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THE EUROPEAN DEBT CRISIS: STRATEGIC IMPLICATIONS FOR THE TRANSATLANTIC ALLIANCE

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THE EUROPEAN DEBT CRISIS: STRATEGIC IMPLICATIONS FOR THE TRANSATLANTIC ALLIANCE

WEDNESDAY, NOVEMBER 2, 2011

U.S. SENATE,
SUBCOMMITTEE ON EUROPEAN AFFAIRS,
COMMITTEE ON FOREIGN RELATIONS,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:35 a.m., in room SD–419, Dirksen Senate Office Building, Hon. Jeanne Shaheen, chairman of the subcommittee, presiding.

Present: Senators Shaheen, Barrasso and Corker.

OPENING STATEMENT OF HON. JEANNE SHAHEEN, U.S. SENATOR FROM NEW HAMPSHIRE

Senator SHAHEEN. Good morning, everyone.

At this point, I would like to call this hearing to order. When we scheduled this hearing we thought it would be timely. We just didn't realize quite how timely.

If I were still a teacher I would ask all of you in the back to move up but I won't do that. But I am delighted to be here with my ranking member, Senator Barrasso. I have a brief statement and then I think he probably will have a statement before we ask our panelists for their testimony.

The Foreign Relations Subcommittee on European Affairs meets today to discuss the ongoing European debt crisis. This crisis presents one of the most complex challenges to European stability since the creation of the European Union and the outcome will have lasting effects for the United States and our transatlantic partnership for decades to come.

This is a particularly timely hearing, given yesterday's surprise announcement by Prime Minister George Papandreou calling for a popular referendum in Greece on the recent Eurozone agreement and, of course, it's also timely because of the G20 meeting which is scheduled to begin tomorrow in France.

We have a very impressive panel of expert witnesses and we look forward to engaging with them on these issues.

In today's global economy, Europe is by far America's most critical ally. Europe is the United States largest trading partner and our biggest export market.

Together, the United States and Europe account for over half of the world's gross domestic product, one-third of world trade and three-quarters of the global financial services, all of which means jobs and economic growth here in the United States and in Europe.

But it also means that what happens in Europe can have significant repercussions for the American economy. Our markets know this, our businesses know this and we ignore this reality at our own peril.

Negotiations at last week's Eurozone summit produced a tentative late-night agreement. The deal included a voluntary 50-percent cut on Greek bonds, a requirement to raise $148 billion in new capital for European banks and a significant increase in the Eurozone bailout fund.

Despite the announcement, many of the details of the agreement are unresolved and significant questions remain unanswered. This agreement is an important first step but challenges still lie ahead.

One of those challenges is the surprise Greek announcement that the Papandreou government would seek popular approval of the bailout package. That decision, as we all saw, roiled markets yesterday and adds new urgency to the G20 meeting this week.

It's critical that the implementation of this agreement does not languish and I encourage our partners in Europe to continue to act with the urgency this situation requires. It's important to recognize that American interests in this crisis go far beyond economic and financial implications and will affect a broad array of transatlantic issues.

From a foreign policy standpoint, America needs a strong European partner if we're to meet today's challenges, including Iran, Afghanistan, and the ongoing "Arab Spring." On the security side, a Europe focused solely on budget cuts will make it more difficult for European NATO countries to meet their resource commitments to this military alliance.

The United States and the transatlantic community have fought two devastating world wars and spent countless resources over nearly six decades to bring about a Europe that is whole, free, and at peace.

Today, the forces of European instability are not war and fighting but financial uncertainty and the specter of a continentwide economic breakdown. How Europe responds to this crisis over the next several months will have dramatic implications across a broad spectrum of U.S. interests.

The subcommittee looks forward to engaging on these critical questions in the next hour, and to help us sort out these issues we have a very distinguished panel. I just want to take a minute to introduce each of you before I turn it over to you for your testimony.

First on our panel today we have Jacob Kirkegaard, a research fellow from the Peter G. Peterson Institute for International Economics where he has served since 2002. Mr. Kirkegaard comes to us from Denmark and is an acclaimed author and expert in European economies, reform, and high-skilled immigration.

Next, we have Bruce Stokes, who is currently the senior transatlantic fellow for economics at the German Marshall Fund, one of the premier transatlantic policy institutions. Mr. Stokes is a renowned former international economics columnist for the National Journal where he remains a contributing editor.

Next, Dr. Desmond Lachman is a resident fellow at the American Enterprise Institute. Dr. Lachman has a Ph.D. in economics from Cambridge University and previously served as managing director and chief emerging market economic strategist at Salomon Smith Barney, also as deputy director at the IMF.

And finally, we have Dr. David Gordon, the current head of research and director of Global Macro Analysis at the Eurasia Group. Prior to his current position, Dr. Gordon spent more than a decade working on U.S. foreign and economic policy at the highest levels of our government including the State Department, the CIA, and the National Intelligence Council.

Thank you all very much for being here. We look forward to hearing from each of you, and let me turn it over to Senator Barrasso for his comments.

[The prepared statement of Senator Shaheen follows:]

PREPARED STATEMENT OF HON. JEANNE SHAHEEN

The Senate Foreign Relations Subcommittee on European Affairs meets today to discuss an issue critical to the global economy and to long term U.S. strategic interests. The ongoing European debt crisis presents one of the most complex challenges to European stability since the creation of the European Union. This is a particularly timely hearing today given yesterday's surprise call in Greece for a popular referendum on the recent Eurozone agreement, as well as the G20 meeting in France, scheduled to begin tomorrow.

My hope is that we will get a chance today to review some of what led us to this crisis, evaluate the Eurozone deal announced last week, and consider where Europe goes from here. But more importantly, I also wish to discuss some of the broader strategic implications and why a resolution in Europe means so much for the United States. We have a very impressive panel of expert witnesses, and we look forward to engaging with them on these issues.

In today's global economy, Europe is by far America's most important ally. Europe is the United States largest trading partner and export market, and together, the United States and Europe account for over half of world GDP, one-third of world trade and three-quarters of global financial services.

All of which means jobs and economic growth here in the United States and in Europe. But it also means that what happens in Europe can have significant repercussions for the American economy, and as we have seen over the last year, financial instability and uncertainty in Europe can easily spill across the Atlantic. Our markets know this, our businesses know this, and we ignore this reality at our own peril.

As we entered last week's historic Eurozone summit, European leaders faced a number of difficult realities. Europe had to deal first and foremost with an insolvent Greek Government by significantly restructuring its debt. Leaders also needed to recapitalize European banks so they could withstand a Greek debt write-down. Finally, they needed to create a credible firewall around much larger Eurozone countries facing pressures from contagion effects.

After a long series of negotiations, urgency finally gave way to a tentative late night agreement among Eurozone economies on some of these critical issues. Leaders announced a voluntary 50-percent cut on Greek bonds, a requirement to raise $148 billion in new capital for European banks and a significant increase of the Eurozone bailout fund. Despite the announcement, many of the details of the agreement remain murky and significant questions remain, including the fate of credit default swap purchases and the composition of the bailout fund increase.

This agreement was no doubt an important step, but it is just a first step. Significant challenges still lie ahead, and it is critical that the implementation of this agreement moves forward with the urgency it deserves.

One of those challenges is the surprise Greek announcement this week that the government would seek popular approval of the bailout package—a decision which roiled markets yesterday and adds new urgency to the G20 meetings this week in France. At the very least, a referendum would likely set back implementation of the Eurozone plans at a time when urgency is needed. At the very worst, as the Chairman of the Eurozone Finance Ministers suggested yesterday, Greece could go bankrupt if voters rejected the bailout package.

As German Chancellor Angela Merkel said last week, "The world [was] watching Germany and Europe"—watching to see if Europe was able to take on the tough decisions required to address this crisis. The world is still watching. I encourage our partners in Europe to continue to act with the urgency the situation requires.

As important as the economic effects of the crisis are for the United States, it is this committee's responsibility to also examine the broader picture.

The strategic implications here go well beyond our economic interests and can affect all transatlantic issues. From a foreign policy standpoint, America needs a strong Europe to partner with on issues around the globe. From Iran to Afghanistan to the Arab Spring, America needs Europe to play an increasingly active role, and a distracted, internally focused Europe will not be able to help us meet these difficult challenges.

A protracted austerity program could also worsen the ongoing problem European NATO countries have faced in meeting their security commitments to the alliance. As we saw in Libya and in Afghanistan, the demand for a strong NATO to meet 21st century challenges is not waning. But a Europe focused solely on budget cuts will surely strain those already inadequate defense resources.

The bottom line is America needs a strong and active European partner, and we need Europe to do what is necessary to put the financial crisis behind them.

The United States and the transatlantic community have fought two devastating world wars and have spent countless resources over nearly six decades to help bring about a Europe that is "whole, free, and at peace." America has made these sacrifices because a stable, secure, and prosperous Europe is in our own vital interests.

Today, Europe faces a much more complex challenge. The forces of European instability are not war and fighting, but financial uncertainty and the spectre of a continentwide economic breakdown. The future of Europe and the transatlantic alliance is at play.

How Europe responds to this crisis over the next several months will have dramatic implications across the broad spectrum of U.S. interests. This subcommittee looks forward to engaging on these critical questions in the next hour.

We have a very distinguished panel today. I will take a moment to introduce each of our four witnesses prior to turning it over to them for their testimony.

First on our panel today, we have Jacob Kirkegaard ("KEER-kuh-guard"), a Research Fellow at the Peter G. Peterson Institute for International Economics, where he has served since 2002. Mr. Kirkegaard comes to us from Denmark and is a widely acclaimed author and an expert in European economies, reform, and high-skilled immigration.

Next, we have Mr. Bruce Stokes, who is currently the Senior Transatlantic Fellow for Economics at the German Marshall Fund—one of the premier transatlantic policy institutions in the world today. Mr. Stokes is a renowned former international economics columnist for the National Journal, where he remains a contributing editor.

Today, we also have Dr. Desmond Lachman ("Lock-man")—a Resident Fellow at the American Enterprise Institute. Lachman has a Ph.D. in Economics from Cambridge University and previously served as managing director and chief emerging market economic strategist at Salomon Smith Barney and also as Deputy Director at the IMF.

Finally, we have Dr. David Gordon, the current Head of Research and Director of Global Macro Analysis at the Eurasia Group. Prior to his current position, David spent more than a decade working on U.S. foreign and economic policy at the highest levels of our government, including the State Department, the CIA, and at the National Intelligence Council.

Thank you all for being here. We look forward to hearing from each of you.

OPENING STATEMENT OF HON. JOHN BARRASSO, U.S. SENATOR FROM WYOMING

Senator BARRASSO. Thank you very much, Madam Chairman. I'd like to just echo your comments and thank you for your leadership in arranging for and organizing this important hearing today.

I'd like to also thank and welcome all of our experts for being here today to take part in this hearing on the European debt crisis. I appreciate you sharing your knowledge, your analysis, and your insight with our subcommittee.

We are meeting today to discuss the European debt crisis and to examine the implications for the United States. I'm concerned about the escalating economic crisis in Europe, as are many Americans. The countries in the Eurozone are committed to a common currency and a monetary policy but retain a patchwork of fiscal policies.

Over the past 2 years, there have been a series of bailouts, credit rating downgrades, and speculation about defaults from countries in the European Union. The fear of contagion and euro instability has stifled markets across the globe.

Last week, European leaders announced their newest proposal to resolve the debt crisis in the Eurozone. The chairman has talked about recent overnight activities and activities yesterday, and tomorrow the G20 summit will begin and the Eurozone crisis will be a central part of that discussion.

The United States and Europe have a critically significant relationship based on our deep history, our shared values and our economic ties.

The countries in Europe include some of our most important allies. Throughout our transatlantic partnership we work closely on numerous global issues including international security, democracy, human rights, and free markets. It's important that we understand the type of impact the current crisis in Europe may place on our strategic transatlantic partnerships.

I believe that the problem in Europe could have a significant and substantial effect on the United States. The United States and Europe have the largest trade and investment relationship in the world. The United States exported a total of over $170 billion in 2010 to Eurozone countries. An estimated 15 million jobs in the United States and Europe are a result of the transatlantic economic activity.

Based on these strong economic ties, the problems facing the Eurozone can create significant risks to the United States economy, to transatlantic trade and economic growth around the world. We must clearly identify these risks and work together to limit the fallout from this crisis here at home.

In addition, the United States should be learning from the crisis taking place in Europe. Due to the increasingly interconnected nature of the global economy, it is clear that unsustainable government debt levels can lead not only to a single sovereign default but it can also produce a widespread global financial crisis.

The situation taking place in Europe must serve as a clear warning sign to all countries about the dangers of irresponsible unsustainable levels of debt.

So thank you again, Madam Chairman. I look forward to hearing the testimony of our witnesses and evaluating the complex situation taking place in Europe.

Senator SHAHEEN. Thanks very much, Senator Barrasso.

Would you like to begin, Mr. Kirkegaard?

STATEMENT OF JACOB FUNK KIRKEGAARD, RESEARCH FELLOW, PETER G. PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS, WASHINGTON, DC

Mr. KIRKEGAARD. Senator Shaheen, Senator Barrasso, members of the subcommittee, it is a pleasure to testify before you today on the European debt crisis and its strategic implications for the transatlantic alliance.

The European debt crisis is characterized by an extreme degree of complexity as the correct diagnosis is not one but at least four deep overlapping and mutually reinforcing crises: a crisis of institutional design, a fiscal crisis, a crisis of competitiveness, and a banking crisis.

None of these four crises can be solved in isolation and no single comprehensive solution to end the crisis promptly is consequently available to EU policymakers, indicating that the drawn out inconclusive crisis containment effort witnessed in Europe since early 2010 will continue.

At their summit last week, euro area leaders agreed to a new set of measures which, while inadequate in scope to end the crisis and calm financial market volatility will, in my opinion, help militate against a new dramatic economic deterioration in Europe. The risk of catastrophic spillovers from Europe to the United States and global economy was therefore reduced last week, although, of course, Prime Minister Papandreou's recent announcement has, to some extent, undone this benefit.

The euro area agreed a voluntary bond swap agreement with private holders of Greek Government debt, resulting in a 50-percent reduction in nominal Greek debt value. This is an urgently needed measure which, however, will not independently restore Greek fiscal solvency.

To achieve this goal, substantial financial support will in the years ahead have to be made available to Greece as well as Portugal and Ireland to avoid a systemic contagion effect in the euro area.

