Congressional Testimony

The European Debt Crisis: Strategic Implications for the Transatlantic Alliance

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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 bailout", 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.

Thirdly, 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

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

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 G-20 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.

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 pre-crisis current account deficits in the euro area periphery and even larger intra-euro 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*[2] 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*[3] 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[4], 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[5], 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 re-instill confidence in private market participants in the midst of a crisis – like the one the euro area is currently experiencing.

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[2] Available at http://aei.pitt.edu/1002/1/monetary_werner_final.pdf.
[3] Available at http://aei.pitt.edu/1007/1/monetary_delors.pdf.
[4] Available at http://www.eurotreaties.com/maastrichtec.pdf.
[5] See Kirkegaard (2010) at http://www.piie.com/publications/pb/pb10-25.pdf.

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[6]. 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).

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[7] 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.

[6] 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).

[7] See EU Council Conclusions March 23rd 2005 at http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/84335.pdf.

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 2 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[8]. 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

[8] 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.

size that makes them "too big to bailout" for the euro area, even with IMF help. The fact that financial markets have begun to doubt the fiscal sustainability of "too big to bailout" members of the euro area is at the heart of the euro area policy makers' fiscal challenge.

The key link between Greece and Spain and Italy is the issue of "contagion"[9], 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[10] and the for political reasons each sovereign members' debts remains distinct[11], 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 21st, 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[12], which states that the central bank "*shall be independent in the exercise of its powers and in the management of its finances. Union*

[9] 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.

[10] 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."*

[11] 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.

[12] http://www.ecb.int/ecb/legal/pdf/fxac08115enc_002.pdf.

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[13]). 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[14]" followed by a list of more than ten 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

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[13] http://www.federalreserve.gov/aboutthefed/section31.htm

[14] 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.

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 bailout" 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[15].

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).

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

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

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[16]. 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[17]. 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[18]. That on the other hand is not true of the most recent volatility to affect the euro area banking system.

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

[16] 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.

[17] 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.

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

average euro area financial institutions' gross debt equal to 143 percent of GDP (U.S. equal 94 percent). Secondly, euro area bank leverage is very high at tangible assets at 26 times common equity (U.S. level is at 12 times); and thirdly, 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).

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.

Lastly, 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 UK, 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.

