Statement before the Senate Committee on Foreign Affairs
Subcommittee on Europe and Eurasia
The European Debt Crisis: Strategic Implications for the Transatlantic Alliance

The Eurozone Debt Crisis and the United States

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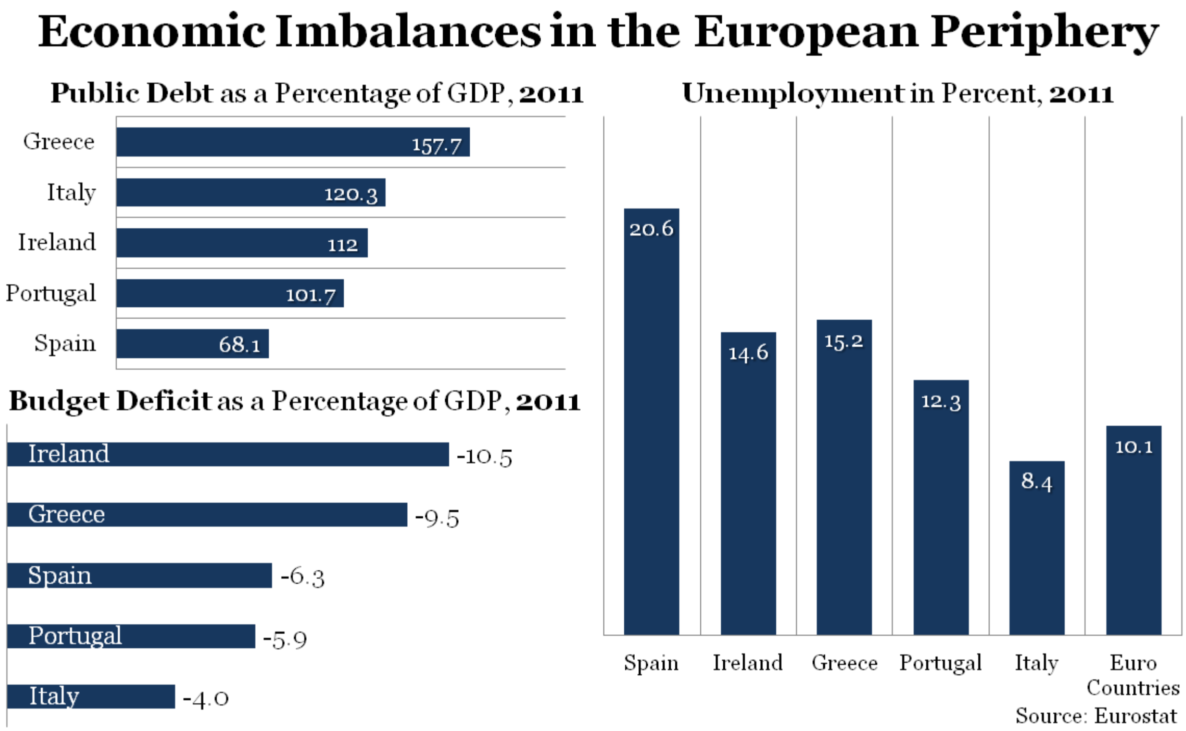
Thank you Chairman Shaheen, Ranking Member Barrasso, and members of the Subcommittee for affording me the great honor of testifying before you today. My name is Desmond Lachman and I am a Resident Fellow at the American Enterprise Institute. I am here in my personal capacity and I am not here to represent 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 Euro-zone 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 US economic recovery.