Such resources should overwhelmingly come from the euro area itself with a component provided by the International Monetary Fund. Ultimately, though, euro area reform will only—or fiscal stability will only be achieved through the longer term domestic consolidation and reform efforts, particularly in Italy.

The Greek debt swap is a voluntary transaction which at this moment looks unlikely to trigger sovereign default swaps.

Apart from the superficial political pride available to European leaders from being rhetorically able to deny that a euro area default has ever taken place, a potential short-term source of dislocation in the financial markets has hereby been removed as it is the case, although the net outstanding Greek CDS contract value amounts to less than $4 billion, very little is known about the extent of individual, including U.S. financial institutions, gross exposures to CDS.

However, the lack of payout after a 50-percent reduction in debt may ultimately lead to the demise of the sovereign CDS product class for at least industrialized nations.

Financial markets will be certain to, in the future, doubt whether or not any advanced economy sovereign CDS restructuring will trigger CDS protection. Given the multiple hedging purposes for sovereign CDS this may, ironically, lead to an increased financial market volatility in the future including here in the United States.

Euro area leaders, second, agreed to raise the capital requirements in euro area or European banks to 9 percent core tier one equity and adjust for the effects of market prices of sovereign debt. This is a helpful further step which will help insulate also U.S. financial institutions against the risk of sudden bank collapses in Europe but will not make Europe's banking system stable and well capitalized.

Third, euro area leaders agree to two options to boost the financial firepower of the European Financial Stability Facility, or EFSF. Both, however, are, in my opinion, almost certain to fail.

Option one, to provide credit enhancement for new debt issued by member state, is a meaningless measure from a systemic euro area stability point of view. When the overlap between the insurer and the insured is as big as in the euro area, the beneficial financial effects will be minimal.

Option two for the EFSF foresees the creation of special purpose investment vehicles open to investments from private and public financial institutions and investors. However, in my opinion, very few if any such investors will exist with the willingness and ability to invest the hundreds of billions of euros required to make a material difference for European financial stability.

China will certainly not bail out Europe and it would not, in my opinion, be prudent use of U.S. taxpayers' money to contribute either, just as the statutes of the International Monetary Fund will in all probability prevent it from direct participation.

Fortunately, though, this does not really matter, as the EFSF's principal purpose is political, not financial. The two EFSF options described here are principally, in my opinion, a smokescreen created by European leaders to provide political cover for the European Central Bank to remain directly involved in the European crisis stabilization measures. This is critical, as only the European Central Bank in the end commands the resources to stabilize the European economy.

Europe is America's largest trading and investment partner and extensive cross-ownership of large financial institutions exist. It is consequently inescapable that the U.S. domestic economy will experience a further negative external shock from any rapid deterioration of the European debt crisis.

However, the possible direct action by U.S. policymakers have been limited by the fact that the European debt crisis is, despite increasing global spillover potential, still at heart a domestic economic crisis inside another sovereign jurisdiction.

The ability of U.S. Government to bilaterally affect the outcome of the European debt crisis is consequently and, indeed, appropriately limited. However, the debt crisis will lead to substantial changes in the European political, economic, and defense potential.

The crisis will with certainty lead to a more institutionally integrated euro area, potentially enabling a more coordinated projection of the continent's remaining capabilities, potentially creating an enhanced European partnership role for the United States.

The fact, however, that the United Kingdom is unlikely to be a part of such a deeper integration of the euro area will, especially from the perspective of the United States, be a complicating factor.

The multifaceted character of the European crisis ensures that it will only be solved through a lengthy and, indeed, very volatile process. Yet ultimately, in my opinion, the European crisis can and will be solved through the use of overwhelmingly European financial resources.

I thank you for the opportunity to appear before the subcommittee today and look forward to answering any questions you might have.

[The prepared statement of Mr. Kirkegaard follows:]

PREPARED STATEMENT OF JACOB FUNK KIRKEGAARD

Senator Shaheen, members of the subcommittee, it is a pleasure to testify before you today on the European Debt Crisis and its strategic implications for the transatlantic alliance.

The European debt crisis is characterized by an extreme degree of complexity, as the correct diagnosis is not one, but at least four deep, overlapping and mutually reinforcing crises—a crisis of institutional design, a fiscal crisis, a crisis of competitiveness, and a banking crisis.

None of the four crises can be solved in isolation and no single comprehensive solution to end the crisis promptly is available to EU policymakers, meaning the drawn-out inconclusive crisis containment efforts witnessed in Europe since early 2010 will continue.

At their summit last week, euro area leaders agreed on a new set of measures, which while inadequate in scope to end the crisis and calm financial market volatility will help militate against a new dramatic economic deterioration in Europe. The risk of catastrophic spillovers from Europe to the U.S. and global economy has therefore been reduced.

The euro area has agreed a voluntary bond swap agreement with private holders of Greek Government debt resulting in a 50-percent reduction in the nominal debt value. This is an urgently needed measure, which however will not independently restore Greek fiscal solvency. Meanwhile, as concerns over fiscal sustainability in the euro area stretches also to Italy, a country "too big to bail out," the principal challenge is how to avoid contagion and how to ring-fence Greece so as to avoid a generalized undermining of the "risk free status" of euro area government debt.

To achieve this goal, substantial financial support will in the years ahead have to be made available to Greece, as well as Ireland and Portugal. Such resources should overwhelmingly come from the euro area, with a component provided by the IMF. Ultimately though euro area fiscal stability will only be achieved through the longer term domestic consolidation and reform efforts particularly in Italy.

The Greek debt swap is a voluntary transaction which looks unlikely to trigger sovereign default swaps. Apart from the superficial political pride available to European leaders from being able rhetorically to deny that a euro area default has taken place, a potential short-term source of dislocation in the financial markets has hereby been removed, as—although the net outstanding Greek CDS contract value amount to less than $4bn—little is known about the extent of individual, including U.S. financial institutions' gross CDS exposures.

However, the lack of payout after a 50-percent reduction in debt may ultimately lead to the demise of the sovereign CDS product class for at least industrialized nations. Financial markets will be certain to in the future doubt whether any advanced economy sovereign debt restructuring will trigger CDS protection. Given the multiple hedging purposes for sovereign CDS, this may ironically lead in increased financial market volatility in the future, including here in the United States.

Euro area leaders secondly agreed to raise the capital requirements in banks to 9 percent core tier 1 equity and adjust for the effects of market prices of sovereign debt. This is a helpful further step, which will help insulate also U.S. financial institutions against the risk of sudden bank collapses in Europe, but will not make Europe's banking system "stable and well capitalized." Substantially more new capital and an end to the solvency concerns surrounding several euro area sovereigns themselves will be required to restore market confidence in the stability of the European banking system.

Third, euro area leaders agreed on two options to boost the financial firepower of the European Financial Stability Facility (EFSF). Both are, however, are almost certain to fail. Option one, "to provide credit enhancement to new debt issued by Member States[1]" is meaningless from a systemic euro area stability point of view. When the overlap between the insurer and the insured is as big as in the euro area, the beneficial financial effects will be minimal.

Option two foresees the creation of special purpose investment vehicles open to investments from "private and public financial institutions and investors." However, few if any such investors exist with the willingness and ability to invest the hundreds of billions of euros required to make a material difference for European financial stability. China will not bail Europe out and certainly, it would not be prudent use of U.S. taxpayers' money to contribute, just as the statutes of the IMF in all probability will prevent it from participating.

Fortunately though this does not matter, as the EFSF's principal purpose is political not financial. The two EFSF options described are a smokescreen created to provide political cover for the European Central Bank (ECB) to remain directly involved in the European crisis stabilization measures. This is critical, as only the ECB commands the resources to stabilize Europe.

Europe is America's largest trade and investment partner and extensive cross-ownership of large financial institutions exist. It is consequently inescapable that the U.S. domestic economy will experience a further negative external shock from any rapid deterioration of the European debt crisis.

However, the possible direct actions by U.S. policymakers have been limited by the fact that it is, despite increasing global spillover potential, still at heart a domestic economic crisis inside another sovereign jurisdiction. The ability of the U.S. Government to bilaterally affect the outcome of the European debt crisis is consequently and appropriately limited.

Yet, the U.S. Government representatives have since the beginning of the euro area crisis exercised important indirect pressure through multilateral channels and especially the IMF and the G20 to expedite the European crisis resolution process and push it in generally beneficial directions.

The debt crisis will lead to substantial changes in European political, economic and defense potential. The crisis will with certainty lead to a more institutionally integrated euro area, potentially enabling the more coordinated projection of the continent's remaining capabilities, potentially creating an enhanced European partnership role for the U.S. The fact that the United Kingdom is unlikely to be part of a deeper integration of the euro area will however especially from the perspective of the United States be a complicating factor.

The multifaceted character of the European crisis ensures that it will only be solved through a lengthy and volatile process. Yet ultimately Europe's crisis can and will be solved through the use of overwhelmingly European financial resources.

I thank you for the opportunity to appear before the subcommittee today and look forward to answering any questions you might have.

The remainder of my written testimony provides additional background information concerning the complex origin of the European debt crisis.

[EDITOR'S NOTE.—The above mentioned additional background information as an appendix to Mr. Kirkegaard's prepared statement can be found in the "Additional Material Submitted for the Record" section of this hearing.]

Senator SHAHEEN. Thanks very much.

Mr. Stokes.

STATEMENT OF BRUCE STOKES, SENIOR TRANSATLANTIC FELLOW FOR ECONOMICS, GERMAN MARSHALL FUND OF THE UNITED STATES, WASHINGTON, DC

Mr. STOKES. Madam Chairwoman Shaheen, Ranking Member Barrasso, and distinguished members of the committee, it's a distinct honor and a privilege to appear before you today. My remarks here represent my own opinions and are not the views of the German Marshall Fund of the United States.

[1] See Euro Area Summit Statement at http://www.consilium.europa.eu/uedocs/cms__data/docs/pressdata/en/ec/125644.pdf.

But I would note that GMF has launched a project on the topic of this hearing to look at the foreign and security policy implications of the euro crisis for the United States. It is particularly timely that we meet a week after another European summit about the euro crisis and the announcement of the Greek referendum yesterday.

It is too early to know whether the measures announced last week will stem the bleeding and start to heal Europe's wounds or how yesterday's events will complicate matters. But experience has taught us that at every juncture in this unfolding saga European actions have been a day late and a euro short. We have every reason to be skeptical and we can only hope for the best.

As you noted, Madam Chairwoman, America has a huge economic stake in Europe finally resolving its crisis. A European "lost decade" would do profound damage to the U.S. economy. But the euro crisis is no longer simply an economic problem. It is increasingly a foreign and security policy challenge for the United States and this crisis has the potential to undermine the transatlantic alliance, something, I might note, that the Soviets never accomplished during the cold war.

Default by one or more euro area countries could well lead to stagnant economic growth, introspection and self-preoccupation in Europe. A weakened distracted Europe would prove a strategic liability for the United States. It would mean a Europe even less able to defend itself, one that cuts back on foreign aid, a Europe that falls short in its effort to curb greenhouse gases.

A weakened Europe will become dependent on China to fund its debt. It will be less able to stand up to Russian energy blackmail or to impose trade sanctions to curb Iran's nuclear ambitions. A Europe where the standard of living is declining could also face a growing public backlash in the form of rising nationalism and populism that could pull Europe apart.

And a disintegrating Europe would only accelerate America's drift toward an Asian-centric foreign policy. That would be a development that is neither in Europe's nor America's self-interest.

A Europe that is tearing itself apart will be by definition less strong, and a Europe that is less strong will be less useful for the United States. In this regard, the most immediate strategic problem for the United States created by the euro crisis will be the coming inevitable budget austerity in Europe.

Belt tightening is already eroding European capacity to share the burden of paying for global public goods. Since the financial crisis began in 2008, European nations have cut military spending by an amount equivalent to the entire annual defense budget of Germany, and more cuts are in the works.

The cost of shortchanging defense was evident in the Libyan crisis where Britain and France would not have been able to carry out their successful mission without United States munitions. Faced with our own budgetary constraints, longstanding American resentment about Europe's lack of burden-sharing in the military area is only likely to grow, poisoning future defense collaboration.

More broadly, the euro crisis is undermining Europe's pivotal job as a democratic free market role model for its immediate neighbors.

The nations of Central and Eastern Europe joined the European Union to share its affluence and political stability.

Now the EU looks to be a club of austerity, pain, and political impotence. In the future, association with the European economy may no longer look so attractive to Turkey, accelerating its trajectory as an unpredictable and unhelpful free agent in the Middle East.

Similarly, as the EU looks less stable and successful, the former nations of the Soviet Union are likely to slip further back into Moscow's orbit. With the stability of North Africa in doubt and the Balkans still unsettled, the last thing Washington needs is for the European Union to become a centrifugal force in the region.

Finally, European preoccupation with the euro crisis could dash all American hope for transatlantic cooperation in coping with China. Beijing is flexing its muscles in the South China Sea and the Indian Ocean. It is extending its influence in Pakistan, in Africa and Latin America. It is developing its own brand of Chinese state capitalism that certainly looks more attractive today to many around the world than that being practiced in Europe or, I dare say, even in the United States.

Washington will be hard-pressed to counter this Chinese influence on its own and we could find ourselves without an effective European partner.

In closing, Madam Chairwoman, the euro crisis is also a crisis of Europe's military and diplomatic leadership and vision, and, as Europe's strategic partner for the last two generations, Europe's problems are now America's headache.

It is imperative that the United States do whatever it can to help Europe resolve its current economic troubles. Most important, we need to work together to mitigate the foreign and security policy challenges created by this euro crisis.

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

[The prepared statement of Mr. Stokes follows:]

PREPARED STATEMENT OF BRUCE STOKES

Madam Chairwoman Shaheen, Ranking Member Barrasso, and distinguished members of the committee, it is a distinct honor and a privilege to appear before you.

My remarks today represent my own opinions and are not the views of the German Marshall Fund of the United States. But, I would note, GMF has launched a project to look at the foreign and security policy implications of the euro crisis for the United States.

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

As my fellow panelists have noted, America has a huge economic stake in Europe finally resolving its crisis. A European "Lost Decade" would do profound damage to the U.S. economy.

But the euro crisis is no longer simply an economic problem. It is increasingly a foreign and security policy challenge for the United States.

And this crisis has the potential to undermine the transatlantic alliance, something the Soviets never accomplished during the cold war.

Default by one or more euro area countries could well lead to stagnant economic growth, introspection and self-preoccupation in Europe. A weakened, distracted Europe would prove a strategic liability for the United States.

