was the same as German debt. So if you were a bank and German debt was commanding an interest rate of 20 or 30 basis points above—Greek debt was above German debt, you lent to the Greek Government. You then could use that claim on the Greek Government to borrow from the European Central Bank and the process began. In effect, the European monetary system initiated a massive increase in the credit ratings of the weaker Southern European economies whose unit labor costs suggest that they were in no position to continue to compete with Germany.

And so, over time, the European debt crisis was built on a premise, that is, that sovereign governments do not default. The U.S. debt crisis, or the systemic financial crisis, was built on the premise, the fallacious premise, that house prices never go down. Those problems come back to haunt you.

Why is it so difficult to address this crisis? First of all, there are really four ways to address it. One, the one that is being contemplated now, is to engineer massive transfers from Northern Europe to Southern Europe, and as others who have testified have suggested, really, we are down to Germany, because even the French have their problems. The EFSF with its 440 billion euros is a bit of smoke and mirrors, as Uri has suggested. Just the journal today, I think when we were discussing that earlier, when you take away the funds that are already committed, you are down to 275 billion. And then when you look at the commitments from Italy and Spain, which are prospectively going to be recipients, you really do not have any fund. So the idea that you can leverage that up by saying that you will somehow guarantee the first 10 or 20 percent of the liabilities of the countries involved, I think, is perhaps wishful thinking.

The second way to deal with the problem, aside from massive transfers—the resources are not there to make the massive transfers, so what else could you do? Well, last year, the idea was to say to the Greeks, we will give you money if you will blow your brains out, that is, if you will make massive cuts in spending, massive increases in taxes, and render the economy or push the economy into a tailspin. That means that the debt-to-GDP ratio will be higher this year than it was last year. That is where we are with Greece. That is conceivably where we could be headed with some of the other countries.

A third alternative which, again, is being rejected, is to force wages and prices in the Southern European countries to go down so rapidly that they are able to compete with Germany. That is not going to happen. Greece, Italy, Spain are not going to turn into Germany, and so that is just not a realistic alternative.

The fourth alternative is to allow currency adjustments within the Currency Union that would address some of the stresses that are there. I think that is probably where we are going to end up, although we are certainly going to exhaust a lot of pain and suffering before we get there. I do not see a way to make Greece a viable member of the European Currency Union. Neither do its citizens. The parallels with the Argentine debt crisis are there. You go through a long period of promise we will do this, we will do that. You have internal strife, and the government is left in a very difficult position where they are really not prepared to undertake the adjustments that are required of them.

So I think it is probably not wise—I would respectfully disagree with my fellow panelist—to put more resources into shoring up what probably is not a viable system, and why would it be a viable system? To say—to impose a single central bank on an area as diverse as Europe, which has 17 treasuries—the Nebraska allegory breaks down—is just not a workable system, and the sooner we recognize that, the better.

Thank you.

Senator WARNER. Well, two out of three. So far, this panel is not going to lack for some questions.

Dr. Bergsten.

STATEMENT OF C. FRED BERGSTEN, PH.D., DIRECTOR, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. BERGSTEN. Mr. Chairman, Secretary Johanns, I will make a few points that will complement what the earlier panel and my colleagues here discussed.

The most important role for the G–20 summit in Cannes is to inject renewed impetus for world economic growth. We are not going to solve the European crisis, whatever financial engineering is done, unless the Europeans can get more growth going. Yet the strong countries in Europe, led by Germany, but also Holland, Austria, and the Scandinavians, are consolidating. They are tightening budgets, under no pressure from the bond market vigilantes. They should stop their tightening of policy and instead start expanding.

Moreover, the European Central Bank should cut interest rates substantially. It is the only major central bank that is considerably away from the "zero bound." Unless Europe gets growth, none of the financing is going to work. Unless the United States—the Congress and the Administration—can get together and provide some new stimulus to the U.S. economy, the world will continue to wallow, as well.

The good news is that half the world economy is still booming. The emerging-market economies, which now make up half the world economy, are expanding by an average of more than 6 percent. Moreover, they have policy space to do even better. They have low budget deficits and debt ratios. They still have fairly high interest rates. We should now ask the emerging markets, which are the leaders of global growth, to do more. They can certainly expand further. They have been worried about inflation, but now with the rich countries slowing down and commodity prices having leveled off, that is no longer of deep concern. They have been the beneficiaries of global growth strategies led by us and Europe for 30, 40 years. It is time for them now to take the lead that their economic capacity and achievements permit.

So this Cannes summit needs to replicate, at least to a degree, what the London G–20 summit did in April 2009, namely take parallel and to some extent coordinated actions, to get the world out of the last economic crisis. We have to do it again. Only this time, the effort should be led by the emerging markets but with Europe and the United States chiming in as well.

It is critical how that emerging-market growth impetus takes place. It has to be done by expanding domestic demand, letting their big trade surpluses decline to impart growth to the world, not take it away from the rest of the world, which higher trade surpluses would do, and that means letting their currencies go up much more and much more rapidly.

On the European crisis, I will make four quick points in addition to faster growth. They need to leverage the European Financial Stability Facility to create a total resume of two trillion to four trillion euros. I disagree with John Makin. I do not think the eurozone is a failed experiment. It is a halfway house and the other half, the fiscal union, has to be completed. The way to do it is to complete the fiscal union, not to abolish the monetary union.

With great respect, I am going to disagree with an analytical point made by Secretary Johanns. Nebraska and other surplus U.S. States do, to a degree, bail out deficit U.S. States, not by direct loans, but through the Federal budget, because when they transfer their surpluses to Washington and it transfers that to deficit Mississippi, there is some degree of bailout. Likewise, when States import citizens from those that have had high and rising unemployment, the importing States help bail out those losing States. The Europeans do not have these two types of mobility. That is why they need fiscal union to complement their monetary union.

I agree with a key point Uri Dadush made, particularly if the Europeans do not get their act together quickly, Plan B would have to center on the International Monetary Fund, because if the Europeans cannot put together an adequate safety net, only the IMF can provide it. His trillion dollars may actually need to be a little bigger. That money would have to be borrowed from the big surplus emerging markets—China, Korea, Brazil, India, and others including the oil exporters. They should provide the money. They need to pay back.

Finally, what should the United States contribute to all this? I have suggested our Government needs to get its act together to get growth on track. We obviously need to move to tangible, credible means of bringing our budget deficit down over time without interrupting growth in the short run. And I think we ought to take on a new commitment to eliminate our trade deficit, because that is a way to create three to four million U.S. jobs over a 5-year period or so. We have been running huge trade deficits for 30 years and facilitating the export-led growth of these emerging markets. They have piled up huge reserves as a result, partly by manipulating their exchange rates. I think we are perfectly justified, and it is not protectionist or beggar-thy-neighbor to eliminate our big external deficit. We are the world's largest debtor country. They all tell us not to keep building it up. The G–20 has agreed at every summit on rebalancing of the world economy. That means eliminating the U.S. trade deficit, which would create three to four million U.S. jobs. If we are serious about getting back to full employment, we have to add that. I would throw that into the hopper at Cannes as a U.S. commitment to implement agreed G–20 strategy, but then we have to do something serious about it like reining in the budget deficit and getting growth going through domestic demand here.

Senator WARNER. You did not disappoint.

Let us—there are so many different places to go with this. I would like to ask Dr. Makin and Dr. Dadush to respond to at least one part of the provocative part that Dr. Bergsten just said, was what do you think—is there any realistic chance that through the G–20 mechanism we could really see a challenge or a coordinated action where the emerging nations would take on these kind of growth policies, since it seems to me that there has been a, for the most part, an enormous lack of coordination amongst the more industrialized nations on issues like currency, and then when we try to perhaps ham-handedly deal with China on a one-off, always maybe not the most effective tool, I will grant, but let us just start with Dr. Bergsten's first prescription. What do you think any chance of that could happen, either one of you?

Mr. MAKIN. Let me just take a—I will just focus on Europe. If I am China or India, why would I want to finance this European experiment that has been struggling since 2009? Why would I want to invest in a system that is just not going to work?

Fred says let us have fiscal union. We are not going to get fiscal union in Europe, and we have a monetary union that is not viable. Are the Chinese going to invest 500 billion euros in trying to turn Greece into Germany? It is just not going to happen.

So while the Chinese certainly, in view of their aggressive geopolitical ambitions, will want to appear to be stepping in here where the United States is unable to do so, I would be surprised if they were willing to commit many resources.

If you look, first of all——

Senator WARNER. Could I just ask one thing here?

Mr. MAKIN. Yes.

Senator WARNER. I can——

Mr. MAKIN. I mean, it would be nice, but——

Senator WARNER. I understand the point that they are—the direct assistance—and I want to come back to your questions about Europe. But the kind of more macro agreement that there could be coordinated growth policies across emerging nations letting their currencies appreciate, I mean, is that even realistic? I guess it could happen, but is it really——

Mr. MAKIN. Well, what have we been doing since 2008?

Senator WARNER. No, but from the emerging—obviously——

Mr. MAKIN. But, remember, in 2008, after the Lehman crisis when the Fed cut rates aggressively and we engineered a large fiscal stimulus in the United States, China engineered the largest stimulus in the world. They engineered a stimulus that was worth 15 percent of GDP over 2 years. They got their economy going. They have, of course, the fortunate situation that they have lots of resources and lots of things that need building. So they made a huge contribution to global growth in 2009 and 2010, although it had its downside in the sense that they were—you know, China is such a new force, their contribution was so great that they were pushing up commodity prices and energy prices and so on.

I am not quite as sanguine as Fred is about where China is headed now, but I think that if I were the Chinese I would say, look, we did a lot. We did a lot, it was in our own interest, we wanted to stimulate our economy, and the spillover effect was very positive.

So I would think what is realistic now at Cannes, or elsewhere, is to see if the Chinese are prepared to back off a little bit on tamping down the growth rate because they are seeing higher domestic inflation, which some estimates are put as high as 10 percent.

So they are involved in a kind of conflict situation. This is a very tough situation. So I would not, let me put it this way——

Senator WARNER. Is your prescription in terms of China or your expectation in terms of China for other emerging nations as well? You know, whether you take India or whether you take South Korea——

Mr. MAKIN. I think China is so big, the South Koreans are certainly—you know, they are in very good fiscal shape. They are not in a position to do what the Chinese could do. My bottom line is this: I would not bet on a lot of help—if I were a realist, I would not bet on a lot of help from emerging markets for the European experiment nor for the American conundrum as well.

Senator WARNER. Dr. Dadush?

Mr. DADUSH. Yes. First of all, I agree with John Makin that the emerging markets played an absolutely instrumental role in 2009 in particular in supporting global economic activity at a very difficult moment, and with China playing a disproportionate role. But I think we need to recognize that that was a very particular situation, and as the emerging markets kind of accelerated extremely rapidly beginning in the second and third quarter of 2009, they within about a year, a year and a half, were running into what is called a "supply constraint." Basically inflation was building up. There is also a real concern in asset price bubbles—there was—in a number of them. So they were reaching their natural limit.

Now, again, Fred Bergsten makes a good point. In a scenario where global economic activity deteriorates in a rather significant way, I think emerging markets can provide a cushion, if you see what I mean, because they do have room and it will take a while. It is not evident right now, but it might take 6 months, 9 months for the inflationary pressures that have built up over the last couple of years to abate in the emerging markets, and then they can accelerate their growth again because they have that capacity.