Origins of the Crisis

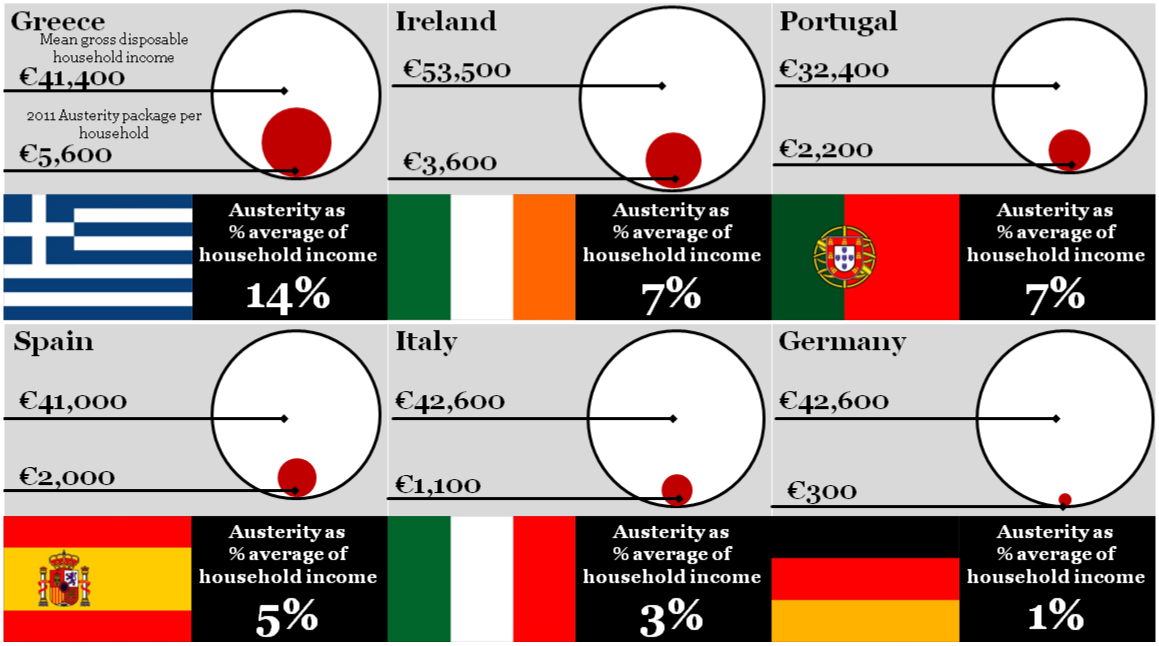
1. The main underlying cause of the Eurozone debt crisis is that countries in the **Eurozone's periphery persistently did not play by the currency union's rules**. In particular, whereas the Maastricht Treaty had proscribed member countries from running budget deficits in excess of 3 percent of GDP, 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.

European Austerity Measures in Relation to Income



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.

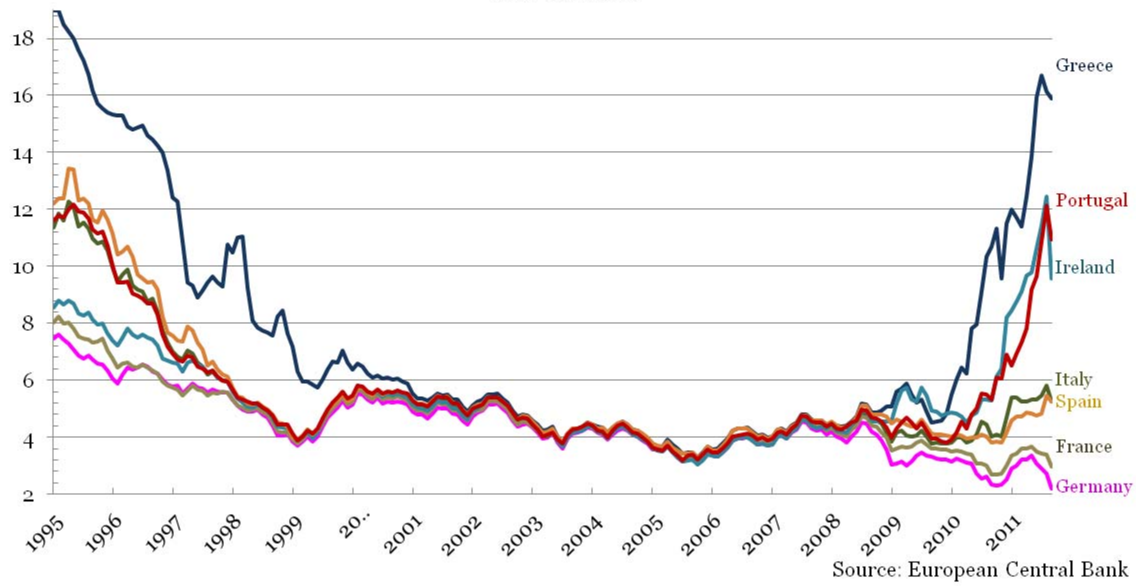
The Euro Crisis is intensifying

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.

Long-Term Government Bond Rates

Interest Rates on 10-year Government Bonds

In Percent



Among the signs of intensification are the following:

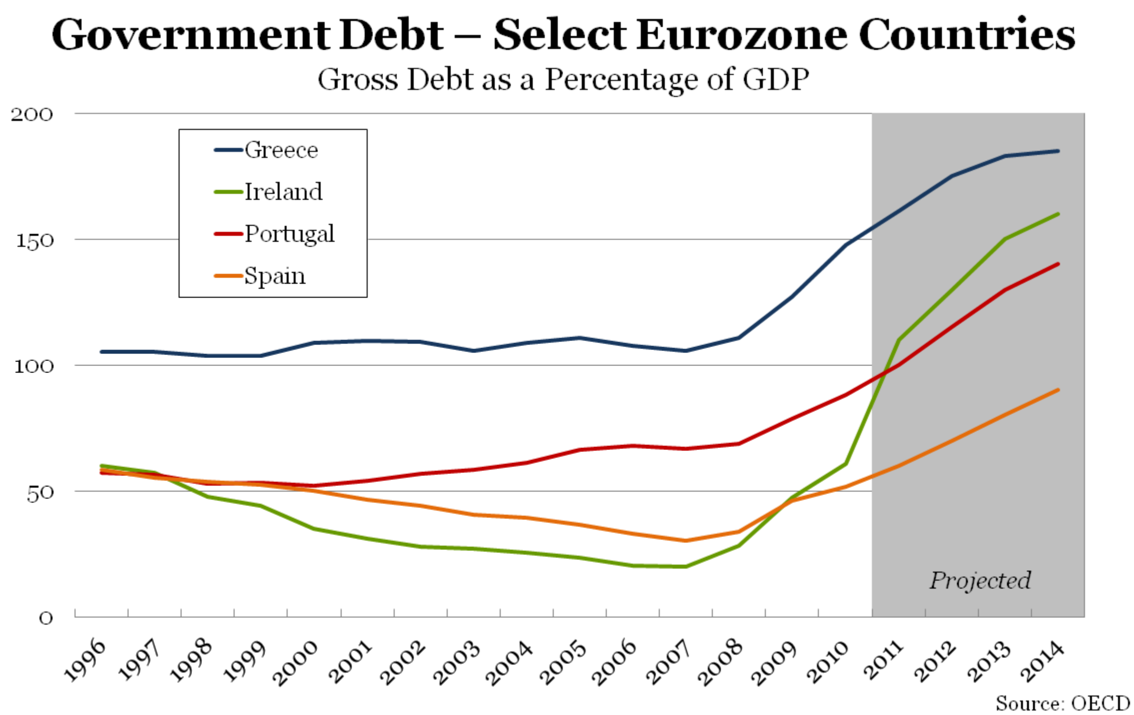
a. The Greek economy now appears to be in virtual freefall as indicated by a 12 percent contraction in real GDP over the past two years and an increase in the unemployment rate to over 15 percent. This makes a substantial write-down of Greece's US $450 billion sovereign debt highly probable within the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

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

c. The 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.

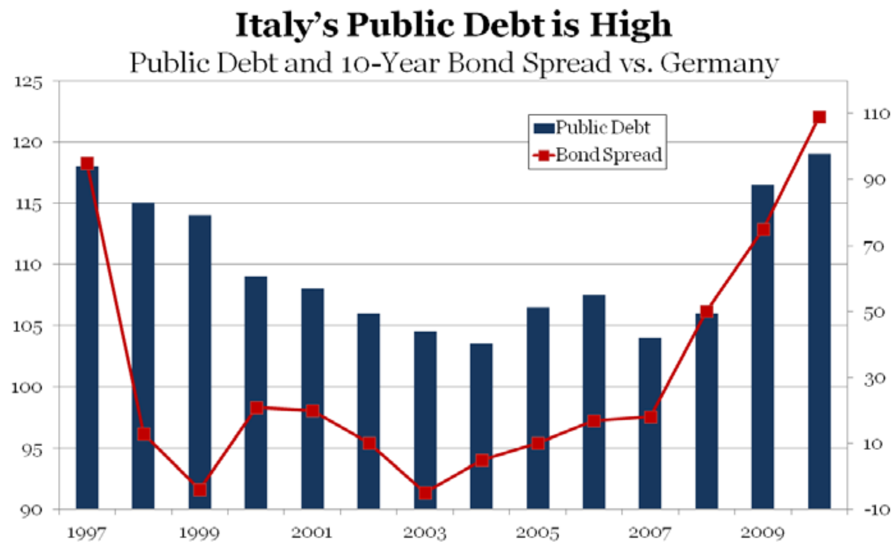


6. The European Central Bank (ECB) is correctly warning that a Greek default would have a devastating effect on the Greek banking system, which has very large holdings of Greek sovereign debt. This could

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 US economic recovery**. In principle, a deepening in the European economic crisis could impact the US economy through three distinct channels:

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

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

c. In much the same way as the US Lehman crisis of 2008-2009 severely impacted the European economy through financial market dislocation, a European banking crisis would materially impact the US economy both through the financial market channel and through a generalized increase in global economic risk aversion.

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 US financial system is hugely exposed to the European banking system**, which in turn is directly exposed to the European periphery. Among the indicators of this heavy exposure are the following:

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

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

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

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

What is to be done?

12. European policymakers are presently engaged in an effort to put forward **a comprehensive plan to address the crisis** ahead of the forthcoming G-20 Summit on November 3-4, 2011. After many months of denial, they now recognize the severity of Greece's solvency problem and the serious risks that a disorderly Greek default would pose to the European economy. The Plan that the Europeans 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 eighteen 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 US Role in resolving the Crisis

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

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 US taxpayers' money at risk given the troubled economic fundamentals of these two countries.

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