It would mean a Europe even less able to defend itself. One that cuts back on foreign aid. A Europe that falls short in its effort to curb greenhouse gases. That becomes dependent on China to fund its debt. That is less able to stand up to Russian energy blackmail. Or to impose trade sanctions to curb Iran's nuclear ambitions.

A Europe where the standard of living is declining could also face a growing public backlash in the form of rising nationalism and populism that could pull Europe apart. And a disintegrating Europe would only accelerate America's drift toward an Asian-centric foreign policy. A development that is neither in Europe's, nor America's self-interest.

A Europe that is tearing itself apart will be, by definition, less strong. And a Europe that is less strong will be less useful for the United States.

In this regard, the most immediate strategic problem for the United States created by the euro crisis will be the coming, inevitable budget austerity in Europe. Belt tightening is already eroding European capacity to share the burden of paying for global public goods.

European defense spending has dropped almost 2 percent annually for a decade and more cuts are in the works. The cost of short changing defense was evident in the Libyan conflict, where Britain and France would not have been able to carry out their successful mission without U.S. munitions. Faced with our own budgetary constraints, longstanding American resentment about Europe's lack of burden-sharing is only likely to grow, poisoning future defense collaboration.

More broadly, the euro crisis is undermining Europe's pivotal job as a democratic, free-market role model for its immediate neighbors. The nations of Central and Eastern Europe joined the European Union to share in its affluence and political stability. Now the EU looks to be a club of austerity, pain, and political impotence.

In the future, association with the European economy may no longer look so attractive to Turkey, accelerating its trajectory as an unpredictable and unhelpful free agent in the Middle East. Similarly, as the EU looks less stable and successful, the former nations of the Soviet Union are likely to slip further back into Moscow's orbit.

With the stability of North Africa in doubt and the Balkans still unsettled, the last thing Washington needs is for the European Union to become a centrifugal force in the region.

Finally, European preoccupation with the euro crisis could dash all American hope for transatlantic cooperation in coping with China. Beijing is flexing its muscles in the South China Sea and the Indian Ocean. It is extending its influence in Pakistan, in Africa and Latin America. It is developing its own brand of Chinese state capitalism that certainly looks more attractive to many around the world than that being practiced in Europe or, I dare say, even in the United States. Washington will be hard pressed to counter this Chinese influence on its own. And we could find ourselves without an effective European partner.

In closing, Madame Chairwoman, the euro crisis is also a crisis of Europe's military and diplomatic leadership and vision. And, as Europe's strategic partner for the last two generations, Europe's problems are now our headache. It is imperative that the United States do whatever it can to help Europe resolve its current economic troubles. Most important, we need to work together to mitigate the foreign and security policy challenges created by the euro crisis.

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

Senator SHAHEEN. Thanks very much.

Dr. Lachman.

STATEMENT OF DESMOND LACHMAN, RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH, WASHINGTON, DC

Dr. LACHMAN. Thank you, Madam Chairman and Ranking Member Barrasso, for affording me the honor to testify before this committee.

As you've mentioned, these hearings are occurring at a most timely moment in the sense that what we're getting is very clear indications that Greece is now bordering on ungovernability that is very likely to lead to a disorderly default on its debt within the next few months.

What is also of significance are developments in the Italian bond market where the markets are giving you the clearest of indications that they're not at all assured by the efforts that the European summit took to try to stabilize the situation. Italian bond interest rates are now at the highest level that they've been in the past 10 years.

In my remarks this morning, what I'd like to do is emphasize the seriousness of the European crisis, to indicate why I believe that this crisis is going to materially intensify in the months ahead and why I think that a worsening of the European situation is going to have a major impact on the United States economy.

I think a good place to start is looking at the origins of the crisis. While there are many explanations, I think that the most basic explanation is that the countries in Europe's periphery did not play by the rules of a currency union for many years.

As a result, they developed severe imbalances, both with respect to their public finances where we had budget deficits routinely over 10 percent of GDP when the rules required that they be 3 percent of GDP, and we had a material deterioration in the countries' external balances. These countries lost like 20 percent competitiveness to Germany, which resulted in very large external current account deficits.

The essence of the problem in Europe's periphery is that those imbalances are very difficult to correct without having the advantage of a currency to depreciate that boost exports.

Following the IMF prescription of fiscal austerity of a hair-shirt variety in those circumstances leads to very deep recessions that undermine the willingness of the population to stay the course and impair the public finances.

I should also mention that the seriousness of the present Eurozone debt crisis extends far beyond the periphery in the sense that while the countries in the periphery might be small they are hugely indebted. Countries Portugal, Greece, Ireland, Spain between them have 2 trillion dollars' worth of sovereign debt and too much of that debt sits uncomfortably on the balance sheets of the French and the German banks.

So if we do get defaults in the periphery, what we should expect is a major European banking crisis. The ECB itself talks about the possibility of Europe having its "Lehman moment."

The crisis has, clearly, intensified. Greece, as I've mentioned, looks as it's on the cusp of default. Contagion has spread to Portugal and Ireland, and now we're having, more worryingly, Italy and Spain being very impacted. Those countries in the markets are described as too big to fail but too big to bail, and we're finding that out.

The European banking system itself is showing signs very reminiscent of what we saw in the United States in 2008, 2009. They're at the beginning of a credit crunch that is going to have a deep impact on the growth prospects of most countries in Europe.

And finally, I'd say that France and Germany—the high-frequency data coming out of those countries are suggesting that those countries are approaching a recession, which is going to make it all the more difficult for the countries in the periphery to grow out of their problems.

The European summit at last, at least, moved out of denial and addressed what were the fundamental problems that we now have. They tried to do something to stabilize the Greek situation. They tried to ensure that banks were properly capitalized and they tried to erect a firewall around Italy and Spain.

The market reaction to this summit has been lukewarm at best. Markets sold off in the bond markets on that announcement, which is hardly an encouraging sign and that was before the announced referendum in Greece yesterday.

Looking at this package, it's not clear that the haircut for Greece is nearly large enough. It's not clear that the Europeans will come up with 1 trillion euros in money for the firewall. That money will be conditional and it's likely that the manner in which they're going about bank restructuring is going to lead to an intensification of the credit crunch.

This all is going to have an impact on the United States economy. In your opening remark you mentioned the trade relation with the United States and the investment relation with the United States. I would emphasize the financial interconnectivity between Europe and the United States.

It disturbs me that money market funds—the United States have over $1 trillion in money parked with European banks, that you've got large exposure to banks, to Germany and France, and there's unknown amount of credit derivatives written. So if we do get a series of defaults, as I expect we will in Europe, we should really be bracing ourselves for an impact in the United States.

Finally, I have to just say that it's very limited what the United States can do rather than exhort the Europeans to try to be more bold and serious in addressing this crisis.

We've extended to them money through the Federal Reserve, through credit—through dollar swaps and we're doing our part through the International Monetary Fund. But I think beyond that there's really very little we can do.

We should only take into account when we formulate our own budget policies, when we formulate our own economic policies, that we've got a sense of realism as to what is going to be occurring in Europe and not be Pollyannaish about how this is going to turn out.

Thank you, Ms. Chairman.

[The prepared statement of Dr. Lachman follows:]

PREPARED STATEMENT OF DR. DESMOND LACHMAN

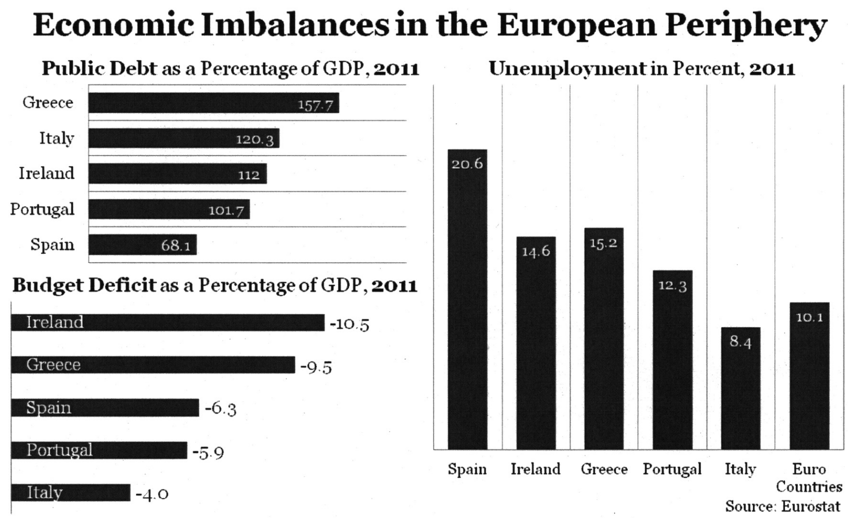
Thank you, Chairman Shaheen, Ranking Member Barrasso, and members of the subcommittee for affording me the great honor of testifying before you today. My name is Desmond Lachman and I am a Resident Fellow at the American Enterprise Institute. I am here in my personal capacity and I am not here to represent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

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

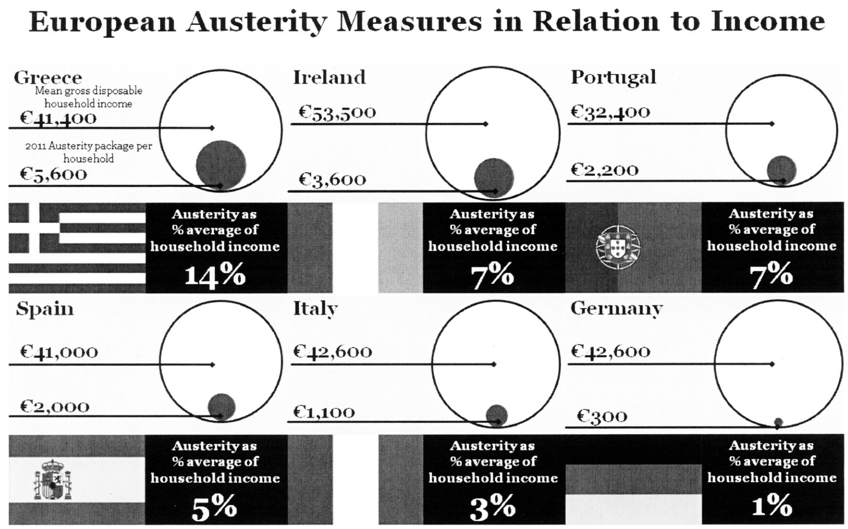
ORIGINS OF THE CRISIS

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

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



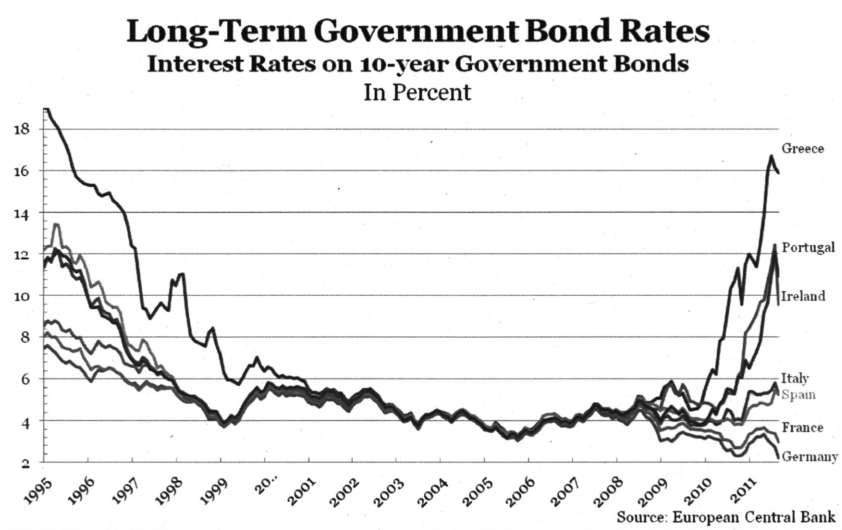
2. The essence of the peripheral countries' problem is that stuck within the Euro they are not able to devalue their currencies as a means of boosting their exports. Attempting to comply with the IMF–EU programs of massive fiscal austerity without the benefit of devaluation to redress their internal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



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

THE EURO CRISIS IS INTENSIFYING

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



Among the signs of intensification are the following:

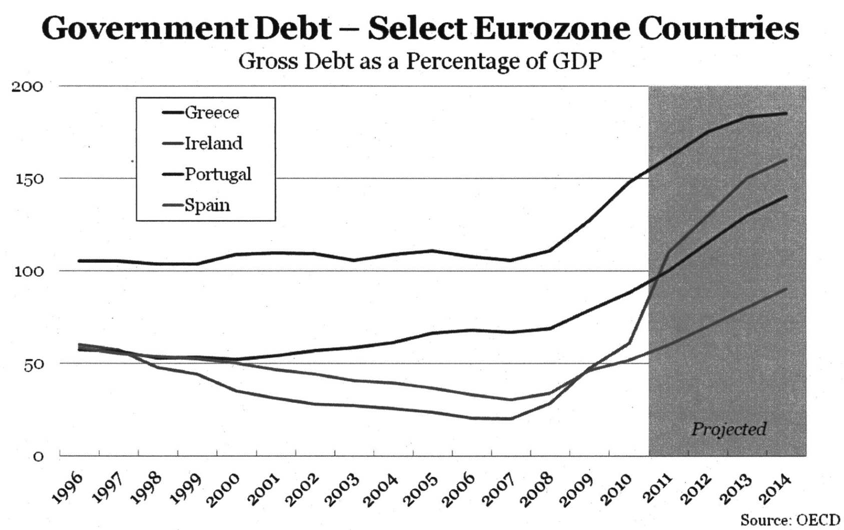
a. The Greek economy now appears to be in virtual freefall as indicated by a 12-percent contraction in real GDP over the past 2 years and an increase in the unemployment rate to over 15 percent. This makes a substantial write-down of Greece's US$450 billion sovereign debt highly probable within the next few months. Such a default would constitute the largest sovereign debt default on record.