But I think it is safe to say that their contribution in this kind of scenario will be relatively modest. And as I put in my written testimony, I think we should always remember that American GDP is, to take one example—I could take other examples from advanced countries—is composed of domestic demand and net exports. The problem is domestic demand is about 34 times bigger than net exports. So, you know, even in the best of circumstances, just simple arithmetic tells you that the real key to American growth—particularly American growth because it is a large relatively closed economy. The key to American growth is the internal dynamics in the United States, and the trade balance will help a little bit at the margin.

And, by the way, I also would stress the fact that there is virtually no conceivable increase in demand from China that would have a significant impact on American economic activity, very simply just as a result of the fact that China is one-third the size of the United States and the United States is a relatively closed economy. So it is about domestic activity, and it is about domestic reforms. It is about domestic structural reforms. It is about domestic fiscal reforms. That is the essence of what will drive American growth in the long term.

Finally, if I may, I also want to disagree with John Makin about not helping Europe, and not because I am a French citizen, but because should Europe not be able to get its act together—and I fear that it might not, or it could not to a sufficient degree—and that led to a collapse of the eurozone of this "half-built failed experiment," as John would describe it, if that were to lead to a collapse of the eurozone, then I assure you we would have a crisis of absolutely global proportions that, again, as I said at the very beginning, would be of much longer duration than the Lehman episode.

Senator WARNER. Senator Johanns.

Mr. BERGSTEN. Could I go back on that at some point?

Senator JOHANNS. No, go ahead.

Mr. BERGSTEN. On this argument about fiscal union in Europe, the Europeans are not going to give up. They are not going to let the euro collapse. That has been their fundamental goal for over 50 years. The history of European integration is that when they face crises—and they have faced many before—out of that and all the uncertainty and the cacophony of the different voices comes progress toward greater union. We better understand that and support their move toward fiscal union because that is the positive outcome for us as well as them over time.

On the debate about emerging-market growth, I absolutely agree with my colleagues. China played a decisive role in the world recovery from the big crisis in 2008–09. I said that in my testimony. I applaud what they did. I draw the opposite inference. They did it last time; they can do it again this time. And the supply side constraints that John talked about have declined sharply as world growth prospects have declined and as commodity prices have leveled off. They have huge further infrastructure needs and demands. They have those programs out there and have plenty of financing for them. The issue is when. From their standpoint, as well as the world's standpoint, now is the time to do it.

Some of the other emerging markets have already reversed policy. Indonesia just last week—or earlier this week—began to cut interest rates. Brazil has begun to cut interest rates. Other emerging markets are also already moving in the direction I suggest, and I believe China, which is by far the biggest but others as well, can do it. I think the G–20 can push that process.

I will reiterate what I said at the outset. These emerging markets taken together are half the world economy. They are growing 3 times as fast as the rich countries, which means their share is rising a couple of percentage points every year. A decade from now, they will be two-thirds of the world economy. They can be drivers if we can get them to do even a fraction of what China did last time around.

Finally, I want to take up Uri's point that the external side is not very important for the United States because we are a closed economy. Well, we are looking at 2 percent growth, maybe. It is perfectly feasible for us to strengthen our external position by one-half to 1 percentage point of GDP per year for the next 4 or 5 years. That would take our growth up significantly and create a big number of jobs.

We are a relatively closed economy in the sense that Uri mentioned, but at the margin our economy can greatly benefit from growth in our external sector. It is absolutely right that exports to China alone are not going to do that. But if we can get the kind of pickup in world growth that I talked about at the outset, with all the emerging markets plus at least a little more in Europe, there is no reason why we cannot expand our international contribution to GDP growth in a major way. We are missing a major bet in not emphasizing that as part of our current job strategy.

Senator JOHANNS. As I look at these issues, the debt of the European Union, its countries, and the United States and slow economic growth, just a whole host of things going on, I wonder what the potential is that inflation kind of rears its head again. How does that fit into the equation here, or does it fit? And maybe that is not a question when actually we probably worried more about deflation in the last few years. We have historically low interest rates, *et cetera, et cetera.* But it just occurs to me that the pressures out there are enormous to roll over debt. You have got a situation where countries will be struggling to finance that debt. What is the potential that inflation becomes a more serious problem as we look 2 years and 5 years down the road? And I would like everybody's thought on that. I am going to work my way across the panel, so everybody is going to get a shot at that.

Mr. DADUSH. Well, right now inflationary pressures are quite muted. You are seeing some pickup in headline inflation in Europe, for example, but a lot of that is a reflection of some—you know, the delayed reflection of commodity prices to a large degree.

There is so much unused capacity and so much risk aversion—in other words, tendency by people to mask cash and banks to mask cash if they possibly can—that even with the expansion of the central bank's balance sheets that we have seen, the actual expansion of credit remains relatively constrained. And that is a general phenomenon in the advanced countries. It is rather different in the developing countries. In the developing countries, you are seeing, have seen a very significant acceleration of inflation.

I think if you look some years forward, a lot depends on what you assume is the capacity of central banks as the economy recovers to withdraw the massive amount of liquidity that they have injected into the system over the last few years. And central bankers will tell you, "We know how to do that." The problem I have and the risk that I see is I know they know how to do that, that they have the instruments to withdraw the liquidity with selling bonds and changing reserve requirements, *et cetera, et cetera*. But the big question is: Will they be able to do it elegantly? Will they be able to do it in a way that you avoid a very rapid rise in interest rates, as has happened many times in the past, against a background of a lot of overextended investment and lending that is maybe triggered over a period of years by the abundance of liquidity?

Senator JOHANNS. Dr. Makin?

Mr. MAKIN. I am not concerned about inflation right at this point. I would add, however, that if a trillion, 2 trillion dollars of additional resources were made available to try to shore up a fixed exchange rate regime in Europe, the possibility of inflationary risks would rise.

In the Great Depression in the United States, and usually after financial crises, there is a greater risk of deflation than inflation. And, second, as we learned in the Great Depression, the requisite way out initiated in 1933 by the U.S. devaluation of the dollar versus gold, which implied a devaluation of the dollar, a sharp exchange rate adjustment, is exchange rate adjustment. And our friends in Europe would like to maintain a single currency. I understand that. And I understand the firmness of their commitment to that. But I think the risks of following that path do include some inflationary potential.

Senator JOHANNS. Dr. Bergsten?

Mr. BERGSTEN. I agree with my colleagues, but, again, you have to make two key distinctions. You made one, which is timing. Over a 2-year horizon, I certainly would not worry about inflation. Over a 5-year horizon, I would on the grounds John just mentioned, and particularly if we do not get our act together here in terms of fiscal policy in a credible way.

The other distinction is, of course, between groups of countries that Uri made. I do not see any inflation risk certainly over the near term in the United States or Europe or Japan, given slow growth and high unused capacity levels. The developing countries and emerging markets have had that risk. They are now recognizing the need to pivot their own policies—I mentioned Brazil and Indonesia already—because of the slowdown in world growth. Nevertheless, they are closer to capacity margins. Supply constraints there are potentially greater, so I would not expect them to do nearly as much as China did in 2008–09, but I still think they can change the sign of their policy from contraction to expansion. And if they do it and the Germans do it and we do it, that could have a huge effect on resolving all the problems we are talking about.

Senator JOHANNS. I would just ask one more question, and it is maybe one of the most complicated things to try to figure out. But it is no secret, if you look at the published polling numbers in Germany and France, leadership there is really struggling. People are looking at what is being asked and required and kind of recoiling. And yet——

Senator WARNER. Is it lower than the United States Congress?

Senator JOHANNS. Well, I am not sure I can add any thoughts on that, but it is a difficult situation, and the political issues here are significant.

What happens if you get a year and a half out there and all of a sudden in response to actions that have been taken you have governmental change, campaigns that have been run on an anti-this or anti-that approach, and all of a sudden you have got a whole different set of circumstances from a leadership situation? Try to factor that in for me and give your best thoughts on that.

Mr. BERGSTEN. Certainly, that is a theoretical risk, and I have worried for a long time about populist politics in Europe that would go in that direction. But I must say there is virtually no evidence to support it. The Germans bitch and moan—pardon my German—but they vote strongly on every occasion in favor of the pro-European policies, the pro-European parties, including those that have mounted the bailouts. The fundamental fact is Germany is a huge beneficiary from the euro and the European Union. We know the underlying politics going back to the wars and the millennium of conflagration in Europe, and the Germans do not forget that. But in pure economic terms, for the reasons Makin described, the euro is nirvana for the Germans. They are the world's largest surplus country, but their currency stays weak. That is the dream of Helmut Schmidt and the other German leaders I used to work with when I was in government. Every time they would run a big surplus, their currency would go up. They would complain about the weak dollar, but they were complaining about the strong Deutsche Mark. Now they have overcome that.

Germany is such a massive beneficiary from the economics of the eurozone that the business community knows it, the labor unions know it. The one party that has opposed the European bailouts, the Free Democrats, got thrown out of the government in the last election in Berlin. Parties that are in favor of continuing the policy are getting 80, 90 percent of the popular votes in the Bundestag. The opposition in Germany is even more strongly in favor of it than Chancellor Merkel's party.

So it is a risk that we need to keep our eyes on. It could happen. But I would say watch what the Germans do, not what they say.

Senator JOHANNS. Dr. Makin.

Mr. MAKIN. I always know when I am getting to Fred, I am demoted from "Dr. Makin" to "John Makin" or "Makin."

Mr. BERGSTEN. Just showing you what good friends we are.

[Laughter.]

Mr. MAKIN. You know, I think that, again, looking at Germany, Germany has been a great beneficiary of the monetary union. But now that the financial complications of the currency area have begun to jeopardize the stability of the financial system and you have a failure of a major financial institution 2 weeks ago in Belgium, German economic activity is slowing rapidly, partly, I would argue, because things are slowing in China, but also partly because European citizens pick up the paper every day, and they look at the headlines in Greece, and they look at what is going on, and they know that something is not working.

So I understand—and I think if we listen to German leadership carefully over the past several weeks, I am sure that they are contemplating their options. A German Finance Minister said a Greek default may be necessary. That is tantamount to suggesting that Greece leave the currency union.

The German public was never asked—it was never permitted to vote on Germany joining the currency union. The German elites are powerful, and they manage the system very well—up to a point. And I think we may be approaching that point. We may see some of the pressure, some of the political pressure, which is obviously in Greece which is on the receiving end of the adjustment. But the political pressure is rising in Germany and could continue to rise. And since they are being asked to pay the bills, that would be a destabilizing factor that could be preempted, again, by being more realistic about what is a viable currency regime for Europe.

Mr. DADUSH. Yes, I tend to agree with Fred that the European project goes very deep in Germany, very, very deep, and that of all the parties, the least likely to desert the euro is Germany, not just because they are the beneficiaries, and right now, I mean, I could make a very Machiavellian argument that Germany is actually benefiting in some way from the crisis because of its low interest rates and because of the low euro. But more fundamentally, if Germany, which is actually benefiting and not under direct pressure at the moment, were itself to say, "No, I am fed up, I am leaving," that really would be the end of the European project. That would be—OK. It is very different if Greece says, "I cannot take the pain anymore."