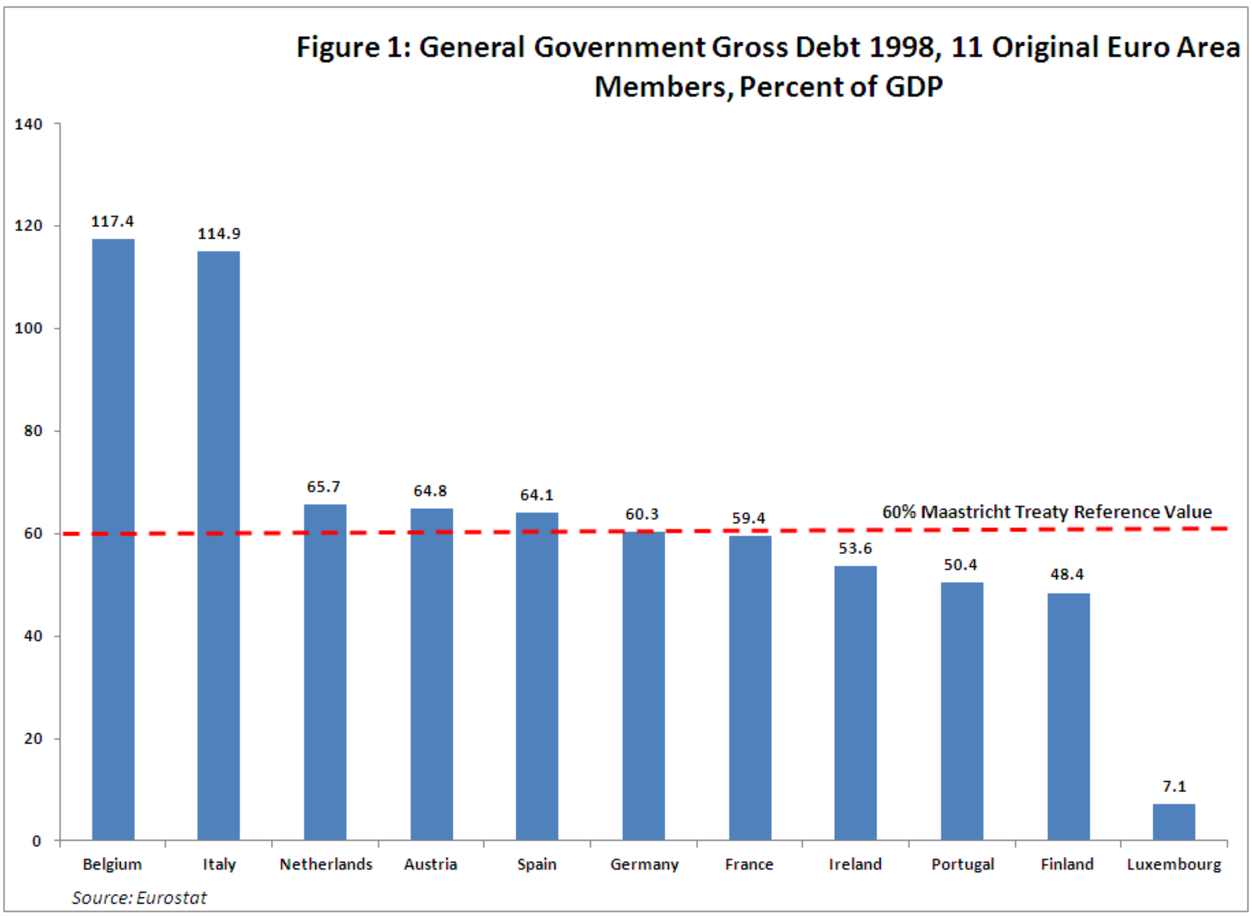
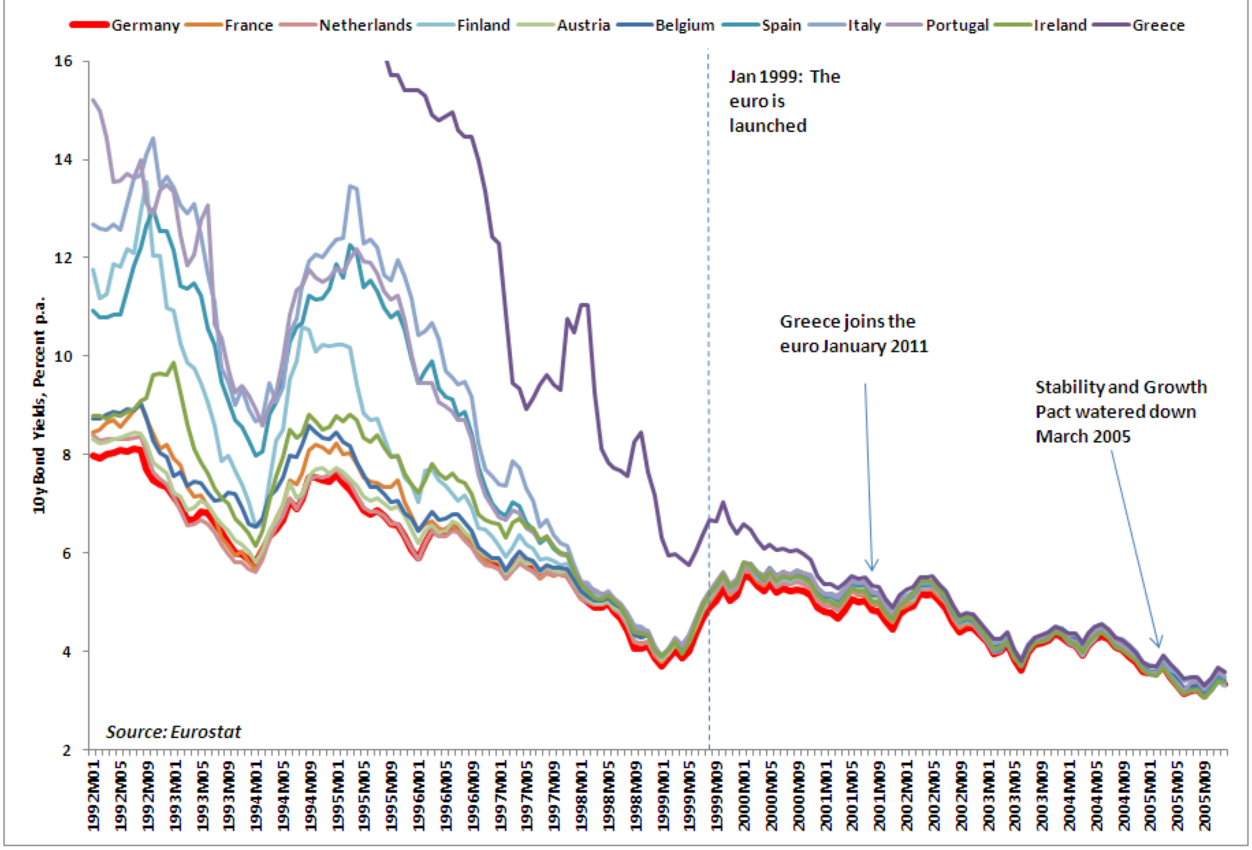