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

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

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

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

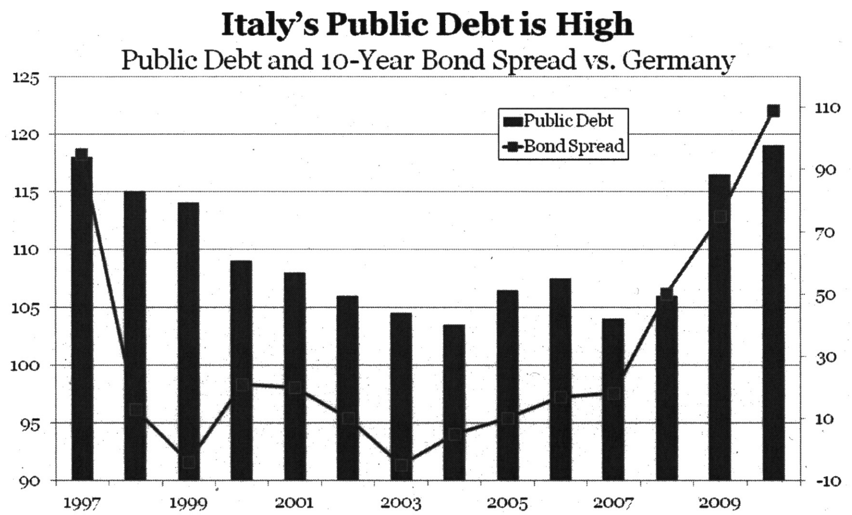


6. The European Central Bank (ECB) is correctly warning that a Greek default would have a devastating effect on the Greek banking system, which has very large holdings of Greek sovereign debt. This could necessitate the imposition of capital controls or the nationalization of the Greek banking system. The ECB is also rightly fearful that a Greek default will soon trigger similar debt defaults in Portugal and Ireland since depositors in those countries might take fright following a Greek default. This has to be a matter of major concern since the combined sovereign debt of Greece, Portugal, and Ireland is around US$1 trillion.

7. Since July 2011, the Italian and Spanish bond markets have been under substantial market pressure. This has necessitated more than US$100 billion in ECB purchases of these countries' bonds in the secondary market. An intensification of contagion to Italy and Spain would pose an existential threat to the euro in its

present form given that the combined public debt of these two countries is currently around US$4 trillion.

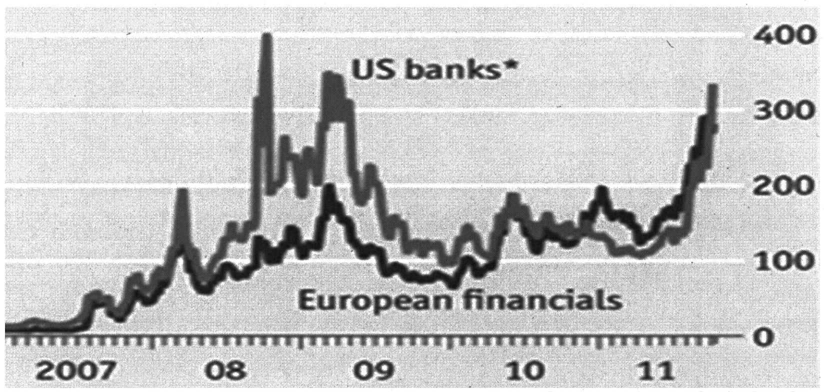
8. While to a large degree European policymakers are right in portraying Italy and Spain as innocent bystanders to the Greek debt crisis, Italy and Spain both have pronounced economic vulnerabilities. Italy's public debt to GDP ratio is presently at an uncomfortably high 120 percent, while it suffers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



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

US and European Banks' CDS Spreads

Five-year credit default swap spreads in basis points



*US Banks represents the average of 6 large banks

Source: Markit, the Economist

IMPLICATIONS FOR THE UNITED STATES ECONOMY

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

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

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

c. In much the same way as the U.S. Lehman crisis of 2008–09 severely impacted the European economy through financial market dislocation, a European banking crisis would materially impact the U.S. economy both through the financial market channel and through a generalized increase in global economic risk aversion.

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

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

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

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

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

WHAT IS TO BE DONE?

12. European policymakers are presently engaged in an effort to put forward a comprehensive plan to address the crisis ahead of the forthcoming G20 summit on November 3–4, 2011. After many months of denial, they now recognize the severity of Greece's solvency problem and the serious risks that a disorderly Greek default would pose to the European economy. The plan that the Europeans announced on October 26, 2011, comprised the following three pillars:

a. A revision to the IMF–EU program aimed at putting Greece's public finances on a sustainable path. The proposed revision would include the requirement that Greece's bank creditors accept a 50-percent write-down on their Greek loans than the 21-percent haircut that was earlier agreed upon in July 2011.

b. The erection of a credible firewall around Italy and Spain. By substantially leveraging up the European Financial Stability Facility (EFSF), European policymakers hope to have at their disposal around US$1.4 trillion that could be used to purchase Italian and Spanish bonds.

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

13. Over the past 18 months, the European policymakers' response to the Eurozone debt crisis has been one of "too little, too late" to get ahead of the crisis. There is the real risk that the efforts presently underway will also fall short of what is needed to finally defuse this crisis. Among the areas of concern are the following:

a. It remains to be seen whether Greece's bank creditors will voluntarily accept the large debt write-downs that are now being proposed by European policymakers. It is also concerning that even after the proposed debt write-down Greece's public debt to GDP ratio would remain as high as 120 percent.

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

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

THE U.S. ROLE IN RESOLVING THE CRISIS

14. To date, the United States has supported the Europeans through the IMF, in which the U.S. has a 17-percent stake, and the through the Federal Reserve. Over the past 18 months, in each of the massive IMF–EU bailout programs for Greece, Ireland, and Portugal, the IMF has provided around one-third of the total funding. Meanwhile, the U.S. Federal Reserve has made amply available to the European Central Bank large amounts of U.S. dollar funding through enhanced U.S. dollar swap lines.

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

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

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

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

Senator SHAHEEN. Thank you, Dr. Lachman.

Dr. Gordon.

STATEMENT OF DAVID GORDON, HEAD OF RESEARCH AND DIRECTOR, GLOBAL MACRO ANALYSIS, EURASIA GROUP, WASHINGTON, DC

Dr. GORDON. Thank you, Madam Chair, and I want to thank other members of the committee, Ranking Member Barrasso, Senator Corker, for inviting me here today, and I want to commend you on your leadership and the attention that you're drawing to the sovereign debt crisis in the Eurozone.

As my copanelists have emphasized, the failure to resolve or at least mitigate the crisis will have sharply negative effects on global markets and on the fragile U.S. economy and will have negative strategic implications for the United States, for Europe itself, and for transatlantic relations.

The timing of the hearing, obviously, is very appropriate, given the meeting in Cannes tomorrow, the European Council agreements of last week and the political turmoil in Greece.

Let me start my testimony by looking at the three-pronged plan to which Eurozone leaders agreed in their summit last week and then move on to U.S. policy and the strategic implications.

To begin with the positive, the specific issues at the latest European response addresses—bank-recapitalization, restructuring of Greek debt, expansion of the size and scope of the EFSF—are, indeed, the three key issues in the almost 2-year-old crisis.

From a symbolic perspective, then, the Eurozone leaders' ability to arrive at agreements on these three issues is definitely a step in the right direction and shows increasing awareness really for the first time of the scope of the crisis.

Their capacity to act on this in a decisive way, however, remains very much in question. The latest agreement is an incremental step forward, not a definitive solution. It's dominated by half measures and skeletal proposals with little detail attached to them.

Market sentiment, as Desmond said, reflects this. Following the announcement of the deal and a lot of enthusiasm last Thursday, markets have tanked this week. I think that this latest agreement is not the beginning of the end of the crisis but rather the end of the beginning, and in fact, I think we're entering into a potentially more dangerous phase.

The latest agreement creates additional risk. Each step that the Europeans have highlighted is necessary but none are sufficient. For instance, the bank recapitalization scheme creates a very serious downside risk for future operations of European banks and financial institutions.

The 50-percent haircut on private bondholders is voluntary in name only. While it may prevent a triggering of credit default swaps, that would simultaneously make Eurozone debt more difficult to insure, not less difficult to insure and then, of course, Prime Minister Papandreou's announcement of a referendum on the deal only adds to the perception of risk in the willingness of the peripheral countries to endure more austerity.

With the IMF, driven by a U.S. unwillingness to commit additional resources, unable to dedicate funds beyond its existing commitments, any new funds for Europe from outside will have to come exclusively from the BRIC countries, the Middle East countries and a small handful of G20 members, such as Japan.

These countries want to keep open the possibility of participation in an eventual resolution but few relish making concrete commitments in the near future.

So the most likely scenario here is the continuation with the muddle-through approach, continued downward pressure on European economies, and a failure of Europe to make significant structural moves toward a more integrated fiscal union. All of this creates important negative strategic implications for the United States.

It should be said that part of the challenge here is that the traditional U.S. role in post-war financial crises is not being seen in this crisis. In the past, the United States would have used our financial strength or political willingness to lead, to build multilateral coalitions, to get ahead of and out in front of the crisis.

Today, we don't possess that same political and economic influence and what you've seen in the last 6 weeks is the effort to use heightened market scrutiny by Secretary Geithner and others to pressure the Europeans into more action. That's begun to work but I fear the timing here, as the Europeans are used to working in a slow and deliberate manner.

This crisis is escalating. It's taken a long time to build, but now that it's building it is likely to speed up beyond Europe's ability to handle it.

Let me highlight a couple of additional risks other than the ones that Bruce talked about, which are absolutely on point. I think the first is that we're really heading toward a two-track Europe here, with closer coordination among members of the Eurozone at the expense of broader European unity.

The key element of European integration will no longer be the 27 members of the Union but 17 or 16, 15, 14 members of the Eurozone, thus putting the decades-long process of European integration, a major source of U.S. post-war foreign policy, into structural reverse.

The Eurozone core is less economically open than are those European countries that have retained their own currencies, and across a host of areas including investment, trade, labor and product markets we could see a greater focus on regulation and on protection from that European core.

Finally, I think that the weakening of Europe will feed a soft power deficit for the traditional Western powers and especially for the United States in the rest of the world as the liberal Western European model, the alternative Western model to the United States, which took a big hit in 2008, will also lose attractiveness to the non-Western world, with deleterious effects on the international rules and norms.

So the United States, I think, needs to be cognizant of the fact that, unable to provide the requisite combination of capacity, funding, and political will to usher through its preferred solutions here, policymakers must prepare themselves for less than optimal outcomes, and here the challenge is that in coming years Europe is likely to be both a seriously less capable and less willing partner for the United States despite continued apparent mutuality of interests.

Thank you very, very much for focusing on this important issue and for offering me the privilege of speaking with you today.

[The prepared statement of Dr. Gordon follows:]

PREPARED STATEMENT OF DR. DAVID F. GORDON

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 U.S. 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 U.S. 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 (G20) meeting that begins in Cannes tomorrow. In particular, much will rest on key G20 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-2-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 9 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.

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 U.S. 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 G20 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 is 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 U.S. response to the crisis. President Obama and the administration have addressed the crisis in three phases. First, until early 2011, the United States 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 United States increased its engagement but remained relatively muted publicly. But beginning with the Eurogroup meeting in Wroclaw in early September, the United States has scolded the Europeans sharply and publicly, fueling market volatility.

This new U.S. response reflects two factors. The first is U.S. 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 U.S. economy. As a result, President Obama has partially inoculated himself publicly if a European crisis spills into the United States. He also potentially benefits in the unlikely event that the stridency of the U.S. response spurs a European resolution, leading to an improving business environment and reduced market volatility on both sides of the Atlantic.

Second, the U.S. response exemplifies a shift in strategy necessitated by a change in the U.S.'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 United States 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 United States does not possess the economic or political influence to force Europe or other actors to accept the U.S.'s preferred solutions. Instead, the United States 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 U.S. involvement in Libya this year, and will increasingly characterize U.S. 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 United States 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 United States 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 United States 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 U.S. 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-a-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 1 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 United States 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 G20.

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 U.S. 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 United States 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.

Senator SHAHEEN. Well, thank you very much, Dr. Gordon, and thank you all. It is not an optimistic picture that you all paint, sadly.

I would actually like to begin with yesterday's events in terms of the crisis and that is the surprise announcement by Prime Minister Papandreou that he would seek a public referendum on the Eurozone deal with respect to Greece.

I think that decision caught everyone off guard and had an impact, as was pointed out on the markets in Europe, here in the United States and erased many of the gains from the deal's announcement last week although, Dr. Lachman, as you pointed out, that seemed like it might be likely anyway.

So I would like to begin with your assessment of what happens as the result of that announcement and, Dr. Lachman, I'll begin with you.

If the referendum goes forward as planned, what are the likely repercussions and how will that affect the wider Eurozone crisis, and if the Greeks do not support the deal, if they reject the Eurozone bailout package, what does that mean?

Dr. LACHMAN. I think the referendum is clearly—the referendum is, clearly, of vital importance to where this crisis is going but I think it's important that when you look at the referendum you should be looking at it against the background of an economy that is virtually in freefall, that the Greek economy has contracted by 7 percent over the last year. It's down 12 percent from its peak.

Unemployment is up 15 percent because of IMF-imposed austerity within a fixed exchange rate system, and what's also occurring is that the country has become virtually ungovernable—that you've got strikes, you've got protests against paying taxes, you've got garbage piling up in the streets of Athens, you've got real anger on the public side.

Papandreou had to do this referendum if he was to regain any authority. So this is a long shot, that apparently as much as 60 percent of the population will vote "No" on the basis of polls right now if the question is formulated do you like the deal that we're doing with the IMF.

So it's all too likely that the Papandreou government is going to fall. If the Papandreou government falls, it's going to be very difficult for them to continue with the IMF program, and this is basically the way in which you get a disorderly default.

To me, the events in Greece the last week or so, the referendum being part of that, is all too reminiscent of the last days of the Argentine Convertibility Plan where you had a political vacuum, that the people had lost the political willingness to stay with the austerity. And if they don't stay with the austerity and they don't get the foreign funding then the logical conclusion of that is they default on the debt, and I don't think that we can be very far from that so if Papandreou loses.

The last thing I would say is that the opposition is not being too responsible. The opposition are indicating that they don't like austerity. They want to go a tax-cut route—that they really are not offering the hope that if the opposition comes in they're going to be following very sensible policies.

So I fear that we're on the way to default and that if we do get a hard default the ECB has—over the past year they've repeatedly said that if you get a hard default you're going to get contagion to Portugal and Ireland but, more importantly, you're going to get contagion to Spain and Italy and that would really put the whole euro experiment at risk.

Senator SHAHEEN. Mr. Kirkegaard, do you agree with that analysis?

Mr. KIRKEGAARD. Yes and no. I have to say I am very skeptical that this referendum will go ahead as planned. I view it as——

Senator SHAHEEN. Why do you say that?

Mr. KIRKEGAARD. Because, first of all, I don't think that Prime Minister Papandreou actually has the majority of the Greek Parliament behind this plan. I think his own party will fracture over this, and I think it's important to realize that this call for the referendum is really, in my opinion, a strategic move or attempt by Prime Minister Papandreou to essentially force the main opposition party of Greece into declaring its political support for the IMF program.