And, finally, I do not want to—I am not ready to predict how things will develop in the European periphery. Let me just point to the fact that domestic demand, consumption plus investment plus government spending, in Ireland is down 20 percent compared to 2007. I mean, the magnitude of that number should strike one. All right? An indication if Greece were already down about 15 percent on 2007.

What we are witnessing in the periphery countries is the equivalent of a Great Depression. It is just not called a "Great Depression" because it happens to occur in some small countries that are sort of a little bit outside the news. But for all intents and purposes, it is a Great Depression. And in Spain, unemployment is now up at 24 or 25 percent.

So I think it is remarkable, the degree to which this structure has held together under enormous economic pressures. But if we go—if as I believe, because I believe it is a structural crisis more than a fiscal crisis, it is a competitiveness crisis, it is a growth crisis that is affecting the European periphery, if we are now talking another 5 years of adjustment, it is very difficult to say whether the polity can actually stay together in these countries. And that is one of the arguments why the combination of the commitment to the European project and the incredible stress under which the system is being put is one of the arguments, I think, to say that Europe should be helped in a situation like that.

Mr. BERGSTEN. Just if I may, two quick sentences back to Dr. Makin. He says the Germans pay the bills. Right, but that is a gross payment. Net they are still huge winners from the eurozone, and you could view those payments as kind of an insurance premium to keep their very big winnings rolling at the tables.

He also suggested that Greek default would equate to exit from the euro, and I disagree. Greece may default. They have to default. It certainly will have to restructure substantially its external debt.

But I think both the economics and the politics suggest they will do it inside the euro not outside, and they will come out better for doing it that way.

Senator WARNER. I have got one last question, but do you want to—because I just——

Mr. MAKIN. Yes.

Senator WARNER. Could you respond to that? Because one of the things in your initial points, you paint, I think, an appropriate challenge. And I clearly think the idea of a currency union without fiscal union has presented a half-built house. I 100 percent agree with you. But I think the implications of yours is that if you are going to break up the currency union, you are going to have some really short-term huge disruption, right?

Mr. MAKIN. Yes, so are we going to have——

Senator WARNER. If you could just give a quick response to that last question.

Mr. MAKIN. Look, we are not in a good situation here, right? And so getting out of it is going to be difficult. It just seems to me that addressing a reality, which is that Greece cannot co-exist in a currency union with Germany without massive transfers in their direction and without infecting the rest of the system, is probably going to be a positive thing. I do not see how it is worse than going from weekend to weekend where we keep saying, oh, well, you know, we were going to settle it this weekend, but we are going to do it next weekend.

Remember, the 440 billion euros was agreed to in July and was finally largely agreed to over the past several weeks, and it is not enough. So how much is enough?

Again, getting a resolution to this problem containing the fallout, it is not going to shock many people in the financial markets if Greece either defaults or leaves the union.

Senator WARNER. Well, listen, I know everybody has been very generous with their time, and I just want to say I really—this has been a fascinating panel, and provocative. I hear at least one major consensus point, that whether this leads to currency breakup or continuing the European alignment, the current resources available to ring-fence or stanch, I think everybody—I am hearing everybody would at least concur on that. There may be different paths. But——

Mr. MAKIN. Well, if we are going to insist on shoring up the currency system.

Senator WARNER. Right, agreed. Agreed. Agreed.

If we each could, please, no more than two or three sentences, if possible, but give me your best projection in terms of what, if anything, will happen out of the EU activities this coming weekend and what should we realistically expect coming out of Cannes in a few weeks, either way, any way you all want to do it.

Mr. BERGSTEN. I will just venture to say what comes out of the EU this weekend is further steps toward the ultimate objectives that we are all talking about here. They cannot do it all in one leap. There are too many players, and too many different actors. But they will take some steps forward on a path that will eventually lead to the outcomes that I was talking about, namely, a highly leveraged EFSF that will provide a ring fence around even Spain and Italy and further institutional reforms that eventually will lead to fiscal union.

But in the meanwhile, there will be so much cacophony and so much uncertainty generated by market pressures that the crisis atmosphere will continue. But I think they will move forward.

At the G–20 there will be more pressure on the Europeans to complete that progress. They may take some steps along the growth path, probably not as much as I would like to see, but I think there may be some steps. The Finance Ministers last weekend actually did reach a fair degree of consensus on the direction that is needed, including a stronger Europe, certainly in the United States, and encouraging the emerging markets.

The IMF portion I think is not as clear, and that will depend a lot on how much uncertainty the Europeans leave. If they leave a lot, I would not be surprised to see some movement toward what I call Plan B and at least putting in train an IMF resource expansion effort that would enable it to plug the gaps—which, incidentally, I think ought to be pursued anyway because in the uncertain world we are facing for several years, who knows when and where the IMF will be needed. And I would shore it up, in any event, though a European act on its own would clearly galvanize that.

Mr. MAKIN. This weekend I think we have already heard what we will hear, we are going to have another meeting next weekend or in the middle of next week, because, again, the problem—the alternatives are so unattractive, it is very difficult to step up to the plate. What the French will do is put out a number that is over $1 trillion that somehow is going to be a shock-and-awe number, but really nothing much will get done. If eventually they do come up with more money and they try to shore up the system, 6 months from now we will be back with more problems and looking for more resources. That is why I think it is a bad idea to go down this road.

Senator WARNER. G–20?

Mr. MAKIN. G–20? Well, I was going to say you could just read the last G–20 statement that came out in April, but at that time they said the global recovery was broadening, so they will have to say the global recovery is narrowing and we have got problems and we hope everybody gets everything straightened out. What else can they do?

Mr. DADUSH. Yes, my projection is, first of all, that the crisis will continue to fester for at least another year or two.

The second is with regard to the next 2 months over to the G–20, I think you will see a bank recapitalization decision in—a significant bank recapitalization decision. You will see a structure for the forgiveness of Greek debts that will be fleshed out.

I think you will see a larger and better articulated EFSF, and I believe that with all that you will also see some significantly greater engagement on the part of the International Monetary Fund. I believe you will see that. I do not know where exactly how that money will be found or how much it will involve the United States. But I believe that that is going to be part of the game going forward.

With all that, the crisis will continue to occasionally rear its ugly head over the course of the next several years because, again, as I said at the beginning, this is a crisis of economic structure, a crisis of competitiveness, a crisis of growth. It is not just a fiscal crisis.

Senator JOHANNS. Thank you very much.

Senator WARNER. Thank you all. The hearing is adjourned.

[Whereupon, at 4:43 p.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

PREPARED STATEMENT OF LAEL BRAINARD

UNDER SECRETARY FOR INTERNATIONAL AFFAIRS
DEPARTMENT OF THE TREASURY

OCTOBER 20, 2011

Chairman Warner, Ranking Member Johanns, and distinguished Members of the Committee, thank you for the opportunity to discuss how we are working with our G–20 partners to advance America's economic interests.

There is no stronger economic imperative today than to strengthen our economic recovery, create jobs, fuel growth, and build a stronger fiscal and economic foundation for our children and grandchildren. That is the prism that shapes our engagement in the Group of 20 (G–20) and with our international partners more broadly.

Safeguarding and Strengthening the Recovery

At the Pittsburgh Summit in 2009, the G–20 adopted as its core mandate achieving strong, sustainable, and balanced global growth. In the G–20 and in our bilateral engagements, we press vigorously for substantive economic, financial, and exchange rate reforms that will help achieve stronger and more balanced global growth in order to strengthen economic opportunities and growth for American families and workers. Our recovery in the United States remains fragile and all too vulnerable to disruption beyond our shores. Earlier this year, high oil prices and the tragic earthquake and tsunami in Japan led to a sharp economic slowdown. Consumer and business confidence was shaken in the summer in part because of the debt limit debate in the United States but increasingly because of the intensification of the European crisis.

Europe's financial crisis poses the most serious risk today to the global recovery. While the direct exposure of the United States' financial system to the most vulnerable countries in Europe is moderate, we have substantial trade and investment ties to Europe, and European financial stability matters greatly for consumer and investor confidence. That is why we have been working closely with our partners to support their efforts to resolve the crisis swiftly and resolutely.

Last week at the G–20 meetings in Paris, the Europeans committed to delivering a comprehensive plan to address their crisis by the Cannes Summit in early November. There are four key elements. First, Europe needs a more substantial financial firewall to ensure that governments can borrow at sustainable interest rates while they implement policies to bring down their debts and strengthen the foundations for growth. Second, European authorities are taking steps to ensure that their banks have sufficient liquidity and build capital cushions to maintain the full confidence of depositors and creditors, and to ensure that banks have access to a capital backstop where needed. Third, Europe is working to craft a sustainable program in Greece as it implements its fiscal and structural reforms. Finally, European leaders must tackle governance changes to address the root causes of the crisis, and ensure that every member state pursues sound economic and financial policies.

The United States must also do our part, and as the world's largest and most vibrant economy, we recognize that we have a global leadership role to play in strengthening the recovery. To promote near-term growth and job creation, the Obama administration has put forward a series of proposals in the American Jobs Act that would put veterans, teachers, and construction workers back on the job while rebuilding and modernizing America's schools and neighborhoods, and put more money in the pockets of every American worker by cutting their payroll taxes in half.

President Obama has also proposed a framework to put our medium-term public finances on a stronger and more sustainable footing. The President's proposal to the Fiscal Commission would place the Nation's debt-to-GDP ratio on a declining path no later than the middle of the decade through a balanced plan to reduce deficits by $4 trillion over 10 years when combined with the $1 trillion in savings enacted in the Budget Control Act of 2011.

Together, pro-growth policies in the near term and meaningful deficit-reduction in the medium term represent our best insurance policy to protect the U.S. economy from further risks from global markets. We must work together to safeguard America's economic resilience and strength from further stress.

Emerging markets must also do their part to strengthen global growth through rebalancing. With demand in the advanced economies likely to remain weak, it is essential for emerging economic powers, such as China, to play a bigger role in bolstering and sustaining global growth. These emerging markets with large current account surpluses have substantial capacity to pivot more rapidly to a pro-growth strategy led by domestic consumption.

At last week's G–20 meeting, the surplus emerging market countries such as China committed to accelerate the rebalancing of demand toward more domestic consumption and to move toward more market-determined exchange rates and achieve greater exchange rate flexibility to reflect economic fundamentals. By allowing its exchange rate to appreciate more rapidly in line with market forces, China could boost consumption, strengthen domestic demand, and help curb inflationary pressures. We have worked aggressively to pressure China in particular to move much faster in allowing the value of its currency to appreciate. We have seen some progress on this front, with appreciation of over 10 percent in real terms bilaterally since June 2010 and 38 percent since 2005, but more is needed.

We will continue to urge the IMF to use the considerable scope it already has to identify risks to the international monetary system—particularly external ones such as exchange rates—and ensure that IMF members are meeting their international obligations.

Strengthening the Global Financial Sector

The second focus of our work in the G–20 and the Financial Stability Board (FSB) has been leading a "race to the top," leveling up the playing field across major and emerging financial centers. In the wake of the financial crisis, and with the leadership of this Committee, the United States moved quickly with the passage of the Dodd-Frank Act to undertake financial reform. We have moved in lockstep on our international financial reform agenda, securing adoption of key conforming reform commitments in the FSB and G–20.

