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Testimony of
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Madame Chairwoman, Ranking Member Barrasso, and distinguished members of the Subcommittee, thank you for inviting me here today. My name is David F. Gordon and I am Head of Research and Director of Global Macro Analysis at Eurasia Group, a global political risk analysis firm. Prior to Eurasia Group, I worked in the US government for nearly two decades, culminating in service as Director of Policy Planning under Secretary of State Condoleezza Rice.

Thank you for your leadership on and attention to the sovereign debt crisis in the Eurozone. The crisis is very severe, and failure to resolve or at least mitigate the crisis would have sharply negative effects on global markets and the fragile US economy. In addition, should the crisis worsen it will have profound strategic implications for the United States, Europe, and transatlantic relations.

The timing of today's hearing is especially appropriate, as continuing efforts to resolve the crisis will dominate the proceedings at the Group of 20 (G-20) meeting that begins in Cannes tomorrow. In particular, much will rest on key G-20 members' response the three-pronged plan to which Eurozone leaders agreed in their summit last week. I begin my testimony by looking at this plan.

To begin with the positive, the specific issues that the latest European response addresses—bank recapitalization, the restructuring of Greek debt, and an expansion in the size and scope of the European Financial Stability Facility (EFSF)—are indeed the three key issues in the almost-two-year-old crisis. European leaders agreed to write down private sector-held Greek debt by 50 percent, avoiding (for now) the triggering of a credit event. They announced plans to leverage the EFSF to insure the first losses if any further bond writedowns occur and to mobilize external funding through the creation of a set of special purpose vehicles (SPVs). Finally, leaders mandated that European banks achieve a core-capital ratio of nine percent by June of next year. From a symbolic perspective, Eurozone leaders' ability to arrive at an agreement does demonstrate a clear commitment to resolve the crisis.

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Their capacity to do so, however, remains in question. The latest agreement is an incremental step forward, not a definitive solution. It is dominated by half-measures and skeletal proposals with a conspicuous lack of detail. It will require significant additions and likely some revisions as the crisis continues. Market sentiment reflects this. After surging last Thursday following announcement of the deal, markets were flat on Friday and declined substantially on Monday.

In short, I do not see the latest agreement reached by European leaders as the beginning of the end of the crisis. Rather, it's more like the end of the beginning. In fact, we are entering a difficult and potentially more dangerous phase.

The latest agreement creates additional risk. Each step to which the Europeans have agreed is necessary, but none (taken singly or together) are sufficient, even with regard to the issues that they were designed to address. The call for banks to raise 106.5 billion euros ($150 billion) is almost literally a half-measure, as most private estimates suggest that about twice that amount will be necessary to safeguard European financial institutions. European government involvement in providing capital is unclear, and the banks may reach the appropriate capital ratio through shrinking their balance sheets, which could have negative effects on economic growth. As a whole, the bank recapitalization scheme creates a serious downside risk for the future operations of European banks and financial institutions.

On Greece, the 50 percent "haircut" on private bondholders is voluntary in name only. While this may effectively prevent a triggering of credit-default swaps (CDSs) on Greek debt, it will simultaneously make Eurozone debt more difficult to insure, because private creditors will doubt that CDSs on Greek or other European peripheral bonds will offer much protection in the future. The agreement also fails to put Greece on a sustainable fiscal path. According to the deal struck last week, Athens will target achieving a sovereign debt-to-GDP ratio of 120 percent by 2020. This is not only a still dangerously high level of debt, but also is based on implausibly optimistic assumptions about both economic growth and Greece's ability to narrow its budget gap with austerity measures and a large-scale privatization program that is wildly unpopular domestically. Greek Prime Minister George Papandreou's unexpected announcement on Monday of a referendum on the latest European aid deal only adds to the risk, and threatens to torpedo the broader agreement as well.

With regard to the EFSF, significant uncertainty exists both on the insurance template and the modalities and potential for any SPV for external financing. The insurance scheme may nurture the seeds of its own destruction, as the announced extension of its value to 1 trillion euros ($1.4 trillion) is at best aspirational. Since the EFSF will now bear first losses in the case of any further writedowns, additional haircuts could entirely eliminate its capital. As for SPVs, with the IMF—driven by US inability to commit more resources—unable to dedicate funds beyond its existing commitments, any new funds will have to come exclusively from the BRIC countries or a few other G-20 members, notably Japan. Though the BRICs and other countries do want to keep open the possibility of participation in an eventual resolution, few relish making concrete commitments to an SPV in the very near term.

The latest European plan thus creates a number of scenarios that are neither adequate nor sufficient. And neither/nor is a very risky place to be. What is needed a set of measures that *in toto* comprise a broad and bold enough package to generate confidence that the crisis is coming to an end. Banks will need to suffer significant writedowns on debt. Even if, as in the present case, these writedowns were imposed (regardless of whether they were deemed "voluntary"), this could provide stability and a solution to the crisis if European periphery countries were placed on a growth trajectory, as were debtor nations in the Brady Plan in the Latin American debt crisis of the 1980s. This latest response, however, does not follow the Brady template—it contains little to build broad confidence and does not place the affected debtors on a sustainable path.

That said, dissolution of the Eurozone remains highly unlikely, nor is any country likely to leave the euro, at least in the foreseeable future. By far the most likely scenario—which the latest agreement only reinforces—is a continuation of the "muddle through" approach that has characterized the European response since the advent of the crisis. In other words, Europe is unlikely to make significant structural moves toward a more integrated fiscal union, will suffer several more years of poor economic performance, and will exhibit an increasingly inward-looking orientation in global affairs.