And the way that that's going to happen is that so far the Greek opposition, the New Democracy Party, has, as Desmond said, essentially been playing, in my opinion, a deceitful political game where they have been refusing to take political responsibility for implementing the IMF program while telling the Greek population that we are going to renegotiate this program and get a better deal.

What this referendum call is going to do and in fact already has done is it's going to make it very clear. I mean, the other European leaders in particular have already made it very clear that this referendum is not going to be about whether or not Greece is going to get a new IMF program or not.

It's going to be whether or not Greece is in the EU and the euro area as a whole or not. You're either in or you're out. I mean, beggars can't be choosers, so to speak. And viewed in that light, I, first of all, don't think that the Greek population, even if the referendum went ahead, would actually vote to leave the euro because there seems to be conflicting sentiments here that they're opposed to the current IMF program but they're also heavily in favor of remaining in the euro because I think at the end the Greek population knows the alternative of leaving the euro area which, in my opinion, would be a graduate slide into de facto third-world status for Greece, and that's not something that the population would, frankly, vote for voluntarily.

But as I said, I think the much more likely scenario to come out of this crisis or this referendum call is either a unity government, which will be joined by the main opposition party which has already said that they will do everything to avoid the referendum to take place, or early elections fought on a sort of electoral platform that shows that both the Socialist PASOK Party as well as the main opposition, New Democracy Party, are fundamentally pro-European pro-euro parties and therefore I think, as I said, ultimately while this will create a new political strategy for implementing the IMF program for which there is no alternative in Greece, I think the main problem is that it risks delaying the entire effort.

The timetable is pushed further into the future. We have all the risks of contagion and financial market mayhem and volatility in the time delay and that's what I think is going to be the main focus of the meeting tonight or the dinner tonight between the European leaders and Prime Minister Papandreou is essentially to make sure that whatever happens in Greece happens quickly.

Senator SHAHEEN. Thank you. I am out of time.

Senator Barrasso.

Senator BARRASSO. Thank you very much, Madam Chair.

You know, it just seems that, you know, people say well, over there and over here. There doesn't seem to me, at least, there is no more over there and over here. We're all interwound, interlinked and it's of great concern.

I hear that the European problem is real, that it is not going away and the question is where do we—where do we go from here and how much impact can the United States and our own economic situation have to have an impact.

Mr. Lachman, I was listening closely to your comments and you said that what they are trying to do now is too little too late. Mr. Gordon talked about the 17 countries that may be then 16, 15, 14.

What scenarios are you seeing? Maybe the two of you want to comment on that in terms of the—and a timeline on how this all unfolds.

Dr. LACHMAN. Well, the first thing I'd say is that what is of the greatest concern is if we do get a series of disorderly defaults because if you do get disorderly defaults what that means is you have big hits on the French and the German banks.

You have an intensification of a credit crunch and then you're in what the ECB would call Europe's "Lehman moment" where the whole European economy goes into big contraction. I don't see how that at this point is avoidable, what's left it far too late. These countries are in deep recession.

There's huge political resentment on continuing that course. I think that the debt is going to have to be written down. We're dealing with solvency problems in these countries, you know, and that's really how I see that playing out. Whether or not the countries leave the euro is debatable.

Defaulting on the debt seems to be more or less a certainty that you're going to get a hard default in Greece in the sense that the debt will be written down by 60, 70 cents on the dollar. Leaving the euro would be a very big choice for any of these countries because, as Jacob has pointed out, that the rules of the game are if you leave the euro you're also obliged to leave the European Union.

I've observed over the past 2 years that the Europeans waive the rules when you get to the crunch—that we were having no bailout clauses and then we find that we have bailouts or the ECB doesn't buy bonds in the secondary market, then it buys bonds in the secondary market.

I think the same will occur here is that they'd make allowances for Greece if Greece were to leave. The essence of the problem though is that what Greece is being offered by the Europeans they're already—I wouldn't say that they're deep in recession. They're in depression, and what they're being offered is more IMF austerity to hold their exchange rate, which means that they're going to have a "lost decade."

When that is the case, it is very tempting to try something different even with all of the risks and I think that this is—basically, my experience with fixed exchange rates is that that's basically where we're headed.

Senator BARRASSO. And Mr. Gordon, did you want to——

Dr. GORDON. Yes. I agree with both Jacob's political analysis and with Desmond's economic and financial analysis here. I think the purpose of what Papandreou was trying to do is to draw in the opposition. I think he's likely to fail.

I think there's likely to be new elections in Greece and then the opposition will likely be the predominant actor in a post-election coalition. But I think that you then are very much in Desmond's dynamics—this will lead to a disorderly resolution of the debt crisis until or unless Europe is willing to put a better deal on the table for Greece.

I think that could very well happen. I think these events are probably 4 to 6 months away. The big challenge for the United States is that, is this going to end with a bang or with a whimper. If it ends with a bang, we get hurt very, very, very badly. If it ends with a whimper, it's bad for Europe. It's not great for us but I think our exposure to it still is containable. But that will depend on what the outcome of this political event in Greece is and then I believe very much that there will be another round of negotiations with the European authorities, particularly the EU and the ECB.

Senator BARRASSO. Mr. Lachman, could you talk a little bit more about the potential credit crunch that you see coming? I think you had described it as the "Lehman moment."

Dr. LACHMAN. Well, you've already got signs that there are real strains in the European credit markets, you know, if you look at the credit default swaps on banks or you look at interest rates or you look at banks cutting back on lending.

One of the key mistakes that the Europeans made at the summit was to identify that the banks are short on their capital ratios, that they need to raise additional capital, but then allowing them 9 months to meet those capital ratios. What one would expect is that the banks aren't going to raise capital. With their share prices so depressed they're not going to want to dilute shareholders' capital.

What they're going to do is they're going to shrink their balance sheets. They're either going to sell assets or they're going to restrict credit and that is the last thing that I think a weak Germany and France right now needs is the banks to pull back.

If we get the disorderly default that I think that we're going to get, and I don't think that we're more than a few months away from that, then that just means that the hit to the banks, their capital ratios, are even more impaired.

So this process of getting a credit crunch is very real and that is going to affect not simply Europeans. You've got to take into account that the European banks are very large. They've got enormous international reach, that there are already reports that Asian companies are having difficulty raising capital from the banks. So that is the way I think this gets transmitted globally.

Senator BARRASSO. And then the question that follows is with the trillion dollars of U.S. dollars in money market funds that are in Europe, how do you see that then playing and what the impact is in terms of the value of those dollars, which people in America think are very safe?

Dr. LACHMAN. Well, hopefully, the Europeans won't let any banks fail on their obligations but nonetheless this is a risk that we're exposed and markets will see this.

We've already seen this in terms of you've just got to look at the share prices of Morgan Stanley or JP Morgan or any of these banks that have got exposure in Europe. You know, the markets are making those connections.

But the exposure that we've got is a trillion dollars' worth of money market funds, over a trillion dollars with the banks. This is not insignificant and I think that the lesson that we've learned from the U.S. experience with our financial crisis is the same way as our financial crisis was propagated throughout the globe what we're now going to have is a similar banking crisis in Europe.

Hopefully, we've learned lessons that they won't make the mistakes of letting banks fold. But, nonetheless, if you've got those tensions that is going to have repercussions through the global economy.

Senator BARRASSO. Thank you, Madame Chairman.

Senator SHAHEEN. Thank you.

Senator Corker.

Senator CORKER. Well, thank you both. I think this is a great hearing. I thank you for having it and certainly the witnesses, I think, have been excellent.

Let me—you know, it's kind of interesting to listen to you and, of course, read everything that's happening around the world. But the fact that Western democracies as a whole—I know Germany and others maybe have handled themselves well but we are in a period of decline because we have not handled our fiscal matters appropriately and therefore our ability to affect the world is lessened, and what we're seeing is that those countries that have the courage and the will to get their balance sheets in order and to get their fiscal house in order are going to be projecting greater strength and leadership around the world.

And so we're witnessing something right now that I think is going to be looked back upon in the future as a real moment in time where world balances are changing and I think that's, for those of us here in this country and certainly in Europe, one of our greatest allies, this is a problem and hopefully a wake-up call even for what we're doing right now this very moment in Congress as it relates to dealing with deficits.

But on that note, and moving back to Europe and some of the things that have taken place, when we had our financial crisis and I know it's been highly—you know, it's been highly criticized by many but we had the ability at that moment in time, obviously, being only one country, a huge advantage, but to really come in with force and to stop it.

It does appear that everything that's happening in Europe right now comes at the last minute and not quite enough and so resources are wasted, effort is wasted. In other words, you're using things up that might actually end the crisis. You're using those resources up. You're still not going to end it. It goes over another hoop.

Is there anything right now, that in spite of all the difficulties of having differing countries with differing interests is there any bazooka, if you will, that Europe has that it could use to actually cause this to end at this moment? Yes, sir.

Mr. KIRKEGAARD. There is only one bazooka in Europe, in my opinion, is the European Central Bank. But they have essentially put themselves under—I think that it's also important to understand that this is a truly independent central bank. You can't tell it what to do. It's constitutionally——

Senator CORKER. Are you saying that unlike the Fed or what are you—I'm going——

Mr. KIRKEGAARD. No, no. [Laughter.]

Not at all. What I'm saying is that it has chosen to not go big or use its bazooka, which it had. It could go big, if you like, and guarantee all the sovereign debt of Italy, for instance.

Senator CORKER. But the European Central Bank, excuse me, is not the lender of last resort. Is that not correct? I mean, its——

Mr. KIRKEGAARD. It hasn't——

Senator CORKER [continuing]. Mandate is very different than the Fed's mandate.

Mr. KIRKEGAARD. It has chosen to—it has essentially chosen its own mandate to not be or act as a lender of last resort. But if it changed that it could, in fact, act as a lender of last resort. What it essentially is trying to do is, in my opinion, to carefully construct financial pressure, as Desmond said, in the financial markets. Now we have Italian interest rates over 6 percent.

Well, that is having a very significant effect and putting pressure on Silvio Berlusconi to do the kind of structural reforms that the European Central Bank has very clearly, in fact, written letters to Silvio Berlusconi instructing him to do.

So what it is trying to do, in my opinion, by not—deliberately not ending the crisis is to get the kind of response from politicians in the euro area and in Italy particularly that it wants. And it actually has the institutional power in Europe to do this because it is, as I said in my testimony, the only credible bazooka in Europe.

So it is ironic that if you wanted to end a financial crisis you would normally go big and a credible commitment—a big number. But Europe actually goes exactly the other way. They deliberately prolong the crisis to build up market pressure to essentially force politicians and policymakers to do these kinds of reforms.

Dr. GORDON. Senator, I think the good news here on the timing is that I think that the move by Prime Minister Papandreou will basically mean that we won't be spending weeks talking about the European plan that was constructed last week as a potential solution.

I think actually that's a positive. We will quickly go beyond that and I think the timing of the G20 will allow leaders to have a chance to get together and think about next steps. Do I think that anything systemic will come out of the G20 meeting? Absolutely not.

But I think where the G20 meeting was headed before this was this endorsement of what the Europeans had been doing, some financial support, particularly from BRIC countries and the Gulf States.

I think none of that is going to happen. I think that's a positive thing because it will bring a greater sense of crisis and an ability to move forward as we iterate toward a solution.

Senator CORKER. Yes, sir?

Dr. LACHMAN. I certainly agree with Jacob that the ECB could be a bazooka that, from a technical point of view, they clearly can expand their balance sheet at will. But the reason that I think that they're not is that their major shareholder, namely Germany, is not too keen about the ECB using its printing press.

What we've seen is over the past year we've seen Axel Weber, a governor on the ECB board from Germany, leaving in protest. We saw Jurgen Stark leaving in protest. We've seen the president of Bundesbank thinking that what the ECB is doing is wrong.

We've seen the President of Germany indicating that he thinks that what the ECB is doing goes beyond legality. So I don't think it's an accident that the ECB doesn't go into the market in this degree.

The ECB has to be very concerned about losing the support of the German people, which would then take away their independence. So I would see the ECB as being politically constrained in dealing with the situation.

Senator CORKER. Yes. Go ahead, Bruce.

Mr. STOKES. If I could tie together a couple of remarks here, I think that—I don't know if I agree or disagree with some of my fellow panelists. I think the problem with the announcement of the referendum, and even if we don't actually have a referendum, is that time is not on our side. The markets are moving already.

We have every reason to believe they will continue to move—that if this takes days or even weeks to sort out that events could get rapidly out of control. I do think the ECB will do what it can, but I don't think there's a lot of evidence that they're willing to take the steps that we would all say the United States took and that they should emulate.

And so to get back to your point, Senator Corker, I think that what we're going to need in the weeks ahead is market-stabilizing initiatives.

We can't necessarily expect those to come out of Europe, which puts new pressure on the United States and the Super Committee. If the Super Committee can come up with a credible plan, this will help stabilize global markets in a way that is not totally sufficient, but it can be our contribution, that, as David said, we're not about to write a check to Europe but just make it our contribution to helping stabilize markets.

If, on the other hand, we have a train wreck on November the 23rd, we'll only be throwing gasoline on the fire of the markets and I think that would be unfortunate.

Senator SHAHEEN. I just want to follow up on that real quickly, Mr. Stokes, because does the Super Committee just need to fulfill its mandate or are you suggesting that it needs to come up with a broader response to the current situation, that grand bargain that was talked about earlier in the discussions about this country's debt and deficits?

Mr. STOKES. At the risk of being Pollyannaish, I think we should have a broader grand bargain. I think that would be the bazooka that we could bring to the table in this timeframe to try to help calm markets and also it would be good for ourselves in the process, because at the end of the day we have to deal with our own problems.

Europeans have to deal with their problems. But markets are going to be worried about instability. Even if we could get a deal, a smaller deal, to fulfill the Super Committee's mandate I think that would send the right signals.

I think what would not send the right signals is if the Super Committee gets to the 23rd of November and kicks the ball down the road. Then we have to worry about the interaction of concern about the European crisis with what might be perceived as a new crisis in the United States.

Whether it is or it is not a crisis is a different issue. And then we would, I think, risk what we had in 2008, which was that credit markets on both sides of the Atlantic would begin to dry up—that people just say, I don't trust things, I will just sit on my money, and that would not be good for the global economy given the fact that we're slowing down already.