With financial markets that are globally integrated, we need financial reforms that are globally convergent. This is particularly important in areas with the greatest potential for small discrepancies in national regulations to create disproportionate dislocations in global markets that could negatively impact our economy and our firms. Accordingly, we have focused on three key areas: stronger global standards for bank capital and liquidity; heightened prudential standards and orderly resolution processes for large, complex financial institutions; and aligning global derivatives markets.

First, following international negotiations that were concluded in record time, G–20 Leaders endorsed new global capital standards in November 2010. These standards will raise the quality and quantity of capital so that banks can withstand losses of the magnitude seen in the crisis, strengthen liquidity standards, and limit leverage. Implementation of these reforms will proceed at a pace that reduces risks to the economic recovery and ensures a level playing field around the world.

Furthermore, we have successfully called on the Basel Committee to ensure that risk-weighted assets are measured similarly across the world. This is essential to maintain a level playing field and to ensure consistency across borders.

Second, for the largest, most complex firms, whose failure could cause the greatest damage to the economy, we are establishing a new international standard for resolution regimes, so that large cross-border firms can be resolved without the risk of severe disruption or taxpayer exposure to loss; more intensive and effective supervisory regimes; and a capital surcharge. The G–20 Leaders in Cannes will endorse this set of reforms for these global systemic financial institutions (G–SIFIs).

Third, G–20 Leaders adopted new principles for the first time to promote international convergence across derivatives markets, which are fully aligned with the Dodd-Frank Act. In the run-up to the financial crisis, few understood the magnitude of aggregate derivatives exposures in the system and the risks embedded in these exposures as derivatives, such as credit default swaps (CDS), were traded over the counter on a bilateral basis and without transparency. Moving derivatives trading onto exchanges and requiring trades to be centrally cleared increases transparency and reduces systemic risk. Central clearing will greatly reduce risk by requiring a central clearinghouse to guarantee the transaction and help market participants better monitor their risk. Mandatory trading on exchanges or trading platforms will improve price discovery and greatly enhance transparency, and reporting to trade repositories will shed light on what was once an opaque market. New work is beginning on our call to establish global standards for margins on un-cleared derivatives trades that will incentivize central clearing.

We are working with our G–20 counterparts to synchronize the implementation of these derivatives principles, and the United States is providing leadership by meeting the end-2012 deadline for implementing new rules consistent with these commitments. When taken together, these reforms will provide policymakers and investors a clearer picture of the true exposures and interconnectedness among and across financial institutions.

The examples above highlight areas where international convergence is imperative to preserve global financial stability. In other areas, the international regulatory system has long recognized differences in the institutional structure of national financial systems, reflecting different laws and histories. For example, the Volcker Rule in the United States and the Independent Banking Commission recommendations in the UK, though taking different approaches, are taking more restrictive positions on the permitted activities of banks than are some other countries which still use the universal banking model.

Retaining U.S. Leadership in the International Financial Institutions

Across all of these economic priorities, sustained and strong American leadership through the international financial institutions helps to facilitate solutions, advance growth, and build a better future.

In 2009, the United States was instrumental in supporting an expansion in the emergency financing of the International Monetary Fund. Rapid Congressional passage of legislation enabling U.S. participation helped stabilize financial markets at home and around the world during the peak of the crisis, paving a pathway for renewed global confidence and growth. Our continued leadership role at the Fund provides us with outsized influence to shape the IMF's responses to economic challenges, such as the European crisis, which matter to American jobs and growth.

Our leadership at the multilateral development banks (MDBs) has likewise offered us immense leverage and influence to shape development around the world, and thereby strengthen our own security and economic growth, while advancing American principles and ideals.

Yet today our leadership at the international financial institutions could be at risk if Congress does not act to support our commitments to these institutions. For example, at the World Bank, we currently have a veto over changes to the Articles of Agreement, which govern Bank membership and leadership, among other issues. At the African Development Bank, we have our own board seat, and can influence regional development to ensure that there are strict environmental and procurement standards. Other nations, particularly China, are eager to take up our shares in these institutions if we do not meet our commitments.

We must continue to work together in a bipartisan manner to renew U.S. leadership at these institutions, just as at the end of the cold war, when President Reagan advocated for the last general capital increase for the World Bank and a Democratic Congress approved it. These institutions provide immense leverage of our scarce resources, with every dollar the United States contributes to the MDBs generating $25 of investments.

It was through the power of our ideas and our values that we became leaders. With the emergence of new powers and new challenges, we will remain leaders by expressing that same commitment and vision through our evolving global partnerships in the 21st century. Our leadership in the international financial institutions, the G–20, and the FSB will be essential to securing the future we want for our children and for their children.

Our leadership in the G–20 helped to avert a much deeper recession after the crisis and to forge a common effort to strengthen the recovery and the financial system. The U.S. will continue to emphasize the critical role of the G–20 in developing a strong, collective response to overcome near-term vulnerabilities, and put in place the building blocks for more balanced and durable growth going forward.

We appreciate the leadership and support of this Committee on these key challenges, and we look forward to working with Congress as we engage with our international partners, and encourage robust policy responses to today's global challenges.

PREPARED STATEMENT OF URI DADUSH, PH.D.

DIRECTOR, INTERNATIONAL ECONOMICS PROGRAM
CARNEGIE ENDOWMENT FOR INTERNATIONAL PEACE

OCTOBER 20, 2011

Mr. Chairman, Mr. Ranking Member, distinguished Members of the Subcommittee, thank you for inviting me here today. In my testimony, I will address three issues: the G20's role in the Euro crisis, its role in restarting sustainable economic growth, and the G20's own functioning.

Can the G20 help coordinate a response to the Euro crisis, and what should that look like?

As it did last weekend, the G20 can exercise moral suasion on the eurozone countries to act more forcefully. More important, in the event that Spain and Italy are unable to raise money at reasonable interest rates—as happened to Greece, Ireland

and Portugal—the fallout on the global and European economy would be so severe that it is doubtful in my view that the Europeans could handle the crisis on their own. In this case, the G20 would then have to coordinate a response.

Bailing out Spain and Italy would entail, as in the case of the other peripheral countries, covering their public financing requirements for 3 years. The associated loans would amount to about $2.1 trillion. This large sum poses two separate problems. First, if the IMF were to fund one-third of the total, as it did in the case of the other countries, its share would amount to about $700 billion, exceeding its current $400 billion new lending capacity—recently indicated by Managing Director Christine Lagarde. The eurozone countries, for their part, would have to find $1.4 trillion, which exceeds the available capacity of the rescue fund, the European Financial Stability Facility (EFSF), by over $1 trillion, not counting any draw on the fund that may be needed to recapitalize European banks.

Though the eurozone economy is large enough to theoretically cover such an outlay, in practice it remains a half-built economic and political union and each individual member would be hard-pressed. Eurozone member nations manage their own fiscal and financial operations as do U.S. states, but there is no Federal Government of anywhere near corresponding size or clout that can spend—and just as importantly, borrow—like the U.S. Government can. Moreover, the European Central Bank (ECB) lacks the Fed's political legitimacy to intervene in support of member nations, and is, in fact, explicitly forbidden by treaty from doing so. The resignation of two German ECB board members over its emergency purchases of the periphery's government bonds is a clear signal of the profound opposition to such a course.

The institutional deficit of the European monetary union explains why marshaling an appropriate and timely response to the Greek crisis, whose debt is less than 15 percent of that of Spain and Italy combined, has been so extraordinarily difficult. But the political dimension is only one aspect of the problem should the crisis spread to the larger countries. Markets are very well aware that a bailout of Italy and Spain may fail, as it has in the case of Greece, and that the ability of the European core countries to cover these losses is limited. The spread on France's Government bonds relative to Germany's has doubled in recent weeks and is now well in excess of 100 basis points. In motivating its recent decision to place France's AAA credit rating on downgrade watch, Moody's pointed to France's share of the EFSF guarantees, which already amounts to 8 percent of its GDP, not counting new commitments to recapitalize its banks. According to the IMF, Germany's debt-to-GDP level is projected at 77 percent and France's at 90 percent by 2015, and it is clear that other large expansions of the EFSF would place France, and perhaps Germany in dangerous territory.

But these calculations greatly understate the problem. Even with a bailout, a sudden halt of financing to Spain and Italy would be accompanied by a severe recession in those countries which would have a major spillover on the rest of Europe. (Real domestic demand in Ireland and Greece, for example, is down 20 percent and 15 percent, respectively, compared to 2007, and is expected to continue to fall in Greece.)

Were, on the other hand, Italy and Spain forced to fend for themselves, in the event of a sudden stop in financing, an extremely dangerous European and global banking and economic crisis comparable in size and virulence to the Lehman episode, further undermining the public finances of all European countries, could erupt. Bearing in mind the disproportionate role that banks play in the European economy, Europe's political divisions, and the European governments' limited ability to respond now compared to 2008, it is easy to envision a scenario in which the acute phase of such a Lehman repeat would last not 6 months, but many years. Some may think that this scenario is alarmist, but I think it is important to bear in mind that, whereas the U.S. subprime mortgage market totaled between $1 and $1.5 trillion at its peak (depending on how subprime is defined), the outstanding debt of the European periphery now totals $4.6 trillion.

The global implications of such a scenario are dire. The United States would be affected, through trade and foreign investment (profits from its international companies and returns on the equity and bond portfolios of U.S. residents), but most importantly through the banking system. U.S. banks have $850 billion in direct exposure to the eurozone, including nearly $400 billion in exposure to eurozone banks. Moreover, they have an additional $1.8 trillion in indirect exposure, through instruments such as derivative contracts and guarantees. These numbers do not include U.S. exposures to banks in the UK and other European countries outside the Euro zone which are themselves exposed.

The emerging markets of the G20 would also be affected through the trade and banking channels as well as through ownership of European government bonds. But they are more exposed to a European crisis than the United States in two main ways: Europe attracts exports equivalent to 5.4 percent of its GDP (compared to 1.7 percent of GDP for the United States) and they are more likely to suffer a contagious withdrawal of external financing, as is already happening, while the United States is protected by its safe haven status.

Were this risk to materialize, it would be entirely appropriate for the G20, operating through the IMF, to seek to support the European adjustment. In order to cover, say, half of the cost of the bailout of Spain and Italy and retain the firepower to deal with the fallout on other countries, the IMF's resources would have to be expanded by about $1 trillion, of which the U.S. share would be $177 billion. It is important to bear in mind that IMF resources represent contingencies, not actual outlays, part of a "bazooka"—to use former Treasury Secretary Paulson's term—that may not need to be used. Such IMF loans have historically been paid back.

In the event of an expanded eurozone commitment, the G20 should insist that the IMF impose demanding conditions not only on the recipient countries, as it does at present, but also on Germany and the other core countries, as well as on the ECB. These conditions would be designed to ensure both that the program is well funded and designed, but also to promote the establishment of the institutional framework needed for the currency union to be sustained in the very long run. Such steps would include new fiscal and monetary arrangements capable of dealing with the diversity of European situations, a powerful European Banking Authority, mechanisms for managing default and exit from the eurozone, as well as structural reforms that increase the flexibility of the markets for goods and services inside the union.