Figure 2: 10y Bond Rates Among Euro Area Members Jan 1992-Dec 2005



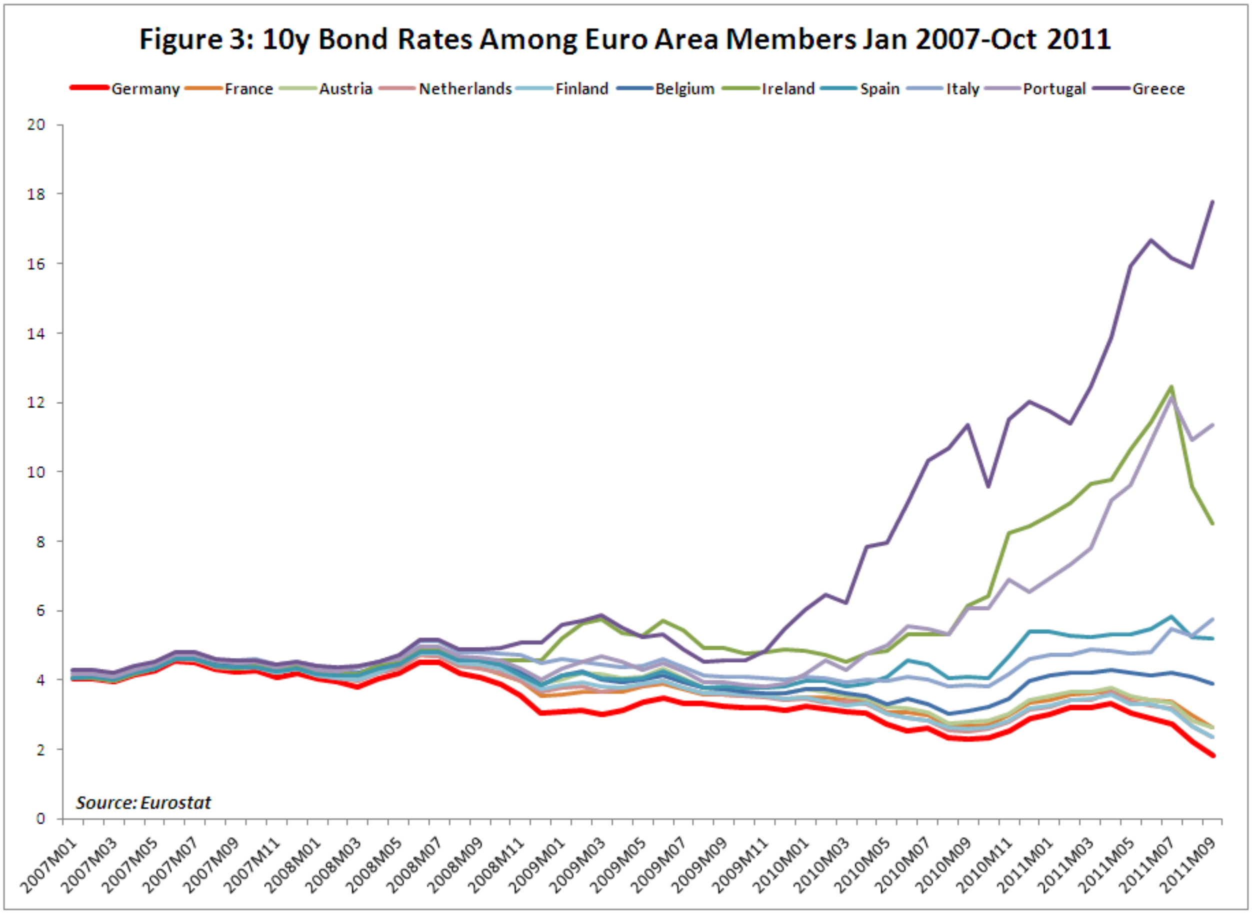


Figure 3: 10y Bond Rates Among Euro Area Members Jan 2007-Oct 2011
Germany
France
Austria
Netherlands
Finland
Belgium
Ireland
Spain
Italy
Portugal
Greece
20
18
16
14
12
10
8
6
4
2
0
Source: Eurostat