Senator SHAHEEN. Mr. Gordon, I'm going to ask you to respond but I want to do another followup with you, Mr. Stokes, first, what should the G20 summit do in response to the euro crisis and what do you think they will do?

So if you could say these are the perfect steps you should take in order to respond in a way that would reassure the markets, that would reassure Europe and the rest of the world that you're addressing this problem and then what do you think they have the political will to do?

Mr. STOKES. Well, I would second Jacob's statement that probably the most important thing that's going to happen in Cannes is this dinner between Sarkozy and Merkel and the Greek Prime Minister because out of that meeting, their dinner, there has to come some strong signal that we're on top of this, we're together on this, we are in accord.

I'm not quite sure how they do that, how they come out with that kind of message, because if it comes out that people are pointing fingers and are not cooperating, I think that would send a very dangerous signal to the markets.

I would have said before the announcement of the referendum that what one could have hoped for at the summit vis-a-vis this crisis is that there would be some agreement that the BRIC countries would in some way be willing to pony up some money to help backstop Europe, and the details could be worked out whether it's a euro bond or other things, that would be left to the technicians, but that there was a commitment and that it be done not through the Chinese investing in Greek port facilities, but through some kind of centralized mechanism that would reduce the concerns about BRIC political influence.

I think now, after the Greek decision, it's inconceivable to me. I think it was already hard to believe that the Chinese would be willing to risk their money and now it seems to me the Greek decision has given the Chinese an excuse to say—you sort this out and come back to us later. My guess is the Japanese might feel the same way. So that's an added complication. But at the very least, it seems to me that the leaders have to have some very reassuring statements in Cannes because markets will be moved by what they do.

Senator SHAHEEN. Mr. Gordon, I know you wanted to respond earlier but can I also ask you as part of that, you pointed out that you thought it was positive that we have jumped ahead in a way that I don't want to say cancels out but looks at what the alternative to last week's Eurozone deal is. So what is the deal that should be put on the table that could reassure markets?

Dr. GORDON. I don't think that we get to grand deal here and this is a connection back to the Super Committee. I think that the best is often the enemy of the good so I think the good for the Super Committee, which is doable—absolutely doable—is meeting its mandate.

A grand bargain is not doable. In our system elections determine the political context. We're very close to a Presidential election. That's when following that election is the time for grand bargains. But the Super Committee has a doable mandate. That's what it should do and that would definitely calm markets.

We're still at a moment of iteration here and I think, importantly, you throw the ball back into the court of the Europeans to say put some real detail on these steps. Move to turn these half measures into whole measures.

Give a pathway here for Greece to see itself being able to grow out of the economic freefall it now finds itself in and I think that that would be a step forward. But there's not going to be resolution coming out of this G20. The basis for it doesn't exist.

Senator SHEEHAN. So you're not suggesting that it's the parameters of the deal, the broad outline, that's the issue. It's that they don't have enough detail to what's being proposed.

Dr. GORDON. Well, and the parameters as announced are insufficient. I think the themes are the right themes. The parameters are half measures and——

Senator SHAHEEN. OK. Let me just, if I could, poll everybody else.

Does everyone else agree with that? Mr. Lachman? No. I'm just going to ask you to do yes or no because I'm about to run out of time but we'll be back to you. Do you agree or not?

Dr. LACHMAN. Partly, but I would just emphasize that you're dealing with solvency problems in a number of the countries—dealing with solvency problems in Greece, Portugal and Ireland to get additional money, to throw additional money at these countries. All you're doing is you're kicking the can down the road. You're not resolving their solvency problem.

Senator SHAHEEN. See, it's not only politicians who have trouble answering yes or no. [Laughter.]

Mr. Stokes.

Mr. STOKES. I would say yes, you need more money for the bank bailout. You need more money for the bailout of the countries.

Senator SHAHEEN. Mr. Kirkegaard.

Mr. KIRKEGAARD. I would say yes but I think we have to recognize that the biggest impact the G20 has had is having the Cannes summit because it has forced the Europeans to move further than they otherwise would, as indicated by tonight's dinner.

Senator SHAHEEN. Thank you. Thank you all.

Senator BARRASSO. Well, I think this follows up, Madam Chairman, the things that Mr. Stokes was talking about. He said it's not just an economic crisis or a global realignment crisis, a security crisis with regard to NATO. And so I do wonder about leverage used by other foreign governments.

We talked about—I think we mentioned China. I think, Mr. Gordon, you mentioned all of the BRIC countries and then what the implications of that are. So just I'd like to ask each of the four of you to just kind of take a look at that globally, if you would.

But also the other question that I'd ask you quickly is on the referendum issue in Greece. Does that mean then that the Germans may say, we want a referendum as well, and if they're going to take the haircut, which is at 50 percent but I think Mr. Lachman said it may have to get to 70 percent.

So I don't know, if we could just go down the panel and if you want to start, Mr. Gordon, we can just ask everyone's opinions.

Dr. GORDON. I mean, on the realignment I think that China is unable to act strategically here because of domestic politics and the power of nationalism. I think that this crisis offers a major potential opportunity for China but there's not going to be an immediate quid pro quo.

Without an immediate quid pro quo, the Chinese are going to be too hesitant because of the potential political backlash at home.

Dr. LACHMAN. Yes, I'd agree that it's going to be difficult to get China and the other BRICs to contribute. But I think that there's a more basic question is whether a 1 trillion euro firewall is big enough and whether it is unconditional enough to do the job that really what you need to contain this crisis is you do need a bazooka and the ECB is the only institution that's got the bazooka but for reason I said it is constrained.

Mr. STOKES. I think that China in particular will probably not pony up as much money as some people might have speculated. In part because, I think, of David's reasons. But we should understand that China is already having an influence.

If you talk to EU officials in their private discussions among themselves, when they're sitting down to talk about should we bring an antidumping case or an antisubsidy case against the Chinese, there will be people from countries in that room, EU member countries, who say, we can't do this—we're looking for money from Beijing. And it's not just that we're worried about this. They've actually called us and threatened us that we won't get the money because they know we're about to make a decision on these dumping cases.

So that kind of influence, which I must admit we probably have also exercised ourselves in the past, is something we both have to worry about as we think about working with the Europeans going forward in dealing with China.

Your other point about does the Greek referendum lead to a German demand for a referendum, it's interesting, there's a piece in a German paper today arguing just the opposite that said, we've already said that any deal has to be passed by our Bundestag—why shouldn't the Greeks have the same democratic option.

Of course, the problem with that is that it slows down these processes even more and one of the needs of a crisis like this is the ability to move fast and that balance between democracy, which we obviously believe in and think is absolutely necessary to bring along the public, and the need to move rapidly to send messages to markets is a tension that the Europeans are trying to balance and I fear may not get the balance right.

Mr. KIRKEGAARD. No, I agree completely with Bruce's comments about that China is already exercising soft leverage on some of the European countries. There's no doubt about that.

Even if they don't for domestic political reasons, as David said, are going to be able to pony up any kind of money that will make a credible bazooka they're not, nor will anybody else, as I said in my testimony.

Quickly, on the referendum, I also agree with what Bruce said there. I think the Europeans will be very, very adamant.

I mean, this will be one of the things that they will say to Papandreou tonight is that we don't want a precedent for referendums on IMF programs because we know that even if, as I said, ultimately I believe that a referendum will probably be won by Papandreou it will be hugely destabilizing and it would work the same way as referendas has worked in terms of getting new European treaties approved.

It basically slows everything down, you know, by several years potentially and that has, obviously, very destabilizing effects.

Senator BARRASSO. Thank you, Madam Chair.

Senator SHAHEEN. Senator Corker.

Senator CORKER. Thank you. I think, again, this has been very interesting. You know, so you see the ECB with German leadership in essence putting sanctions on countries.

I mean, that's what's really happening here and the question is will the length of time intersect properly where you actually end this crisis. And I agree with you. Having this referendum in January means that basically nothing else can happen and so you basically have no real progress underway except for, I guess, at the end of this month hearing more details about the three steps that European Union has taken.

So to me it's pretty—it's not heartening to see that there's not a real step taken. My guess is by the time it's all said and done the European Central Bank will play a different role than it is now playing and it's just a matter of time.

Let me ask you this. On the credit default swaps, I mean, it seems to me that, No. 1, we're in this era where even in a more exaggerated way he who has the gold rules.

I mean, we're seeing that play out very strongly. Those countries, again, that had their fiscal house in order are going to be the dominant players in the world.

We're diminishing in that regard right now because of our own ability. We still have major economy but our resources and our ability to act are diminishing. The credit default, the other piece it seems to me that's really illuminated right now, is this whole

CDS—I mean, now sovereign entities issuing debt. If all of a sudden you can just change the rules on the credit default swaps sovereign debt is now in a very different place, is it not?

I mean, you literally cannot buy—well, you will not be able to buy insurance for sovereign debt and feel good about it if all of a sudden you can say well, you know, your living room burnt down, your kitchen burnt down, you know, your bedroom has burnt down but your garage is still standing so we owe nothing. It'd be like this—that would be the relevant place for home insurance.

So tell me the effect that this is going to have on lesser countries, if you will, as it relates to issuing sovereign debt.

Dr. GORDON. I think the European plan is that you have the 50-percent haircut, no CDS and then you have some European insurance on this and I think that you're right.

I think that basically this whole thing makes the efforts to hedge sovereign debt much more challenging but, and again, it gets back to your point that it reinforces the position of those countries that don't have to go there, basically, in the world and makes it tougher for those that do.

I think the other thing that it does here is that it will create incentives if we do get a disorderly default here. It will create incentives for others to follow and that's the challenge of putting the ring fence here around Greece that's going to be very difficult to do.

Dr. LACHMAN. The point that you raise about credit default swaps is a lot more serious because it's affecting not the smaller countries but it's affecting a country like Italy where the bond holders now feel that they don't have the insurance, and Italy's got something like 1.9 trillion of sovereign debt outstanding and if people begin selling that really could tip Italy into a bad equilibrium and that is really what we're fearing.

Senator CORKER. Yes.

Dr. LACHMAN. You know, your second point about the emerging market finances versus the developed countries' finances couldn't be more true. These countries—whereas most G7 countries have now got debt to GDP ratios with a 90-percent-plus handle or that they're running very large budget deficits, if you look at countries like Brazil, Russia, China, all of these countries have got public debt levels that are half the levels of ours and their budget deficits are half the levels of ours.

So they're really in very much stronger position to weather these kind of storms than we are.

Mr. KIRKEGAARD. If I could just say quickly, I actually think that it's an even bigger issue with respect to the CDS because what does it actually signal? Why do we need CDS on sovereign debt is because there is a fundamental impairment of the risk-free status in financial markets of government debt.

The full faith and credit of Country X is, clearly, not what it used to be and I think that has very tremendous or very large implications for how governments more broadly, and this includes, I believe, the United States as well as large—other G7 countries, how are they going to be able to act going forward in future crises in a countercyclical manner.

One of the ways that we traditionally have fought large, you know, cyclical swings in the economy is that the government in a crisis acts. Because it has the capacity to borrow at the risk-free rate, it can expand expenditure in a countercyclical way.

Well, if government credit as is now happening and, clearly, in the Eurozone begins to be swinging procyclically so that it goes up with—in a downturn just like the riskiness of all other types, that will essentially impair the ability of government to act in this way, which I think will ultimately lead to much more volatile, you know, advanced economies.

Senator CORKER. OK. So you have a—so speaking of Italy, you have a situation where now credit default swap is worthless—maybe not worthless but certainly its credibility is damaged. Their interest rates when we walked in the room were at 6.22, which is, you know, a multidecade high, not just a 10-year high.

At what level do interest rates in Italy get to a point where it's absolutely a downward spiral? I mean, have you all looked at what that level is?

Mr. STOKES. Well, they already are at levels where Portugal and Ireland had to get a bailout. I know Italy is a different country. The debt of Italy is held more by its own people than some of these other countries. But it is a danger.

One thing I wanted just to jump in on is the CDS issue to highlight something that Jacob said in his testimony. We aren't sure we know the data on CDS and at least this summer both the Fed and the IMF claimed they weren't really sure who held this—who had written this.

Now, it may well be they know and they just don't want to talk about it because that would move markets. But I think that it is the kind of thing that Congress needs to get on top of.

We at least need to know what the exposure is even if it's not public information so that we can begin to plan for worst case scenarios.

Senator CORKER. May I ask one more question?

Senator SHAHEEN. Sure.

Senator CORKER. And by the way, we have been pursuing that. Is there any discussion at any level that makes any sense?

I know in a crisis mode it's hard to focus on anything other than the crisis at hand and I think, again, the multicountries involved we know that's difficult and, you know, it creates lots of frustrations by us as onlookers.

But is there any discussion about the growths out of this? I mean, at the end of the day there's a downward spiral that's being exacerbated by all of these actions. Has anybody over there articulated any thought about how growth resumes?

Obviously, that's the easiest solution to this but or any prospects of something that would generate growth.

Mr. KIRKEGAARD. Well, I think it's fair to say that the short-term growth outlook for Europe is bleak. I don't think there's any doubt about that. I think we will possibly have a short technical recession in one of the quarters, either the fourth quarter of this year or the first quarter of 2012.

But there is some movement toward a growth strategy in the periphery by basically through the traditional European Commission budget where investment funds are being now made available to Greece, Portugal, and Ireland without the traditional need for national copayments.

So it essentially becomes investments fully funded by the European Union. And there was actually in the leaders' communique—the euro group communique—last week a reference to this project. It's called Project Helios and it's essentially a 50 billion euro solar panel investment project in Greece that obviously has the potential to create some kind of growth in the short term.

But having said that, growth agendas are not central to the European debate and to the degree that it should be, given the growth outlook.

Mr. STOKES. Senator, one thing that it seems to me that we can do at the margin but I think would be a terribly useful thing to do is to begin to talk to Europe about how we remove all tariffs on goods traded across the Atlantic, how we encourage investment across the Atlantic.

We can make a contribution that both helps Europe and helps us by deepening and broadening the transatlantic market, which right now is the world's largest market. But it won't be that forever.

So we have something we can contribute. There's a EU–U.S. summit coming up November 28. It's my understanding that they're at least considering the possibility of trying to make some statement along these lines, not a commitment but at least a commitment to look into it.

Certainly, the U.S. Chamber of Commerce supports this. The National Association of Manufacturers is looking at it. So I do think there is a potential there for us to make some small contribution which will both help them and help us.

Senator CORKER. Madam Chairman, thank you and thank each of you. You all were great.