The suggestion that the United States may need to provide additional IMF resources while it has not yet ratified the previously agreed-on expansion will appear audacious to some. But this is, in my view, the situation we may soon have to confront. Against the risk of a eurozone collapse, the G20, including the United States, should see expansion of IMF resources as a relatively cheap form of insurance. Even if it remains unused by the eurozone this time around, it may well come in handy in the not too distant future as the fallout from the financial crisis and the Euro zone crisis continues to reverberate.

Can the G20 help restart sustainable economic growth?

Yes, by appropriately mandating the main specialized economic agencies—the IMF, OECD, World Bank, and WTO—and by monitoring their work. This is already happening to a degree, but here, I would like to highlight two areas where a shift of focus is warranted and where leadership from the United States is badly needed. The first relates to the appropriate focus of global growth policies, while the second relates to restarting the world trade system as a driver of reforms.

Global Growth Policy

Policies for restarting sustainable economic growth as managed, for example, through the Mutual Assessment Process of the G20/IMF, suffer from two deficiencies in my view. First, they do not place sufficient emphasis on domestic policies and instead overstate the importance of global rebalancing. Second, domestic policies are not paying sufficient attention to structural reforms as distinct from macroeconomic management.

It should be obvious that domestic policies, and not those of other countries as reflected in trade balances, are the overwhelmingly important drivers of economic growth. After all, in the United States, for example, domestic demand is 34 times larger in absolute terms than (negative) net exports. And any single trading partner has only a very limited impact on the United States' GDP through net exports. For example, I have made the following calculation.

Assume that, in response to U.S. pressure, Chinese leaders could dictate that their country's savings be reduced immediately by 10 percent of GDP—approximately $500 billion. Even more implausibly, assume further that none of this additional spending could go toward domestic products, and that all of it instead went to imports, immediately making China a larger external deficit nation proportional to its GDP than the United States. If the increase were allocated geographically in proportion to China's recent import spending, the direct effect on U.S. exports and demand would be only $40 billion—or 0.3 percent of U.S. GDP—equivalent to about one-ninth of U.S. Fiscal stimulus measures in 2010.

This type of calculation actually overstates the importance of policy changes in other countries on the United States, since imported components and raw materials account for a significant part of the total value of U.S. exports. So the demand impulse from exports is less than it appears. On the other hand, the importance of imports in assuring the efficiency of U.S. producers and exporters, not to mention living standards, tends to be overlooked.

More generally, while demand stimulus is sometimes needed in emergencies, its importance—whether it occurs through fiscal and monetary policy in the United States or in its trading partners—in assuring sustainable long-term growth is almost insignificant. Structural reforms, such as privatization and liberalization of product and factor markets and encouragement of research and development, are a much more important driver of long-term growth. Under a broad definition of structural reforms, I would also include tax and expenditure reforms that modify incentives, reduce waste, and assure that a nation's fiscal situation remains on a sustainable path.

A good example of inadequate attention to structural reforms comes from Japan, which has been mired in slow growth and deflation for close to two decades. Japan has tried every trick in the macroeconomic policy book—repeated fiscal stimulus, zero interest rates, and quantitative easing—without any notable success in breaking out of its rut, and its public debt has exploded. The fact that it has systematically run a current account surplus has not helped. But observers of the Japanese economy long ago identified a number of structural weaknesses on which little or no action has been taken—for example, the nation's demographic decline combined with extremely restrictive immigration policies; an inefficient, overregulated, and protected service sector; super-protected agriculture; overbuilt and corrupt infrastructure sectors; and a state-owned post office and savings bank that artificially channels a huge part of the nation's savings to the purchase of government bonds instead of to more productive activities.

Similar structural weaknesses help explain the dire growth and competitiveness problems in countries such as Greece, Italy and Spain, which in addition suffer from extremely inflexible labor markets, where "insiders" enjoy job security and extensive benefits while an army of outsiders remain in precarious occupations or are unemployed.

Instead of insisting that the G20 pay so much attention to trade imbalances, which are a minor part of the problem and largely reflect a needed adjustment to domestic imbalances, the United States would be well served to place a greater focus on the latter, and especially on how structural distortions, including misguided tax and expenditure policies are hobbling the G20 economies. The OECD and World Bank are especially well-placed to support this work.

There is also a very rich reform agenda here on which the United States and China, the two largest economies, could lead the G20 by example. Detailing the needed structural reforms in the United States and China would take us beyond the current topic, but one structural reform area of great importance—in which the United States has just taken a notable step forward through ratification of agreements with Korea, Colombia, and Panama—is trade.

Trade Policy

WTO disciplines, reinforced by the G20's standstill agreement on new trade restrictions in November 2008, helped contain protectionism during the height of the crisis and avoid a repeat of the disastrous experience of the 1930s. That is the good news.

The bad news is that the failure to conclude the Doha Round of multilateral trade negotiations 10 years after they began shows that the WTO is broken as a liberalizing force. This means that huge parts of global economic activity, including large segments of services, foreign investment, manufactures imports in developing countries, and agriculture—all areas of vital interest to the United States—may remain essentially exempt from effective WTO disciplines. The world economy is still being propelled by the great opening up that occurred in the 1980s and 1990s as country after country embraced more market-friendly policies, but the inability to move forward on deeper global trade reforms will, in my view, increasingly constrain sustainable growth in years to come.

Just as it has done with the IMF and the World Bank, the G20 should now focus its attention on how the WTO can be reformed. How can the WTO regain the effectiveness of its predecessor, the GATT system?

Drawing on work carried out by the trade council of the World Economic Forum, of which I am a member, I would recommend that agreement to the current Doha draft be linked with establishment of a forward agenda of "plurilateral" negotiations. Plurilateral negotiations are negotiations among a critical mass of countries on a specific issue, such as trade in environmental goods, for example. Unlike multilateral rounds, they do not require that all members agree on every single agenda item before a deal can be struck. Examples of successful prior plurilateral negotiations include the Government Procurement Agreement and the Information Technology Agreement. Examples of plurilateral agreements that could be of great interest to the United States and to many other countries would include many areas in services and trade in high-technology products.

By supporting such a course, the United States would accept an admittedly low-ambition Doha deal, but, in the process, capitalize on a few aspects of the Doha draft that are of interest (such as trade facilitation), break the impasse in the WTO, and establish a new, much more flexible negotiating framework capable of yielding gains in a wide range of sectors in the decades to come. Though I believe there is interest in adopting a plurilateral approach to negotiations among the WTO membership, progress is only possible if the United States actively supports it and works through the G20 to promote it. As the next step, the G20 meeting should mandate trade ministers to meet to: a) link a Doha conclusion to plurilaterals, b) reach agreement on such a deal, and c) establish an agenda for reforming the WTO. The G20 trade ministers would then promote this approach among the entire WTO membership.

What should the G20's role be in the long run, and what would make it more or less likely to succeed?

The G20 heads of state summit was born of the financial crisis, was sponsored by the United States for its first meeting in Washington in November 2008, and was charged to be the preeminent forum for global economic policymaking at the Pittsburgh summit in September 2009. Comprising 10 emerging markets, 9 advanced economies, and the EU, the G20 has the potential to fill a large gap in global economic governance that its predecessors, such as the G7 and G8, were not able to bridge. It reflects the reality of a global economy where emerging countries are headed toward representing well over half of global GDP and trade.

In a forthcoming paper co-authored with Kati Suominen of the German Marshall Fund, I argue that, to succeed in global economic governance as well as crisis-fighting, the G20 needs to confront four major challenges: sticking to its comparative advantage, being realistic in what it can achieve, effectively integrating emerging economies in decisionmaking, and clarifying its own structure and composition. It will also need leadership from its largest members, beginning with the United States but supported by China.

Comparative Advantage

The G20 is not designed to be a decisionmaking body: it is not universally representative and its deliberations are not ratified by parliaments. It is also not well-suited to engaging at the granular level, which would risk encroaching on the territory of established multilateral institutions, such as the IMF, World Bank, or WTO, whose technical competence is far greater.

The G20 is very well-positioned, however, to function like a steering committee. It is flexible enough to react quickly to events and, therefore, manage crises, but also to provide general guidance for how the international institutional architecture should evolve.

The G20 countries, which together account for the vast majority of the ownership and voting power in the major global institutions, should focus on the big picture and look to these institutions to translate the G20-designed strategy into explicit decisions.

Realism

The G20 has unique strengths as a coordinating forum, but it also has limitations that should inform its agenda. Expectations of what it can accomplish must be tempered.

While the G20 economies were able to deliver on most of the commitments they made during the peak of the crisis, including fiscal stimulus, they have had much less success in dealing with longer-term issues, for example, restarting the trade agenda.

For one, the G20 and its watchers need to differentiate between the issues that multilateral institutions can genuinely make progress on and those—for example, taming global imbalances—that depend instead on domestic political processes in the largest economies and their willingness to engage.

One has to distinguish, in other words, between the need to improve the rules of the game and the need for key players to raise their game. Lacking enforcement tools, the G20 cannot induce action. But, over time, it can aim to develop broad consensus on the approach to take on global issues, nudge the executives in member states in new directions, and provide political cover for policy change at home. Such an approach is not always given to dramatic successes or flashy announcements.

Include the Emerging Economies

The G20 has created the possibility of shifting coalitions that cut across developing and advanced country lines. But including emerging countries as full participants could also limit the G20's effectiveness. The argument is often made that even as the emerging powers demand a larger voice in international organizations, they resist taking on the associated responsibilities and are reluctant to yield sovereignty, even at the cost of torpedoing international consensus. There is some truth to this argument and, in my view, examples of it can be found in the Doha trade negotiations and in aid policy. But equally clearly, developing countries are not the only ones that have failed to live up to their international responsibilities, in areas ranging from agricultural trade policies to control of carbon emissions, not to mention taking adequate precautions to avoid financial booms and busts.

So while both the emerging and advanced economies need to learn from their mistakes, emerging economies need to be given time to get the hang of international negotiations, to articulate a clear vision of the specific policies they want to drive on the global stage, and to establish a clearer ordering of their various preferences and interests.

Structure

To play a strategic role in global economic policy, the G20 must strike a balance between bringing too many countries and institutions around the table and being too small to be representative. Thoughtful leaders in such nonmember nations as Denmark or Chile have questioned the legitimacy of the self-appointed G20, even though its members account for some 80 percent of world GDP.

But catering to these concerns would only lead to ineffectiveness. The G20 already borders on being too unwieldy and is also taking on too many issues at once, which risks diluting its focus. At the same time, power on the international stage, rather than numbers, ultimately determines who will call the shots. In the final analysis, the five or six largest G20 members are in charge and including another economy the size of Argentina will not change that fact.

To improve continuity and build institutional memory and capacity, proposals have also been aired to establish a G20 permanent secretariat and a more durable presidency. The current set-up is not ideal, but it is not clear that any alternative, such as the IMF model of national groupings headed by rotating chairs, would be preferable. A longer Presidential term would also give one nation too much weight, as the 19 others would have to wait for their turn for years. And while a permanent secretariat would lead to more continuity, it would also, once established, increase the risks of bureaucratization, mission creep, and competition with other institutions.

The U.S. Role

As the crisis began spreading across the globe in 2008, the G20, led by the United States, which was at the epicenter of the crisis, helped avoid descent into a second Great Depression. Since then, it has also shown glimpses of its longer-term potential—beginning the hard work of revising the roles and structures of major institutions and setting the long-term global economic agenda.