2007M01
2007M03
2007M05
2007M07
2007M09
2007M11
2008M01
2008M03
2008M05
2008M07
2008M09
2008M11
2009M01
2009M03
2009M05
2009M07
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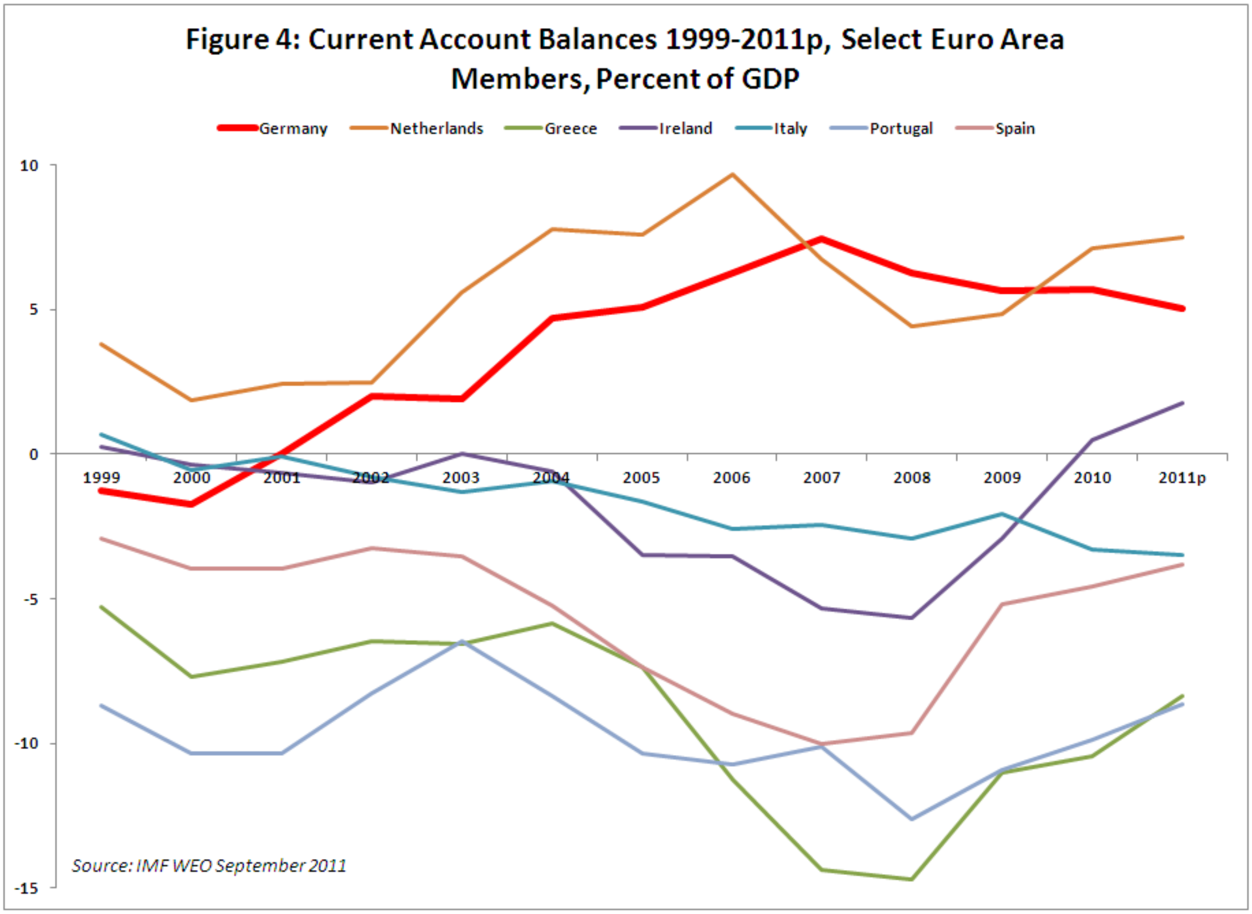
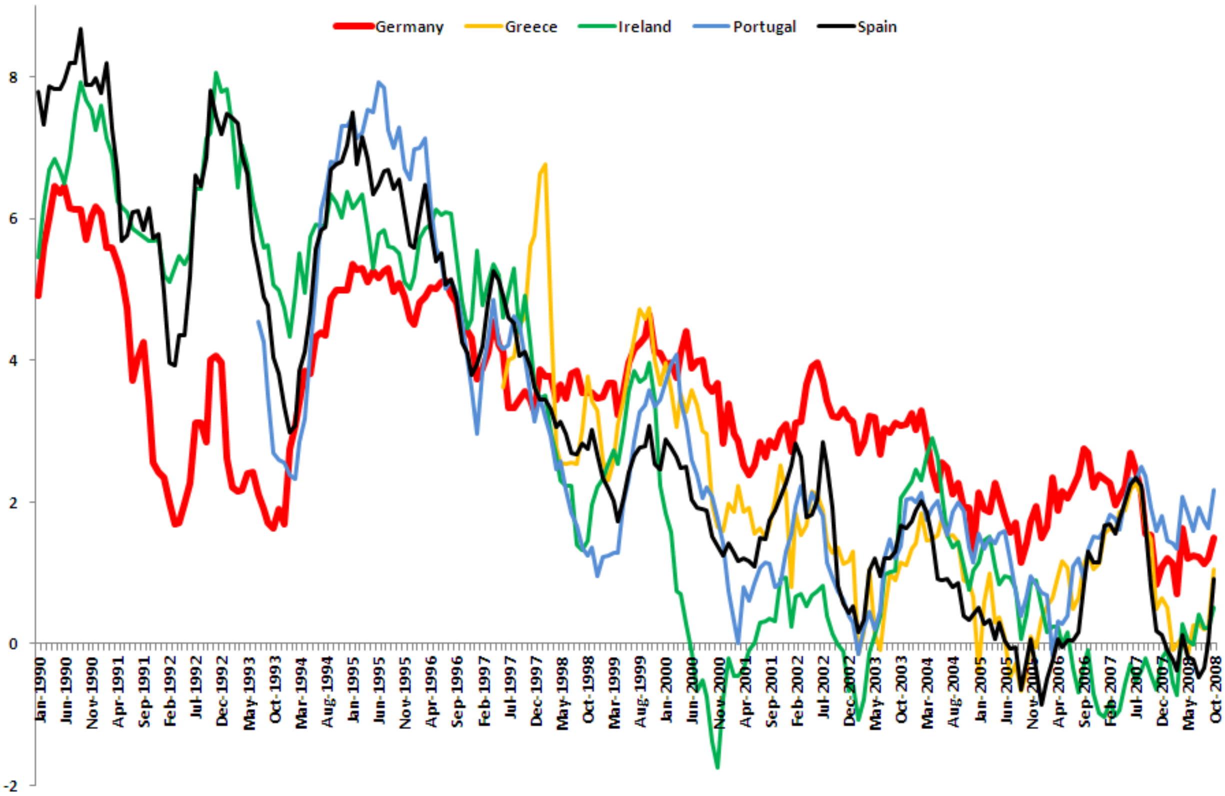


Figure 4: Current Account Balances 1999-2011p, Select Euro Area Members, Percent of GDP
Germany
Netherlands
Greece
Ireland
Italy
Portugal
Spain
10
5
0
-5
-10
-15
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011p
Source: IMF WEO September 2011

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*

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