Senator SHAHEEN. Thank you. I want to follow up on the line of discussion that Senator Corker has opened because as has been pointed out from the beginning of this crisis the focus in Europe has been on austerity measures and cutting budgets, and yet as you pointed out, Mr. Kirkegaard, there have been a number of factors and I think probably you said this too, Mr. Lachman, that have contributed to the crisis.

So should the focus have only been on austerity measures? Has that been the correct response? Should there have been a kind of one-size-fits-all? I mean, you've all talked about how difficult the measures have been on Greece in terms of the tightening of their economy.

So should they be looking at efforts that emphasize more than just austerity? And Mr. Kirkegaard, do you want to respond first?

Mr. KIRKEGAARD. I have to say that I believe that for the peripheral countries and those would be, of course, Greece, Portugal, and Ireland, I believe austerity to the extent that it has been imposed by the IMF programs was indeed appropriate because what we saw during the crisis and was in fact that it turned out that these countries, apart from having a significant structural budget, they also had very procyclical government revenues.

So the crisis itself creates this negative spiral to a certain extent that Desmond has talked about. But when you have the kind of debt levels and the kind of structural deficits that these countries have, yes, then I believe austerity was appropriate.

It doesn't mean that you should not try to have outside capital brought in from the European level for investment growth-stimulating purposes. But I believe austerity was the appropriate measure.

Senator SHAHEEN. Yes.

Dr. LACHMAN. I guess I draw different lessons from the experience of Greece. You know, I think that the degree of austerity imposed on a country in a fixed exchange rate system the IMF should have known that that was going to fail and, indeed, events have borne that out. When the IMF started these programs they thought that Greece's debt to GDP level was going to peak at 130.

Now they're talking about it peaking at 180, maybe going to 200, and the reason that that is occurring is because the economy has contracted at a very much faster rate, deeper rate than they anticipated.

But that should have come as no surprise to anybody because if you tighten budget by 5, 6, 7 percentage points of GDP in a single year and you're in a fixed exchange rate, it's difficult to see where the growth comes from.

Looking forward, I think we're in an even worse situation because what the IMF is doing is they're continuing to impose a lot of austerity but now they're going to be doing it in the context of a credit crunch developing so monetary policy is effectively tightening and a global environment that is a lot less benign than before.

So I don't think one should be surprised to see if we stick with these policies, no restructuring of the debt, no devaluation of the currency, really then what you must expect is very deep recessions and you must expect the kind of political situation you get in Greece and I'll tell you that Portugal is the country that is the next in line.

Senator SHAHEEN. Mr. Gordon.

Dr. GORDON. I think the IMF—the striking thing to me is that the IMF learned all of these lessons from dealing with similar crises in the developing world over a long period of time and got increasingly, I think, sophisticated about the need to balance austerity programs with growth programs and the need for local political ownership. All of these have sort of gone out the window in dealing with Europe and I think it's really unfortunate.

Mr. STOKES. But to answer your question, Madam Chairwoman, I think that there are things that they could have done; they could have lowered interest rates. The ECB could have lowered interest rates. It did not.

There are things now that they are doing they could have done earlier. Jacob mentioned the EU funds that are being transferred to the periphery. There were proposals from the very beginning that said look, these funds are supposed to be appropriated over 5 years—why don't you frontload them, just do it all at once.

They didn't initially do that. So I think there are things that—lessons we could learn hopefully for the next crisis that we should have known to do from the beginning.

Senator SHAHEEN. Well, given those lessons for this crisis, is there a way to reset any of the efforts that are under way that would provide a more positive outcome than what we're currently seeing? You're shaking your head, no, Mr. Lachman.

Dr. LACHMAN. I think that there were reasons that the IMF imposed those kind of policies on these countries. They didn't want the defaults because they were concerned about what that would do to the French and the German banking system, which are holding the debt.

So I think that Greece was used—that Greece was—they weren't particularly concerned what would be the outcome in Greece. They were concerned should the banks take the hit. I think that the mistake that was made is that strategy made sense if you used the time to strengthen the position of the banks so that when the inevitable default occurred the banks would be in a better position to do it.

Sadly, that hasn't occurred. All they've done is they've kicked the can down the road, they've made the problem bigger and if we throw more money at it all we'll be doing is postponing it a little bit further.

But eventually this debt has to be written down big time and that is going to be a big hit to the European banks.

Senator SHAHEEN. Well, so just to sum up, at this point it sounds to me like what everyone is suggesting is that there is no reason to be optimistic that the efforts undertaken will have a real impact on the European financial crisis and therefore we are going to see further impacts on not only the European countries but on the United States and other parts of our global markets.

Is that the conclusion that everybody has come to?

Dr. GORDON. I don't think we're at a denouement here. I think that this is getting sped up. As I said, I think that the silver lining here is that we aren't going to spend a month talking about this plan from Europe next week.

But several of us talked about the changing potential role of the ECB here. Germany would have to give a mandate to that but the question is, when push comes to shove, will Germany enable the ECB to play a different role here? Because I think that in the first half of next year we really are likely to come to a denouement.

Mr. KIRKEGAARD. If I can just say, too, quickly, I think we will certainly not see an end to the kind of volatility that we've seen in the markets in the last couple of days.

Because of the structural nature of this crisis in Europe it is going to take several years to work it out. But I think you will—I think the Europeans does, on the other hand, and through principally the ECB have the capacity to avoid a disastrous outcome like another "Lehman moment," as Desmond has talked about several times.

And on that point I think I will disagree slightly with the emphasis that a lot of people put on Germany at the ECB because it is true that Germany may have the biggest shareholding at the ECB at about 27 percent. But we have to recall that the ECB uniquely in the European Union actually works like the U.S. Senate. Germany only has one vote. Germany has the vote——

Senator SHAHEEN. That doesn't make me feel better. [Laughter.]

Mr. KIRKEGAARD. Well, the ability for Germany to actually block these things in the short term is essentially, in my opinion, not there. They can't do it, and the Germans on the governing council represent—there's 23 members on that council and there's a—you know, the Germans are a very small minority.

Senator SHAHEEN. Thank you.

Mr. Stokes.

Mr. STOKES. I think I agree here. I think that there is nothing that is likely to transpire in Europe in the next few days or even weeks that is going to defuse this crisis. It's going to continue to build. That's the challenge we face.

I think from an American point of view, there are three things we need to think about. One is to send as positive of signals as we can to the markets that we are getting our house in order. Two, I think we do need to consider what we can do at the margins to improve trade and investment across the Atlantic to at least contribute to helping getting them and us out of the problems we're in.

And then I would raise an issue that no one on Capitol Hill wants to talk about and that is what are we prepared to do to help the IMF if things really go badly. Congress has already spoken already to a certain extent on this and I think it's not a sign that we want to send to the markets in a crisis.

Senator SHAHEEN. Thank you. I would—I have just one final question and I would be remiss as the chair of this subcommittee and given the conversations that I've had with representatives from a number of the other European countries that are still looking to get into the EU.

Do you have any view of what the prospects are for those continuing discussions and whether the financial crisis will have a dampening effect on the interest that some of those countries have in getting into the EU?

Mr. Kirkegaard.

Mr. KIRKEGAARD. I think it will clearly have a dampening effect on people or countries wanting to get into the euro area. I think that's already happening.

But I have to say that in the 10-year time horizon I think we will see a euro area of 26 countries. The only country that will not join is the U.K. and the reason is that for the other smaller Eastern European countries in particular but also Denmark and Sweden, as the euro area begins to integrate institutionally and becomes the forum in which major decisions are taken in the EU, the political costs for these small countries to remain outside becomes prohibitive.

I think that they would—they will probably want to wait to see what happens and what kind of euro area they join and they would probably also prefer for some of the bills to be paid before they join. But as I said, in the 10-year time horizon I think they all will.

Moving to the issue of expanding the EU beyond the 27, I think that'll be very difficult. I believe that the chances of Turkey of ever joining the European Union are zero, and the main reason for that is that you have in the European Council right now a dual-majority rule which means that it weighs the influence of a country both by GDP and by population.

So if Turkey ever joined, Turkey would quickly become the most powerful country in the EU and Germany and France will never accept that. But I would also say that I think the process of prospective Turkish membership has actually already worked the way it should.

I think the process, if you like, has been the goal here because I think without the potential for, even if never materialized actually, for Turkish EU membership you would not have seen the reduction in the role of the Turkish military and a whole host of other very positive developments in Turkey.

So I think both countries, both the EU and Turkey, has actually had great benefits from this ultimately, you know, futile effort and I think with respect to the Ukraine, it all depends on internal Ukrainian politics. What has happened in the last couple of weeks in Ukraine will certainly not make them a prospective EU member.

Senator SHAHEEN. What about some of the other Balkan countries and——

Mr. KIRKEGAARD. Oh, sorry. Yes. I think ultimately all of the Western Balkans will become members including Albania, and obviously, I also forgot to mention that Iceland has recently opened up and they will also join relatively quickly.

Senator SHAHEEN. Thank you.

Mr. Stokes.

Mr. STOKES. I think the issue may be that up to this point it was the internal debates inside these applicant countries that slowed down or complicated their joining.

I think increasingly there will be reluctance among the existing members of the EU to move for membership very rapidly because of the impending recession in Europe, because of the fears that we wouldn't want to admit a country that would somehow turn out to be another Greece.

And I agree with Jacob. I think if there was any chance that Turkey joined the EU, which I think was probably zero before this crisis, the crisis has really put a nail in that coffin.

Senator SHAHEEN. Certainly, I appreciate what you're saying about internal disagreements within many of those potential member countries, although I think their perception, at least among some of them, is that there has been more of a reluctance as time has gone on to allow for increased EU expansion and that that has hurt their chances.

So hopefully that is not the case. Mr. Lachman, did you want to weigh in on that?

Dr. LACHMAN. No, I just have a different view that——

Senator SHAHEEN. OK. Good.

Dr. LACHMAN. I just think that we're going to see—within the next year or 18 months we're going to see countries leaving the euro.

I don't see how Greece and Portugal and probably Ireland remain within the euro and I think I would agree with Bruce that it's very difficult if Europe's in recession. Countries are leaving. You've got all these crises. To then be expanding the euro would just make no sense.

Senator SHAHEEN. Mr. Gordon.

Dr. GORDON. I think that if we are in Jacob's world that would be a huge success. I suspect we're going to be in Desmond and Bruce's world.

Senator SHAHEEN. Well, we'll give you the last word. Thank you all very much. It's been a fascinating discussion.

The hearing is closed.

[Whereupon, at 11:18 a.m., the hearing was adjourned.]

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

APPENDIX TO JACOB KIRKEGAARD'S PREPARED STATEMENT

THE ORIGIN OF THE EURO AREA'S FOUR DIFFERENT CRISES, THEIR OVERLAPS AND MUTUAL REINFORCEMENT

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

The Euro Area Design Challenge

The concrete thinking about an economic and monetary union (EMU) in Europe goes back to 1970, when the Werner Report [1] laid out a detailed three-stage plan for the establishment of EMU in Europe by 1980. Members of the European Community would gradually increase coordination of economic and fiscal policies, while reducing exchange rate fluctuations and finally fixing these irrevocably. The collapse of the Bretton Woods system and the first oil crisis in the early 1970s caused the Werner Report proposals to be abandoned.

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

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

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

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

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

Similarly, the divergence in the economic starting points among the politically prerequisite “founding members” of the euro area moreover made the imposition of firm, objective fiscal criteria for membership in the euro area politically impossible. The Maastricht Treaty in principle included at least two hard “convergence criteria” for euro area membership—the so-called “reference values” of 3 percent general government annual deficit limit and 60 percent general government gross debt limit.[5] However, in reality these threshold values were anything but fixed, as the Maastricht Treaty Article 104c stated that countries could exceed the 3 percent deficit target, if “the ratio has declined substantially and continuously and reached a level that comes close to the reference value,” or “excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value.” Euro area countries could similarly exceed the 60-percent gross debt target, provided that “the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.”

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

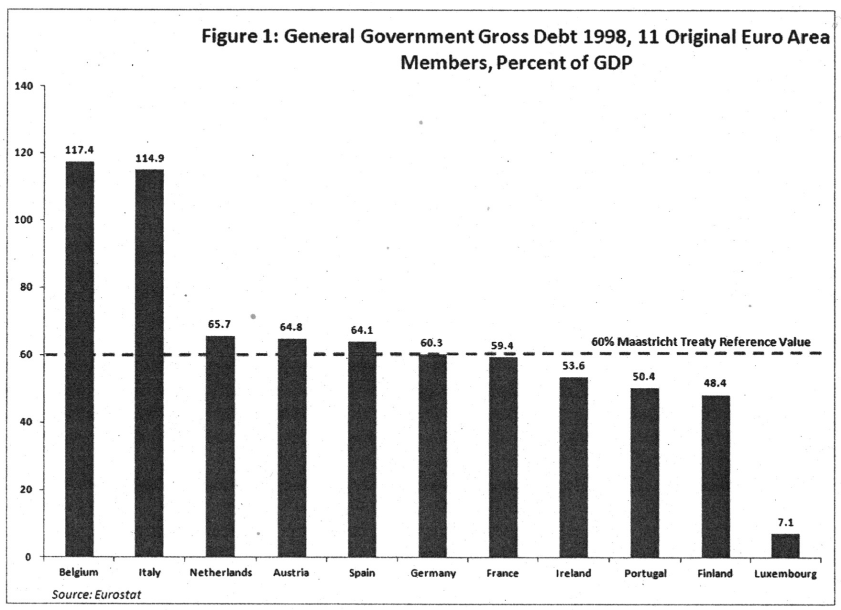
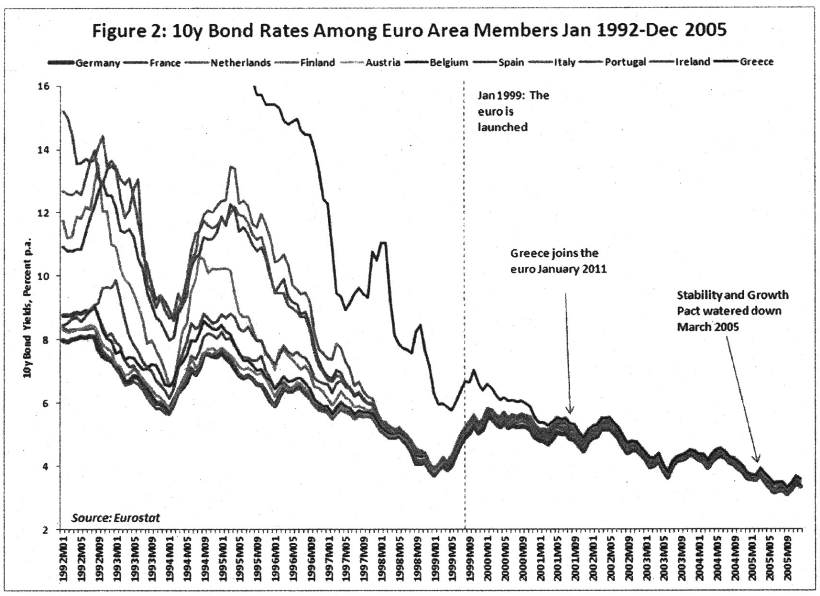


Figure 1: General Government Gross Debt 1998, 11 Original Euro Area Members, Percent of GDP

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

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

By 2005 the euro area was as a result of numerous shortcuts taken to achieve and sustain a political goal, a common currency area consisting of a very dissimilar set of countries, without a central fiscal agent, without any credible enforcement of budget discipline or real deepening economic convergence. Initially, however, none of these danger signs mattered, as the financing costs in private financial markets of all euro area members quickly fell towards the traditionally low interest rates of Germany (Figure 2).