Above all, the G20 needs to avoid the temptation to be all things to all nations and instead keep its eye on the ball—the systemic short- and long-term global policy issues that affect all nations and require major coordinated reforms. It also needs to know how to pick its fights and focus on those issues where there is a genuine emerging consensus about what to do.

The key factor between success and failure will be leadership. As in the past, there are only a handful of members that can swing the big decisions. Of these, the United States is still by far the most important and the only plausible leader—and will, in my view, remain so in coming decades. No relationship is more crucial for the United States in leading the G20 than that with China, a developing economy that is also the world's second-largest and fastest-growing economy. As in the past, the United States will lead best by example.

PREPARED STATEMENT OF JOHN MAKIN, PH.D.*

RESIDENT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE

OCTOBER 20, 2011

Thank you, Chairman Warner, Ranking Member Johanns, and Members of the Committee for the opportunity to testify.

The first paragraph of an article on how to save the euro in a recent issue of the *Economist* captures a significant part of what has gone wrong with the European economy.

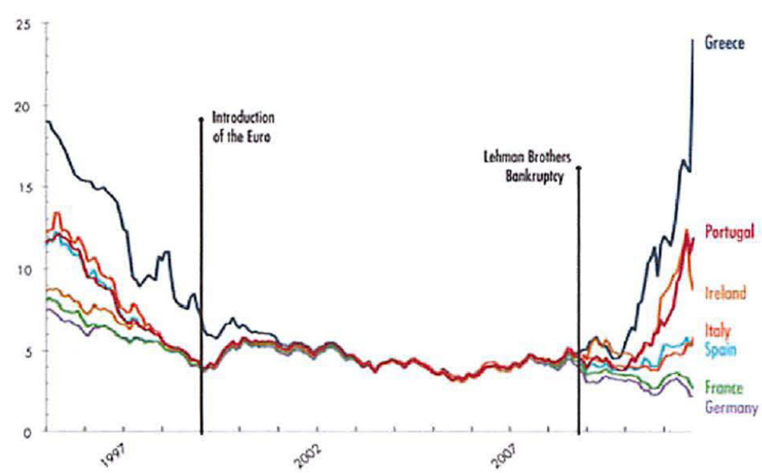
So grave, so menacing, so unstoppable has the euro crisis become that even rescue talk only fuels ever-rising panic. Investors have sniffed out that Europe's leaders seem unwilling ever to do enough. Yet unless politicians act fast to persuade the world that their desire to preserve the euro is greater than the markets' ability to bet against it, the single currency faces ruin. As credit lines gum up and outsiders plead for action, it is not just the euro that is at risk, but the future of the European Union and the health of the world economy.[1]

As we enter the fall of 2011 , 3 years after the Lehman Brothers crisis, Europe and the United States are teetering on the brink of another, potentially more serious, systemic crisis. It is surely fair to ask how we got to this point just a few months after the U.S. recovery had been declared well-established and European leaders had created a fund with resources that were supposed to be sufficient to ensure that Greece, the fulcrum of Europe's debt crisis, would not default on its debt. Figure 1 shows the sharp rise in interest rates on some European governments' debt—especially Greece, Ireland, and Portugal—and a recent jump in Spanish and Italian yields that is emblematic of Europe's intensifying debt crisis.

FIGURE 1

INTEREST RATES ON TEN-YEAR GOVERNMENT BONDS

(in percent)



SOURCE: European Central Bank

The crisis in Europe is somewhat mirrored and amplified by a parallel sharp growth slowdown in the United States. After last year's second round of quantitative easing (QE2) and extra fiscal stimulus spawned expectations of 3.5 percent growth, actual U.S. first-half growth of only 0.7 percent has changed everything. During the spring, the Federal Reserve began talking about detailed strategy for

* The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

[1] "How to Save the Euro," The Economist, September 17, 2011, *www.economist.com/node/21529049* (accessed September 20, 2011).

exiting high levels of monetary accommodation, while during July's debt ceiling fiasco, U.S. policymakers wrestled with the need to reduce deficits and debt accumulation. In the end, they left the heavy lifting to a congressional "super committee" that is to report back to President Obama by Thanksgiving. But before the super committee could even meet, the President reversed course in the face of the threat of a double-dip recession and proposed nearly a half trillion dollars in additional fiscal stimulus for 2012 that repeated and expanded measures the last Congress passed in December 2010.

Americans who follow deliberations in Washington, especially about taxes and Government spending, can be forgiven some confusion. During much of the second quarter in the lead-up to the July debt-ceiling debate, which was punctuated by threats of America's default on its debt, politicians loudly touted the benefits of living within our means, which meant cutting the deficit, which in turn meant cutting Government spending, raising taxes, or both. As Congress returned from vacation, the President offered up a jobs program costing nearly half a trillion dollars that involves cutting taxes and increasing Government spending.

Of course, the President followed up his jobs plan with proposals for future tax increases and spending cuts he claimed would provide more than $4 trillion in deficit reduction over the 10 years after 2013 "as the economy grows stronger."[2] It seems unlikely, though, that the tax cuts and higher spending that are supposed to make the economy stronger in 2012 will, when reversed in 2013, somehow not cause it to grow weaker.

We, and many in Europe, are left to wonder whether it is deficit reduction that is good for the economy or euphemistically named things like "jobs programs" that increase the deficit. It is important to ask how, at the time of this writing in September 2011, Europe has reached an acute sovereign-debt crisis while the U.S. economy simultaneously threatens to contract, exacerbating both its own budgetary problems and Europe's sovereign-debt crisis.

What Happened in Europe?

Europe's problems, which are probably more acute than America's, spring from a simple cause: an attempt to forge and maintain an impossible currency union. The European Monetary Union, which includes such disparate economies as Germany on the strong side and Greece, Ireland, Portugal, Spain, and Italy on the weak side, requires the assumption that monetary policy that is appropriate for Germany is also appropriate for Greece. Europe's adoption of monetary union enabled less credit-worthy countries such as Greece to borrow on virtually the same terms as Germany because both were issuing debt denominated in euros and the European Central Bank (ECB) was treating those debts as being of identical quality.

The European Monetary Union was, at first, attractive for all of its members, including Germany. European banks were happy to make euro-denominated loans to government and private borrowers in southern Europe who could suddenly borrow for less, given that the loans were denominated in euros. If a bank lent money to, for example, the Greek Government, it acquired a claim on Greece that it could take to the ECB and use as collateral for further borrowing. The terms for that transaction were virtually identical to the terms available if claims on the German Government were used as collateral. Easy credit accelerated European growth, not to mention German exports. As inflation and growth surged in southern Europe, so too did borrowing in those countries.

Adoption of the euro by countries like Greece and Spain meant that they got a German credit rating that enabled them to purchase more Mercedes—on credit. At first, German exporters were pleased. But now, Germans are being asked to help borrowers in these southern European countries repay these loans.

By 2009, some lenders began to notice that Greek budget deficits and government debt were rising rapidly. When Greece revealed late in 2009 that its deficits and debt were substantially larger than previously reported, the first phase of the European debt crisis began. However, the ECB continued to allow banks to use Greek, Italian, Spanish, and any other sovereign debt from the European Monetary Union as collateral for loans. Banks were also not required to hold reserves against their sovereign-debt loans because it was effectively assumed that sovereigns do not default.

The solution to the Greek crisis that emerged in the spring of 2010 was essentially perverse. In exchange for additional loans so that Greece could roll over its

[2] White House Office of the Press Secretary, "Fact Sheet: Living Within Our Means and Investing in the Future: The President's Plan for Economic Growth and Deficit Reduction," September 19, 2011, *www.whitehouse.gov/the-press-office/2011/09/19/fact-sheet-living-within-our-means-and-investing-future-president-s-plan* (accessed September 22, 2011).

debts and pay its debt service, the International Monetary Fund (IMF) and the European Union imposed strict conditions on Greece in the form of higher taxes and sharply contractionary cuts in government spending that caused the economy to slow further, undercutting its ability to service outstanding debt and additional debt.

By the second quarter of 2011, it was clear that Greece would require additional funding to meet its debt service obligations, while similar problems arose for Portugal, Spain, and Italy. Ten years of pretending that loans to southern European governments carried as little risk as loans to the German Government left Europe's banks with nearly $2 trillion worth of claims on those riskier borrowers. For the purpose of "stress tests," it was assumed that these claims were worth 100 cents on the dollar when the marketplace implies substantially lower values. The large sovereign-debt holdings by European banks pose a threat to the solvency of many of those banks that rises in proportion to doubts about governments' ability to service those loans. Given these conditions, if Greece, for example, defaults on its debts, the possibility of defaults by other sovereign governments in Europe may rise, triggering solvency problems for most of Europe's private banks.

Many hope to preempt this disaster scenario by recommending aggressive steps to prevent a Greek default. The problem is that Germany, the country that would have to foot most of the bill, is insisting that Greece adopt additional austerity conditions in exchange for the loan. The austerity conditions, in turn, imply that Greece will be less able to service its debts a year from now, given that the economy is expected to contract at a 5 percent rate if these austerity conditions are imposed.

Impact of Europe's Debt Crisis on the United States

Americans are exposed to the European debt crisis through money market funds, among other channels. The rapid slowdown of U.S. economic growth, along with the elevated uncertainty tied to July's debt-ceiling fiasco, caused many households to sell stocks during August. Typically, investors move such funds into "cash equivalents" or money market funds, which pay virtually no interest but are meant to be highly liquid should households need to reinvest the funds or to purchase goods and services. As Europe's debt crisis intensified during the summer, U.S. money market funds were, in effect, lending heavily to European banks that in turn were significantly exposed to shaky sovereign-debt issuers like Greece, Portugal, Spain, and Italy. The result was that Americans who wanted to avoid more risk by exiting stocks and entering money market funds were effectively lending to Greece and Portugal. This discovery led money market funds to sharply reduce their exposure to European sovereign debt as depositors began to exit for fear that the funds would be vulnerable to a Greek default and other European sovereign-debt problems.

The search for safety outside money market funds drove risk-averse American investors into U.S. Treasury bills, bonds, and notes. As a result, the yield on 4-week and 3-month Treasury bills was driven to zero or below by late August, while the yield on 1-year Treasury bills was driven to an incredibly low six basis points. So desperate were American households, and undoubtedly some firms, for a risk-free cash repository that in some cases they were willing to pay the U.S. Government one or two basis points for the privilege of lending to the Government for a short period. Those who wanted more yield bought 10-year notes and 30-year bonds, pushing yields on 10-year notes below 2 percent, even lower than they had been after the Lehman crisis, and yields on 30-year bonds down to 3.25 percent or below. Other investors seeking safety and expecting higher inflation bought gold, pushing its price over $1,900 per ounce at some points.

It is worth commenting on the simultaneous increase in the price of gold and the drop in interest rates on 30-year bonds. Because gold pays no return, buyers are essentially betting on an increasing price of gold to reward them. If inflation continues to rise, as gold buyers expect, purchasers of 30-year bonds will be at risk since they will be paid back in dollars with less purchasing power. As a result, the most popular fixed-income instrument, whose returns rival that of gold during 2011, have been U.S. Treasury inflation-protected securities (TIPS). So eager are investors for a safe haven that the real yield on TIPS has been driven well below –1 percent. That means buyers of TIPS are willing to pay the U.S. Government more than a percentage point for the privilege of owning a long-term, inflation-protected asset.