Before moving to the strategic implications, I would like to make a few brief observations on the US response to the crisis. President Obama and the administration have addressed the crisis in three phases. First, until early 2011, the US had virtually no response. It occasionally offered rhetorical support, but for the most part left the Europeans to their own devices. Then, through the spring and summer of this year, the US increased its engagement but remained relatively muted publicly. But beginning with the Eurogroup meeting in Wroclaw in early September, the US has scolded the Europeans sharply and publicly, fueling market volatility.

This new US response reflects two factors. The first is US domestic politics. The administration has preemptively called attention to the Europeans' failings—which, I should be clear, are serious—to place public blame elsewhere in case the crisis worsens and induces a severe downturn in the US economy. As a result, President Obama has partially inoculated himself publicly if a European crisis spills into the US. He also potentially benefits in the unlikely event that the stridency of the US response spurs a European resolution, leading to an improving business environment and reduced market volatility on both sides of the Atlantic.

Second, the US response exemplifies a shift in strategy necessitated by a change in the US's international position. In previous similar crises, such as the Latin America debt crisis of the 1980s, the Mexico peso crisis of 1995, and the Asian financial crisis of 1997-98, the US consistently took the lead in generating the solutions to the crisis (as with the Brady Plan), mustering support among relevant stakeholders, and building a flying buttress of financial backing from international organizations.

Today, the US does not possess the economic or political influence to force Europe or other actors to accept the US's preferred solutions. Instead, the US has used criticism to induce scrutiny and market reactions to pressure Europe—speaking loudly but letting markets carry the stick, if you will. This is the financial equivalent to the military strategy of "leading from behind" that has governed US involvement in Libya this year, and will increasingly characterize US engagement with Europe in the coming years.

In the most likely scenario of muddle through, the debt crisis will weaken Europe, with negative strategic implications for the US and the transatlantic relationship. For one, the need for fiscal retrenchment will increase pressure on European military budgets and drive an increasingly inward focus. These two forces will in turn lead to reduced European willingness to engage militarily beyond Europe. Military interoperability between the US and its European allies will decrease, and NATO's New Strategic Concept, adopted with much fanfare less than a year ago, will become irrelevant. Former Defense Secretary Gates's warnings of a two-tiered alliance, with a few countries providing nearly all of the military resources, will prove prescient.

As a result, leading from behind will be a problematic strategy. The Libya operation will prove to be the exception, not the rule. And even that operation, in which the US did effectively maintain a supporting rather than leading role, underscored the decreasing European capability to project force. NATO shortages in intelligence-gathering aircraft, precision-guidance systems for ordnance, and in-air refueling equipment necessitated US involvement. The Eurozone crisis will only exacerbate this situation in future alliance interventions.

The crisis will also foster closer ties within the Eurozone itself, but at the expense of broader European unity. The key element of European integration will no longer be the 27 members of the European Union proper, but instead the 17 countries of the European Monetary Union. The crisis has, in other words, put the decades-long process of European integration—one of the most significant geopolitical developments since World War II—into structural reverse.

The Eurozone core is in general less economically liberal than are those European Union countries that have retained their own currencies. Across a host of areas, including investment, trade, and labor and product markets, Eurozone countries are inclined toward regulation on all dimensions. The core's assumption of a more dominant role in the Eurozone and the Eurozone's supplanting of the European Union as the locus of European integration creates the risk of a decreasing openness in the European economy and investment environment and an increasing inward focus in European trade.

Strategically, Europe's increasing inward orientation—as exemplified by the trends in defense, investment, and trade noted above—will make transatlantic cooperation vis-à-vis China and other emerging powers much less likely. Nowhere is this better illustrated than in the ongoing speculation about a Chinese financial contribution to Europe. Fundamentally, this story is much more about the paradigm shift underway globally than about the solvency of European banks.

The shift is not about a revisionist China pushing to change all the rules of the international order in one week—and certainly not this week. This crisis will not be a game-changing event for China on the international stage, and Beijing is neither inclined nor in a position to take on the mantle of global leadership. China does not want the responsibility or the risk required to save Europe, and China's proclivity to free ride on the existing international system will hold true in this case as well.

Beijing will make some contribution, but will be more focused on getting the maximum benefit for the minimum amount: providing enough funding to be constructive without risking a domestic backlash or assuming ownership over Europe's problems. Especially because the Europeans (and the US as well) are reluctant to grant the concessions, such as market economy status or significant revisions to the IMF voting structure, that Beijing might demand in return for backstopping Europe, I expect that China will offer limited assistance either bilaterally or through a multilateral approach centered around the BRICs or the G-20.

A bilateral deal would be less risky and more typical for Beijing, and less useful for Europe. A multilateral approach, by contrast, would pay strategic benefits to China by allowing Beijing to partner with other countries that share similar goals about (eventually) changing the international economic order. These alliances could pay dividends in the future as China and other developing markets bargain for more representation in international economic institutions.

This possibility is a further component of the challenge of a financially weakened Europe and will have negative ramifications for US efforts to incorporate developing economies into the political, economic, and security architecture that has underpinned the international system since World War II. European insularity and economic weakness will feed a soft-power deficit for the traditional Western powers in the rest of the world, and the liberal European model will lose attractiveness to the non-Western world, with deleterious effects on international rules and norms.

I want to emphasize once more that the foregoing implications all result from the most likely, not the worst case, scenario. The US is no longer able to provide the requisite combination of capacity, funding, and political will to usher through its preferred solutions to global fiscal crises. Accordingly, policymakers must prepare themselves for less than optimal outcomes. And here the challenge is that in the coming years Europe is likely to be both a less capable and less willing partner for the United States, despite continued mutuality of interests.

I wish to thank the Subcommittee for its focus on this very important issue, and for offering me the privilege of testifying today.