It is beyond this testimony to speculate about the causes of this lasting colossal mispricing of credit risk in the euro area sovereign debt markets by private investors in the first years after the introduction of the euro. The financial effects of this failure on the other hand were obvious, as euro area governments and private investors were able to finance themselves at historically low (often significantly negative real) interest rates seemingly irrespective of their economic fundamentals. Large public and private debt overhangs were correspondingly built up in the euro area during the first years of the euro area and in the run up to the global financial crisis in 2008. Financial markets' failure to properly assess the riskiness of different euro area countries papered over these issues until the global financial crisis finally struck.

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

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

The Euro Area Fiscal Challenge

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

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

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

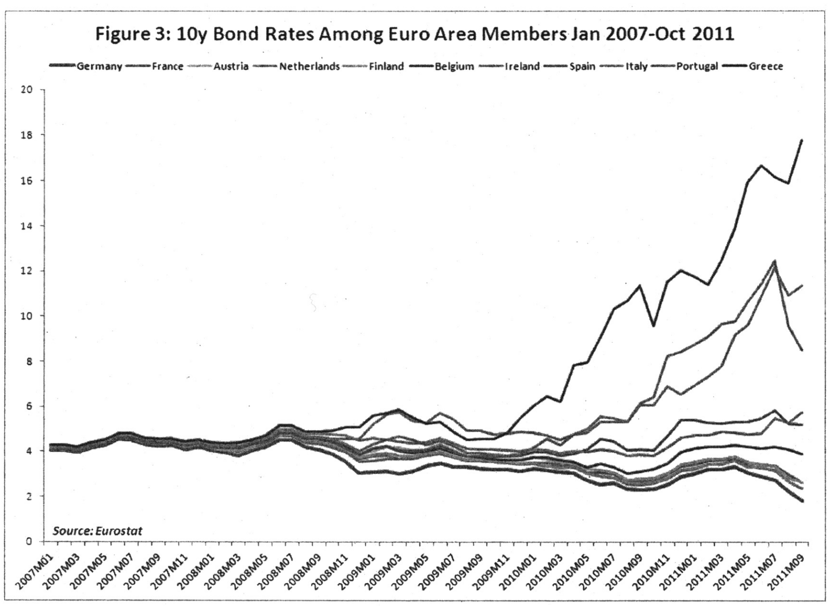


Figure 3: 10y Bond Rates Among Euro Area Members Jan 2007-Oct 2011

The key link between Greece and Spain and Italy is the issue of "contagion"[8], i.e., a situation in which instability in a specific asset markets or institutions is transmitted to one or more other specific such asset markets or institutions. Inside a currency union like the euro area, where the central bank is legally barred from guaranteeing all the sovereign debts of individual member states[9] and for political reasons each sovereign members' debts remains distinct,[10] yet the debt is denominated in the same currency and governed by at least some common institutions, the phenomenon of contagion has particular force. If private investors begin to fear that a precedent will be set inside the euro area with the imposition of haircuts on Greek sovereign debt, they will assess the riskiness of other euro area members' sovereign debt differently once the "risk free status" of euro area sovereign debt has been impaired. The large increases in the interest rates on Italian and Spanish Government debt seen immediately following the July 21, 2011 EU Council decision to first introduce haircuts on Greek Government debt looks, in the absence of simultaneous new bad economic news released from the two countries, to be largely due to contagion.

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

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

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

On the other hand, the ECB's independence and status as the only pan-euro area institution capable of direct forceful action to calm global financial markets bestows upon the ECB's governing council a degree of leverage over elected officials in this crisis not seen elsewhere in the world. This gives the ECB leadership the ability to engage in horse-trading with democratically elected governments behind closed doors, where it can quietly demand that government leaders implement far-reaching reforms. A clear example of this came in August 2011 just ahead of the ECB's initiation of emergency support purchases of Italian Government debt. The sitting and incoming presidents of the ECB wrote bluntly to Italian Prime Minister Silvio Berlusconi, stating that "the [ECB] Governing Council considers that pressing action by the Italian authorities is essential to restore the confidence of investors[13]" followed by a list of more than 10 specific required reforms to be implemented by the Italian Government.

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

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

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

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

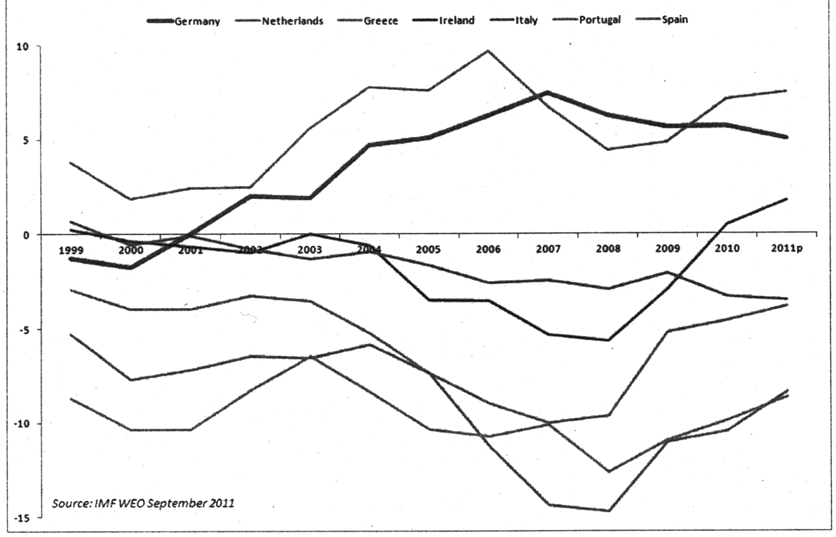
Ultimately, the euro area will have to rely on its large members to "bail themselves out" through a lengthy period of fiscal consolidation. Financial markets are unlikely to be satisfied with this outcome, and while the ECB will continue to act as a conditional final defender of financial stability in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

The Euro Area Competitiveness Challenge

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

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

Figure 4: Current Account Balances 1999-2011p, Select Euro Area Members, Percent of GDP



Financing their large external deficits posed few obstacles for peripheral countries prior to the global financial crisis, even as it became clearer that the inflows of foreign capital were increasingly channeled towards financing speculative real estate investments, rather than adding to new productive asset investments. With the disappearance of foreign private capital following the onslaught of the global financial crisis, peripheral euro area deficit countries and their banks suddenly found themselves instead overwhelmingly dependent on financial support from the ECB. However, while such central support will be continuous inside any functioning currency union, a longer term requirement for peripheral euro area nations to regain competitiveness and restore external balance (or surplus) remains.[15] Without improving external competitiveness and increasing exports/reducing imports, the euro area periphery will not during their current prolonged period of fiscal consolidation be able to restore domestic economic growth.

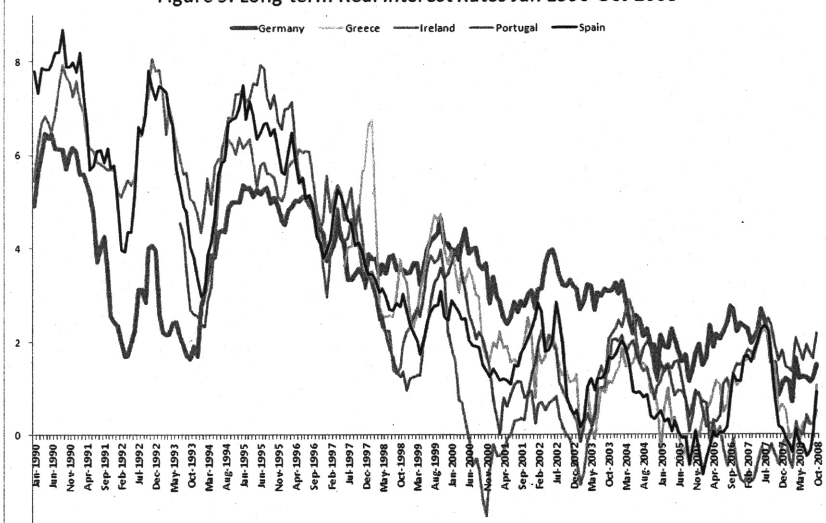
Inside a currency union without the ability to devalue their currency against major trading partners, peripheral euro area members, however, do not have access to the traditionally fastest and most effective way through which a country can regain external competitiveness.[16] Consequently, the euro area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

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

The Euro Area Banking Crisis

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

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



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

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

Table 1: Banking Systems in the Euro Area 2011

	Financial Institutions' Gross Debt (% of GDP)	Bank Leverage (Ratio of tangible assets/common equity in domestic banks)	Bank Claims on the Public Sector (Percent of GDP)
Euro Area	143	26	N/A
Belgium	112	30	23
France	151	26	17
Germany	98	32	23
Greece	22	17	28
Ireland	689	18	25
Italy	96	20	32
Portugal	61	17	24
Spain	111	19	24
United States	*94*	*12*	*8*

Source: IMF GFSR September 2011, table 1.1

The sheer size of the euro area banking system makes it—as illustrated in Ireland in 2008–10—problematic for individual already indebted euro area governments to credibly issue guarantees to stand behind their domestic banks in a crisis. This issue is aggravated by the low level of common equity (core tier 1) capital in the euro area banks. With low private shareholder risk capital levels in euro area banks, euro area governments risks being frequently called upon to rescue domestic banks as only a thin layer of private equity capital is available as first-loss risk capital. Disproportionally large capital injection requirements are another risk to euro area tax payers in rescues of thinly capitalized banks. There is consequently across the euro area a large degree of interdependence between the financial solidity of large domestic banking systems and national government solvency.

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

Fearful that banks would require very large amounts of new equity capital, which would in many instances have to come from governments themselves and might therefore pose a challenge to some governments' own solvency, European banking regulators have been reluctant to include any potential impairment of banks' sovereign debt holdings in EU bank stress tests in 2010 and 2011. Given, however, the justified market concerns about the solvency of at least one euro area sovereign

(Greece) and the potential for contagion to other euro area sovereign bond markets, stress tests that do not include the potential for losses on sovereign bonds cannot provide a credible measure of the riskiness of any euro area banking system. As long as solvency concerns exists about euro area governments, a high degree of volatility will surround the euro area banking system, which again provide a powerful feedback loop to increased investor fears about the financial stability of governments in the first place.

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

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

Not all euro area governments are in the same situation though, as for instance the German Government would quite easily be able to manage an even very large government-led recapitalization of its national banking system. However, due to the close linkages among sovereigns (and consequently their banking systems) inside the euro area and the observable presence of contagion between them, a key challenge for European policymakers will be to move expeditiously to a new system of tougher pan-European banking support, regulation and supervision. The establishment of a new set of common regulatory institutions for the European banking system will, however, due to the obvious implications potential government financial crisis support for banks have for governments' own solvency require a new level of fiscal integration in the euro area and the commensurate loss of national fiscal sovereignty. The fact that the city of London, the EU and euro area financial center, is located in the U.K., which can safely be assumed to remain outside the euro area itself for the foreseeable future, further complicates this type of banking sector integration initiatives.

End Notes

1. Available at http://aei.pitt.edu/1002/1/monetary__werner__final.pdf.
2. Available at http://aei.pitt.edu/1007/1/monetary__delors.pdf.
3. Available at http://www.eurotreaties.com/maastrichtec.pdf.
4. See Kirkegaard (2010) at http://www.piie.com/publications/pb/pb10-25.pdf.
5. The actual numerical reference values to article 104c of the Maastricht Treaty are in a Protocol on the Excessive Deficit Procedure to the Treaty. Available at http://www.eurotreaties.com/maastrichtprotocols.pdf. The Maastricht Convergence Criteria for euro area membership eligibility include three additional metrics; inflation (within 1.5 percent of the three EU countries with the lowest inflation rate); long-term interest rates (within 2 percent of the three lowest interest rates in the EU); and exchange rate fluctuations (participation for two years in the ERM II narrow band of exchange rate fluctuations).
6. See EU Council Conclusions March 23rd 2005 at http://www.consilium.europa.eu/uedocs/cms__data/docs/pressdata/en/ec/84335.pdf.
7. See IMF press release 11/374 at http://www.imf.org/external/np/sec/pr/2011/pr11374.htm and IMF press release 11/330 at http://www.imf.org/external/np/sec/pr/2011/pr11330.htm.
8. See speech by ECB Vice President Vitor Constancio for a precise definition and discussion at http://www.ecb.int/press/key/date/2011/html/sp111010.en.html.
9. Article 123 in the EU Treaty states "Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States (hereinafter referred to as 'national central banks') in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments."
10. As discussed above, with the vast majority of European citizens still self-identifying as citizens of their respective countries (rather than the euro area), a pooling of all the national sovereign debts of the euro area into a single debt instruments—similar to what Alexander Hamilton achieved for the U.S. States war debts in 1790—is not a realistic political option in Europe at this point. Another critical political difference is that unlike the war debts incurred by U.S. States during the Revolutionary War, the outstanding debts of individual euro area members have not been incurred in order to achieve a "common cause." The political narrative of seeing such debts "honored in common" by all euro area members consequently does not exist.
11. http://www.ecb.int/ecb/legal/pdf/fxac08115enc__002.pdf.
12. http://www.federalreserve.gov/aboutthefed/section31.htm.

13. Full text of ECB letter to Silvio Berlusconi at http://www.corriere.it/economia/11__settembre__29/trichet__draghi__inglese__304a5f1e-ea59-11e0-ae06-4da866778017.shtml?fr=correlati.

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

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

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

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