But why are some investors betting on inflation by purchasing gold while others are willing to bid up prices on long-term Treasuries that would be harmed by higher inflation? The answer may be that the extremely high level of uncertainty in financial markets implies a wide range of possible outcomes, including both higher inflation and deflation. Gold is a somewhat illiquid way to play the inflation scenario, while longer-term Treasuries are a bet on the deflation outcome. Investors who remember Japan's deflationary experience after 1998 and the resulting drop in long-term interest rates to below 1 percent may buy Treasury bonds, while those who fear debasement of paper money may buy gold. Gold buyers are also concentrated in countries like China and India where local-currency, long-term government securities are not available and gold is the preferred safe-haven asset.

No Place to Hide

The systemic mess the United States and Europe—and eventually, the rest of the world—are facing in the fall of 2011 is greater than the sum of its parts. The U.S. economy slowed down even after substantial monetary and fiscal stimulus had been applied. The slowdown was surprising and also disconcerting to policymakers who had to entertain the notion that the policy levers they were pulling were no longer effective. Just as these disquieting realizations were arising in the United States, the European debt crisis reintensified as Greece teetered on the edge of default and the crisis environment spread to the rest of southern Europe. These conditions raise some serious questions.

Why Isn't the United States Stimulus Working?

The short answer is this: monetary policy is not stimulating the economy because the United States is in a liquidity trap. At first, the Fed's QE2 was followed by higher interest rates as markets expected further growth. But as growth failed to materialize, interest rates came back down, stock markets weakened, and funds went back into cash. Viewed another way, the Fed's QE2 initially induced investors to put more money into riskier assets like stocks, but when growth failed to materialize, the funds left those riskier assets for cash. It was additionally disconcerting that one of the first cash destinations, money market funds turned out to be essentially lending to European borrowers who were even riskier than U.S. borrowers. As a result, funds flowed into the Treasury markets, pushing short-term Treasury yields to zero or below. Those fearing eventual currency debasement and inflation bought gold.

The Fed's latest attempt to offer additional stimulus is somewhat bizarre. After its August meeting, the Fed indicated strongly that it would hold short-term interest rates at zero for another 2 years. That amounts to promising that the economy will not recover for 2 years because if it did, short-term interest rates would rise as cash balances sought higher returns on investments in the equity markets, which would improve as the economy improves. Those seeking a positive return on investments must bet either on higher inflation and buy gold or on higher growth and buy stocks.

The Fed has sought to push down immediate and longer-term interest rates with Operation Twist, whereby it is concentrating its purchases in the Treasury market on 10-year notes and 30-year bonds at the expense of shorter-term bills and notes for which interest rates are already virtually zero. Lower interest rates—even lower longer-term ones—are not likely to produce much growth in an economy with virtually no demand for credit from qualified borrowers.

Fiscal stimulus is not working because the constraints of rising deficits and resulting debt mean that it is by definition temporary and must be reversed after implementation. Last December, the Obama administration announced temporary tax cuts. Enactment boosted incomes, but termination a year later will slow their growth. Obama's early September 2011 proposal for a $450 billion stimulus package for 2012 was followed in mid-September by another package proposal that promised more than $4 trillion in deficit reduction—nearly 10 times the stimulus proposal—over the next decade. The impetus for Obama's 2012 stimulus was the end of the 2011 stimulus, which not only did not work to boost the economy but also will cause a slower economy once it ends. In other words, because the 2011 stimulus did not work, the President is claiming that we need another one in 2012 that will be reversed in 2013.

Why Doesn't Europe Either Let Greece Default or Bail It Out?

The question of Greek debt has to be addressed very soon. If Greece unilaterally defaults, fears of defaults elsewhere in southern Europe may produce a run on European banks that hold claims on those countries, leading to a full-blown financial crisis in Europe. It probably would be better for the ECB—or the ECB, European Union, and IMF, collectively—to offer unconditional guarantees on sovereign European debt. This would mean the euro would likely end up as a relatively soft currency, so the German Government, which would have to fund much of the sovereign-debt bailout, has so far refused to agree to this plan. Given the cumbersome nature of the European Monetary Union and its institutions, it appears likely that an agreement will not be reached and that some kind of Greek default, probably preceded by capital controls, will occur before the end of this year. The fallout, sharply lower European growth and sharply elevated financial turmoil, will be negative for the United States and the rest of the world.

What Should the United States Do?

This fall, while Europe is awaiting Greece's impending default, it appears that American policymakers will repeat July's debt-ceiling fiasco: ambivalence about whether tighter or easier fiscal policy is better for the United States (that is, are we supposed to raise deficits or reduce them?) will be rendered moot by the super committee's likely inability to find an additional $1.5 trillion (or more, if any stimulus measures are enacted) in deficit cuts over the next 10 years. If that is the case and U.S. fiscal policy essentially continues on its current path through the end of the year, while Europe is in a default mess the United States will be experiencing fiscal drag equal to about 2 percentage points of gross domestic product, exacerbating any global slowdown caused by a failure to resolve Europe's debt mess.

No easy or obvious ways exist to bypass this bad outlook that has grown out of the inability of European and U.S. economic policymakers to make hard decisions over the last several years. The signs that such an outcome is becoming more likely include a slowdown in inflation and a threat of deflation as more households and businesses seek the relative safety of cash equivalents like Treasury bills and rein in their spending in anticipation of substantial financial turbulence and slower growth. That development, coupled with the surge in demand for liquid assets that usually accompanies an acute financial crisis, will require central banks to print a lot more money to avoid a self-reinforcing deflationary disaster that raises the real debt burden at the root of the problem faced by banks and governments in Europe and banks and households in the United States.

One encouraging sign is that we may already have seen an initial step toward preempting deflation. On September 15, the Fed, in conjunction with the central banks of Europe, Great Britain, Switzerland, and Japan, arranged to supply dollars to Europe's banking system. The flow of dollars to Europe's banks has dried up as other banks and U.S. money market funds feared their exposure to large quantities of sovereign debt issued by southern European countries. The swap lines, as they are called, will be available to help with year-end funding needs by supplying the dollars European banks need to finance their dollar loans and other dollar liabilities. At the least, this step represents a solid move toward financial coordination among central banks that may help ease what appears to be an upcoming global financial mess.

PREPARED STATEMENT OF C. FRED BERGSTEN, PH.D.

DIRECTOR, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS [1]

OCTOBER 20, 2011

The world economy obviously faces major risks. There are three separate though related problems: the possibility of renewed recession in the three large high-income areas (United States, Europe Union, Japan), the continued fragility of the global financial system and most immediately the threat of renewed crisis in Europe.

At the same time, the global economy does exhibit several significant strengths. The emerging markets and developing countries, which now account for half of all global output, continue to grow rapidly. Many of the design shortcomings and implementation failures of the previous financial regulatory regime have been reduced by the Basel III agreement and by regulatory reform at the national level, including importantly the Dodd-Frank law in the United States. World trade has continued to expand and the feared outbreak of protectionism has failed to materialize.

In this mixed setting, what should the G–20 do at its upcoming summit in Cannes on November 4–5? I recommend a three-part initiative.

Promoting Global Growth

The most critical task is restoring economic growth throughout the world and the G–20 should act to do so at Cannes as it did at London in April 2009. The group should postpone its 2010 pledge "to cut budget deficits in half by 2013." There is no problem in the emerging markets: they continue to expand at an average rate of 6 percent and some, including China and India, are doing much better. Such

[1] And formerly Assistant Secretary of the Treasury for International Affairs and Assistant for International Economic Affairs to the National Security Council. His 40 books on global economic issues include *Global Economic Leadership and the Group of Seven* in 1996 and he chaired a "shadow G7" during 2000–2005.

growth is pervasive across all groups of these countries, including Latin America and sub-Saharan Africa as well as East Asia.

All three of the traditional global economic leaders, however, are struggling to reach even 2 percent growth. All are experiencing high and persistent unemployment. Compounding their policy problems, all simultaneously face large budget deficits and rapidly growing debt burdens that require fiscal corrections rather than the expansions that would normally be adopted in such circumstances.[2] Nor can monetary policy do very much since all three central banks are at or not far from the "zero bound" of interest rates.

The world will thus have to continue to rely—increasingly so—on the emerging and developing economies led by China, which alone accounts for one quarter of all global growth.[3] *These countries should adopt new stimulus programs to strengthen the global prospect.* Some, notably Brazil and Indonesia, have already begun to do so. Fortunately, almost all of them have fiscal and/or monetary policy space to deploy expansionary policies. Moreover, they are already planning to spend trillions of dollars on new infrastructure projects over the coming decade and acceleration of these efforts should be feasible as well as desirable. Their recent concerns over inflation, which justifiably have deterred some of them from shifting their policy gears heretofore, should be mitigated by the weakened prospects in the high-income countries and the leveling off of most commodity process.

In short, *it is time for the emerging economies to assert the leadership of the global economic system for which their dramatic progress of the last decade or so has prepared them.* China already did so to an important extent in 2008 when it acted most quickly and most decisively of any major economy to promote recovery from the Great Recession. This time *the emerging markets as a group need to move with equal vigor to prevent another Great Recession.*

It is also essential that the emerging markets promote *global* growth through the shape of their expansion strategies. China and the other countries with large reserves must provide stimulus through domestic demand and *reductions,* rather than renewed increases as forecast by the International Monetary Fund, in their external surpluses. This is the only way they can help the world as a whole, including a number of poorer countries as well as the high-income trio, attain renewed growth—which is of course critical to them as well.

China continues to buy $1–2 billion every day to keep the exchange rate of its renminbi 20–30 percent below equilibrium levels. It and other emerging and developing countries spent $1.5 trillion in 2011 alone to hold their currencies down, substantially increasing the trade and current account deficits of the United States (and Europe and a few others). *These countries achieved much of their rapid development by exploiting demand in the rich countries and it is time for them* to promote domestic consumption and social infrastructure spending and to let their exchange rates appreciate much more rapidly (which will also help counter any inflationary pressures from their new stimulus initiatives).

The European Crisis

The most immediate problem is of course the European crisis, and the G–20 should be in a position by Cannes to endorse a comprehensive action plan.

Here too, however, renewed growth is essential. Austerity alone cannot restore economic viability in Greece, Italy or the eurozone as a whole. Two steps are required on this aspect of the European problem:

- Germany, the Netherlands and the other *strong countries of the European "core" should,* at a minimum, postpone the further tightening of their fiscal policies that is now planned and let their automatic stabilizers play through, and preferably *adopt temporary stimulus measures for the next couple of years;*
- *The European Central Bank,* which alone in the high-income world has tightened monetary policy this year and is some distance from the "zero bound," *should reduce its interest rates by at least 100 basis points.*

In addition, *the eurozone must deal decisively with its financial perils.* The only way to do so is *by leveraging the European Financial Stability Facility* (EFSF), through the European Central Bank (which will remain the ultimate source of

[2] See Joseph Gagnon, *The Global Outlook for Government Debt over the Next 25 Years: Implications for the Economy and Public Policy,* Policy Analyses in International Economics 94, Peterson Institute for International Economics, Washington, June 2011.

[3] China accounts for about 10 percent of global output (at purchasing power parity exchange rates) and has been growing at about 10 percent per year for over three decades. Hence it contributes 1 percent to global growth, about 25 percent of the current total and 20 percent even in the boom years of 2003–07.

eurozone bailouts) or whatever techniques prove to be most feasible politically, *to create a total reserve of 2–4 trillion euros.* Such a war chest would assure markets that the zone itself could handle any conceivable contingencies, including defaults by Italy and Spain, as well as provide the financing necessary to provide the essential recapitalization of European banks and enable Greece to buy back large portions of its existing debt and thus restore national solvency.

For the longer run, the Europeans must continue with the steps toward completing their Economic and Monetary Union that have already been galvanized by the crisis. These will include a fiscal union, a European Monetary Fund to systematize their rescue capabilities (and the accompanying conditionalities) and a comprehensive mechanism for regional economic governance. Such evolution will almost certainly require changes in the EU treaty and national constitutions. It will obviously take time, perhaps 5–10 years, but is an essential complement to the current crisis management to prevent replication of the present difficulties and restore assured stability to the European Union as the single largest component of the global economy.

If *the Europeans fail to get their act together* sufficiently to deal with their crisis themselves, which we should know by Cannes, *it will be necessary to move to Plan B: mobilization of global resources* to do so *through the International Monetary Fund.* The Fund is the only alternative through which such financing, along with the requisite adjustment programs, could be obtained.

The G–20 would have to play a crucial role in any such process, as it did in raising $750 billion for the Fund in 2009, because *the IMF would have to raise several trillion dollars* to enable it to deal effectively with the European difficulties. Such funds could only be borrowed *from the emerging market economies that have built huge reserves of foreign exchange: China, Russia, Brazil, Korea, India, Mexico, Singapore, Hong Kong and several others including a number of large oil exporters.*

Such investments would be attractive for these countries because almost all of them would like to diversify their reserves out of dollars. A claim on the IMF would provide them with an asset that was both diversified in terms of currency risk and paid a higher interest rate. They might also, quite legitimately, link their provision of such funds to the IMF to further substantial increases in their quotas, and thus voting rights, at that institution.

I believe that the IMF should seek to avail itself of such additional resources, with or without an immediate need in Europe, due to the ongoing fragility of the global economy and its uncertain prospects for at least the next several years. But Europe's requirements could provide a compelling case for urgent action and *this issue could in fact leap to the top of the G–20 agenda in Cannes.*

Global Financial Regulation

It would clearly be desirable to implement a common financial regulatory regime that encompassed all major parts of the world and all classes of financial institutions. We are still far from being able to achieve such a regime, however, as indicated by the fierce battles over key components such as capital requirements and resolution mechanisms.

The G–20 should thus agree to implement on schedule—and sooner where feasible—the minimum bank capital and liquidity requirements under Basel III including the capital surcharge for global systemically important banks. In view of the market funding strains and contagion risks facing banking systems in some important economies, this is decidedly not the time to be heeding pleas to weaken and/ or postpone these key reforms. This is of course especially the case in the Euro area, where large holdings of beleaguered sovereign bonds by banks and credibility problems with previous bank "stress" tests have increased the risk of significant spillovers from the smaller periphery countries to larger ones at the center (particularly Spain and Italy).

In this connection, it is instructive to note that, in the latest (September 2011) IMF Global Financial Stability Report, bank leverage (defined as the ratio of tangible assets to tangible common equity) in the Euro area is over twice as high as in the United States (26 versus 12) with particularly high leverage for German, Belgian, and French banks (32, 30, and 26, respectively). Concerns that efforts to increase bank capital ratios will result in a fire sale of bank assets (by lowering the denominator of the bank capital ratio) can be countered either by requiring banks to meet the higher capital requirements in absolute terms (that is, by raising a specific amount of capital without regard to risk-weighted assets) or by picking a benchmark for the capital ratio that uses a level of (risk-weighted) bank assets prior to the required increase.

The G–20 should also redouble its efforts in two other reform areas. First, it should underline further the importance of the FSB and national authorities monitoring carefully the buildup of risks in the "shadow banking system" so that tougher capital and liquidity standards in the banking system do not merely result in a shifting of risk to less regulated but increasingly systemically important nonbank entities. Second, it should press the FSB to make further and faster progress in securing G–20-wide agreement on a cross-border resolution regime—especially for the 28 globally active banks that have been identified as global systemically important institutions. This should be a priority since such global institutions typically have hundreds or even thousands of majority-owned subsidiaries in other countries and resolution cannot take place effectively without such a cross-border agreement.

What Role for the United States?

The United States must obviously play a central role in galvanizing such a G–20 program at Cannes if it is to eventuate. It can make five major contributions:

- agreement between the President and Congress to adopt a *new stimulus program to enhance U.S. economic growth* for 2012; we can hardly expect China and Germany to take responsibility for maintaining global expansion if we continue to be paralyzed in moving similarly;
- *tangible progress toward credibly reining in the U.S. budget deficit over the remainder of this decade,* going far beyond the procedural legislation passed on August 2, to stabilize our debt buildup and thus restore global confidence in our economy and the dollar;
- *a commitment to eliminate our current account deficit,* which would create 3–4 million new U.S. jobs and carry out previous G–20 pledges to correct the large global imbalances in order to achieve sustainable world growth;[4]
- *House passage and Presidential signature of the China currency bill recently passed by the Senate,* to emphasize our seriousness concerning the rebalancing issue and thus increase the incentives for China to both stimulate world growth via domestic demand and let its exchange rate strengthen more rapidly; alternatively, or in addition, *the numerous G–20 countries concerned by China's currency manipulation could file a joint case against it in the World Trade Organization;* and
- support for augmenting the reserves of the IMF as suggested above, including a commitment by the Senate and House leadership to enact the pending IMF reform legislation once it is sent to the Congress by the Administration and an expression of U.S. willingness to increase the weight of the emerging markets at the Fund (primarily at the expense of the Europeans, who would be gaining directly—indeed rescued—from the new funds provided by those countries).

The United States has a massive *national* interest in successful revival of the *world* economy, especially as a large part of our own recovery will depend on our success in expanding sales to external markets. We must exercise a new style of leadership to catalyze action by the still-new, and diverse, G–20 but a good start has been made over the past 3 years and the stakes are so high that we must place the highest priority on utilizing the institution effectively over the coming months and years.

[4] C. Fred Bergsten, "An Overlooked Way to Create Jobs," *The New York Times,* September 29, 2011. Copy attached.

THE NEW YORK TIMES **OP-ED** THURSDAY, SEPTEMBER 29, 2011

An Overlooked Way to Create Jobs

By C. Fred Bergsten

WASHINGTON

BY virtually ignoring trade, President Obama and Congressional Republicans are missing a major opportunity to create jobs. The United States runs an annual trade deficit of about $600 billion, or 4 percent of our entire economy. Eliminating that imbalance would create three million to four million jobs, according to Commerce Department estimates, at no cost to the budget.

It is clear that our economy can no longer rely on consumer borrowing, housing bubbles, government deficits and super-low interest rates. The United States must start selling much more to other countries, especially China and other emerging markets that are growing at 6 percent or more per year.

Mr. Obama has set a goal of doubling the nation's exports over five years. But his administration has done little to achieve that goal, which is inadequate to begin with. For one thing, the focus should not be the level of exports but the overall deficit — the difference between what we import from abroad and what we sell overseas.

This will of course require us to get our house in order: balancing the budget over time; investing in education, infrastructure and scientific research; and making taxation and regulation more efficient. But there are three steps we can take that would pay off more quickly.

First, the United States must, in effect, weaken the dollar by 10 to 20 percent. This step alone would produce one million to three million jobs. It's been done before: In 1971, President Richard M. Nixon ended the dollar's convertibility in gold, and in 1985, Treasury Secretary James A. Baker III reached an agreement with foreign countries to devalue the dollar relative to the yen and the Deutsche mark.

The bulk of our current misalignment is vis-à-vis the Chinese currency, the renminbi, and a small group of other Asian currencies. Partly in response to pressure from the United States and other

Weaken the dollar to help our exports.

countries, China has let its currency rise modestly over the past year, but it continues to intervene in foreign exchange markets, purchasing one billion to two billion United States dollars every day to prevent the value of the renminbi from rising more quickly.

The artificially low value of the renminbi — it is 20 to 30 percent less than what it should be — amounts to a subsidy on Chinese exports and a tariff on imports from the United States and other countries. The United States should take China to the World Trade Organization in Geneva for engaging in illegal competitive currency devaluation, and retaliate if China does not cease this protectionist policy. Many members of Congress have urged such action, but Mr. Obama, like President George W. Bush before him, has been too timid to take this step.

Along with pressuring the Chinese, Congress and Mr. Obama should reduce the budget deficit, the Federal Reserve should continue to pursue an expansionary monetary policy and politicians should drop the "strong dollar" rhetoric of the past. An overvalued dollar only exacerbates the trade imbalance.

Second, the United States must negotiate a reduction in foreign regulations, monopoly practices and other barriers to the export of American services. Work done by American architects, engineers, lawyers and accountants for foreign customers is an export, just like Boeing planes and Caterpillar tractors. We run a $750 billion trade deficit in goods but a $150 billion trade *surplus* in services.

Services make up 80 percent of our economy, and we have a huge opportunity to serve emerging markets like Brazil, China and India. We could expand services exports by at least $200 billion a year by completing a free-trade agreement with South Korea; pursuing a trade agreement known as the Trans-Pacific Partnership; and reviving the Doha round of global trade talks, with a focus on services. The administration has not pursued these steps with enough vigor.

Third, we must get serious about defending the intellectual property rights of our companies against theft by foreign companies and governments. A recent study by the International Trade Commission suggested that Chinese companies alone, with support or at least acquiescence from their government, are stealing $50 billion to $100 billion in United States products each year. The global total is probably at least twice as large.

The theft of intellectual property cuts across such highly competitive products as Microsoft Windows, Apple iPads, groundbreaking pharmaceuticals and award-winning films. Negotiations have failed to achieve significant progress. We must take many more intellectual property cases to the W.T.O. and credibly threaten unilateral retaliation if the foreign piracy continues.

These steps are no doubt aggressive. They would require taking tough initiatives with some of our main trading partners, especially China, and giving trade a more prominent, even central, role in our overall foreign policy. To be sure, some American corporations will fret that these actions would needlessly antagonize the Chinese and threaten a trade war. Some economists worry that a weaker dollar would invite inflation and endanger the dollar's status as the dominant global currency. I believe these fears are overblown. The real threat to the world trading system is, in fact, the protectionist policies, including undervalued currencies, of other countries and the vast trade imbalances that result.

Not every country can expand its economy through exports, because one nation's smaller deficit is another's smaller surplus. But the United States has a unique claim now to pursue such a strategy, because it has run large deficits for most of the last three decades, become the largest debtor country and accommodated other countries' desire for export-led prosperity. If we want to avoid bankruptcy and raise growth, we have got to attack the trade deficit. □

C. Fred Bergsten, an assistant Treasury secretary from 1977 to 1981, is director of the Peterson Institute for International Economics.